STATE CONTRACTUAL LIABILITIES AND THE CONTRACT CLAUSE; WHAT NOW?

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By Professor Robert D’Agostino*

I. INTRODUCTION

The extent of the various states’ unfunded pension and health care liabilities to their retired and current employees is reported to be $450 billion.1 Other sources using more realistic models place the total of unfunded liabilities at as much as $2.5 to $3 trillion.2 These numbers do not include the unfunded liabilities of municipalities. Although these numbers seem insignificant compared with the unfunded federal liabilities,3 the states unlike the federal government cannot just print money. Some have proposed that states like municipalities should be able to declare bankruptcy.4 It is unlikely that Congress would amend the bankruptcy code to allow this.5 Even if it did, it is questionable that Congress could or would allow massive defaults by states.

This paper will explore the case law applicable to the states which would allow them to avoid liabilities currently unfunded, taking into account the application of the Contract Clause, a state’s reserved powers including the exercise of a state’s police power, and concepts of substantive due process. Of course, this analysis assumes that the Supreme Court’s Commerce Clause6 jurisprudence has transformed that clause into a vehicle for the regulatory state which, if

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3 Robert Novy-Marx & Joshua Rauh, Public Pension Promises: How Big Are They and What Are They Worth? J. Fin. (manuscript at 50 tbl.4) (forthcoming 2011).
6 U.S. CONST. Art 1, Sec. 8, clause 3. See, Gonzales v. Raich, 545 U.S. 1, 125 S. Ct. 2195 (2005) wherein the respondent/marijuana grower and user challenged a federal law “categorical prohibition of the manufacture and possession of marijuana as applied to the intrastate manufacture and possession of marijuana for medical purposes pursuant to California law [as exceeding] Congress’ authority under the Commerce Clause.” Id at 16.
desirable on the federal level, is likewise desirable on the state level as long as a convincing (to the courts) rationale can be advanced since the Contract Clause as a protection for liberty of contract has to a large extent been eviscerated. This evisceration has left the door open for a state’s impairment of its own obligations as well as interference with the obligations of private parties.

Although certain cases have raised Takings Clause issues, this article will make no distinction between a regulatory taking that may destroy existing contract rights and a taking of private property in the traditional sense.8

I suggest that every opinion wherein a state is permitted by the courts to impair or invalidate a contract is premised on an aspect of an interest even absent an emergency (for example, to protect its citizens from potential future harm). The exercise of impairment is premised on some aspect of sovereignty, that is, a state’s reserved powers, an emergency wherein the state exercises its police power (as a reserved sovereign power), the incorporation of existing regulatory authority of which contracting parties are, at least, constructively aware, or even a policy choice that a court, particularly the Supreme Court, favors at that time.

As was stated in Merrion v. Jicarilla Apache Tribe9 “sovereign power, even when unexercised, is an enduring presence that governs all contracts subject to the sovereign’s jurisdiction, and will remain intact unless surrendered in unmistakable terms.”10

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7 U.S. CONST. amend. V (which applies to the states through the Fourteenth Amendment).
8 See, Connolly v. Pension Benefit Guarantee Corp., 475 U.S. 211 (1986); Buffalo Teachers Federation v. Tobe, 464 F.3d 367, 374 (2nd Cir. 2006) (“the law recognizes species of takings: physical takings and regulatory takings”).
9 455 U.S. 130 (1982).
10 Id. at 148.
In fact, a number of instructive opinions do not deal with the Contract Clause per se, but rather with contracts between private parties and the federal government. In those opinions discussed herein, the rules enunciated are applicable by analogy to contract impairment or invalidation under state law.

I do make a distinction between the exercise of a state’s sovereignty in the absence of an emergency as an aspect of its police power and its exercise of its police power as a result of an emergency. That distinction is not necessary or even generally made.\textsuperscript{11}

I also suggest that the law applicable to a state’s impairment of its own contract with a private party is different from the law applied when legislative or regulation general in nature impairs contracts between private parties.

In considering this analysis it becomes apparent that courts increasingly defer to a state’s judgment as to when and how their inherent powers are to be exercised in derogation of either Contract or Due Process Clause considerations. Courts also are reluctant to impose a solution, such as declaring impairment unconstitutional, re-imposing contractual obligations as opposed to occasionally awarding damages, or ordering tax increases to cover unfunded liabilities.

II. THE CONTRACT CLAUSE

Article 1, Section 10 of the Constitution provides in part that “[n]o state shall…pass any…law impairing the obligation of contracts…”\textsuperscript{12} The Clause was passed due to the debtor

\textsuperscript{11} See, Brown v. State of Maryland, 25 U.S. (12 Wheat.) 419, 443 (1827)(wherein the Court stated that “[t]he power to direct removal of gun powder is a branch of the police power, [presumably to protect the citizens of the state] which unquestionably remains, and ought to remain with the States.”)

\textsuperscript{12} U.S. CONST. art. 1, § 10. (states: “No State shall enter into any Treaty, Alliance, or Confederation; grant Letters of Marque and Reprisal; coin Money; emit Bills of Credit; make any Thing but gold and silver Coin a tender in payment of debts; pass any bill of attainder, ex post facto law, or law impairing the obligation of contracts, or grant any title of nobility.”); See, Samuel R Olken, Charles Evans Hughes and the Blaisdell Decision: A Historical Study of Contract Clause Jurisprudence, 72 Or. L. Rev. 513 (Fall, 1993).
relief legislation passed by state legislatures just prior to the adoption of the Constitution and apparently was not meant to apply to contracts in which a state was a party.\textsuperscript{13}

Chief Justice Marshall took another view in \textit{Fletcher v. Peck}.\textsuperscript{14} \textit{Fletcher} established that the Contract Clause limited both the power of the state to modify its own contracts as well as those between private parties.\textsuperscript{15} In \textit{Fletcher} the Court struck down Georgia legislation that provided for the rescission of a sale of public land \textit{ab initio}, thereby depriving all subsequent purchasers of title.\textsuperscript{16} The land was subsequently sold to purchasers not implicated in any fraud surrounding the initial charter.\textsuperscript{17} Invalidation was not only based on the state’s impairment of contracts, but also specific prohibitions against bills of attainder\textsuperscript{18}, and \textit{ex post facto} laws.\textsuperscript{19} Notwithstanding the references to bill of attainder and \textit{ex post facto} in the \textit{Fletcher} opinion, the Court has restricted those provisions to the imposition of punishment\textsuperscript{20} and “general principles which are common to our free institutions,” that is, a deprivation of property without compensation or, by implication, absent due process by a state.\textsuperscript{21} Of course, the due process clause of the Fifth Amendment was relied upon explicitly in \textit{Dred Scott v. Sanford},\textsuperscript{22} as the basis for the protection of established or vested property rights against government invalidation. In \textit{Fletcher}, Chief Justice Marshall’s opinion was concerned with protecting economic expectations of parties who had not dealt with the state directly, rather it dealt with the economic security of

\textsuperscript{14} 10 U.S. 87 (1810).
\textsuperscript{15} \textit{Id.} at 137-139.
\textsuperscript{16} \textit{Id.} at 123.
\textsuperscript{17} \textit{Id.} at 133-35.
\textsuperscript{18} \textit{Id.} at 136.
\textsuperscript{19} \textit{Id.}
\textsuperscript{21} \textit{Fletcher}, 10 U.S. at 139.
\textsuperscript{22} 60 U.S. 393 (1857).
an investment against a state’s impairment. This issue was to be treated later on in the famous opinion rendered in *Charles River Bridge v. Proprietors of the Warren Bridge*\(^{23}\).

Economic expectations, however, are subject to contemporaneous state law and regulations. In *Ogden v. Saunders*\(^{24}\), the parties executed a bill of exchange subject to an implied condition of partial payment created by the preexisting New York insolvency law.\(^{25}\) The prospective nature of the laws operation put the parties on notice, thus, the law became part of the contract. The parties were held to have implicitly assented.\(^{26}\) In short, if an existing law had foreseeable potential future consequences the parties’ obligations could be modified or impaired.\(^{27}\)

In *Fletcher*, the subsequent law impaired a contract between private parties based, not on a pre-existing law’s potential consequences, but rather on a dispute with the state which involved a transfer of real estate from the state based on fraud, which was later transferred by the fraudster to innocent parties. This was a clear impairment of vested property rights since the innocent parties had nothing more to perform under their contracts.

Even subsequent to the ratification of the 14th amendment, the court noted that “[i]n every case …where the protection of the Federal Constitution is sought, the question necessarily arises: Is it a fair, reasonable, and appropriate exercise of the police power of the state, or is it an unreasonable, unnecessary, and arbitrary interference with the right of the individual to their personal liberty, or to enter into those contracts in relation to labor which may seem to him appropriate or necessary…If the act be within the power of the state [here a New York Statute

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\(^{23}\) 36 U.S. 420 (1837).

\(^{24}\) 25 U.S. 213 (1827).

\(^{25}\) *Id.* at 231-232.

\(^{26}\) *Id.* at 233, 235-236.

\(^{27}\) *Id.* at 240-41, 246-54.
forbidding employment in a bakery for more than 60 hours a week and 10 hours a day] it is valid…But the question would still remain: Is it within the police power of the state.”\textsuperscript{28}

Applying the Fourteenth Amendment’s Due Process Clause, which protects freedom of contract, the \textit{Lochner} court found that New York’s attempt to limit the hours of bakery workers was “a mere meddlesome interference with the rights of the individual”\textsuperscript{29} and not supported by the rationale given to support this legislation.\textsuperscript{30} It should be noted that this piece of New York legislation was directed at a class of workers not to the public in general.

Governing bodies may enact generally applicable laws, that is, they may legislate, without affording affected parties so much as notice and an opportunity to be heard.\textsuperscript{31} In order to claim deprivation of substantive due process rights, an aggravated party must show that a law or regulation of general application infringes a fundamental liberty interest\textsuperscript{32} or that the law or regulation is “arbitrary and unreasonable, having no substantial relation to the public health, safety, morals, or general welfare.\textsuperscript{33} Fundamental rights that implicate substantive due process do not apply to non-individuals; hence, a reliance on that doctrine is misplaced unless the aggravated party is an individual.\textsuperscript{34}

Furthermore, a law or regulation generally applicable on its face but enforced for no legitimate reason against only an individual or a particular class may violate the Equal Protection Clause.\textsuperscript{35}

\begin{footnotesize}
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\item Lochner v. New York, 198 U.S. 45, 57 (1905).
\item \textit{Id.} at 61.
\item See, David E. Bernstein, Rehabilitating Lochner: Defending Individual Rights Against Progressive Reform (U. of Chicago 2011).
\item Bi-Metallic Inv. Co. v. State Bd. Equalization, 239 U.S. 441, 445 (1915).
\item Euclid v. Ambler Realty Co., 272 U.S. 365, 395 (1926).
\item Board of Regents v. Roth, 408 U.S. 564, 572 (1972).
\item Yick Wo v. Hopkins, 118 U.S. 356, 373-74 (1886); Esmail v. Macrane, 53 F. 3d 176, 178-79 (7th Cir. 1995) (\textit{Esmail} involved a challenge by a liquor store owner to a revocation of his license. He charged that the Mayor-Liquor Control Commissioner of his town treated his operation much differently than other within the area. Others}
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Legislatures may however, enact generally applicable legislation as a prophylactic to the danger posed by one particular actor as long as the end of the legislation is legitimate and, assuming the legislation does not distinguish between classes on bases susceptible to intermediate or strict scrutiny, the means are rationally related to the end. In other words, the fairness of a state’s action is always determined, in cases of low-level scrutiny, by the rationality of the state action, whether the questioned action is the enactment of an ordinance or the enforcement of it.\(^{36}\) This is so even if the state action was initially directed at a party as long as it has general application and is rationally related to a legislative government end.\(^{37}\) Both Pro-Eco, Inc. and Flying J. Inc. v. New Haven\(^{38}\) based their holdings on Connolly v. Pension Benefit Guaranty Corp.,\(^{39}\) wherein the Court stated, “the fact that legislation disregards or destroys existing contractual rights does not always transform the regulation into an illegal taking. … If the regulatory power is otherwise within the power of Congress . . . its application may not be defeated by private contractual provisions, and therefore such contractual provisions, even if destroyed by the regulation, do not always entitle the parties to compensation from the government.”\(^{40}\) Unless the government itself financially benefits by such action, as opposed to the public at large, there is no entitlement to compensation. On the other hand if the government action constitutes a regulatory taking, compensation might be in order. For example in Flying J.

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\(^{36}\) Pro-Eco, Inc. v. Board of Comm’rs of Jay County, 57 F.3d 505, 515 (7th Cir. 1995) (Pro-Eco sought damages against the Jay County Board of Commissioners that allegedly stem from an illegal landfill moratorium ordinance to prevent Pro-Eco from building a landfill in Jay County. Pro-Eco obtained a declaratory judgment under 28 U.S.C. § 2201 invalidating the ordinance that was affirmed on appeal. Pro-Eco v. Board of Comm’rs of Jay County, 956 F.2d 635 (7th Cir. 1992). Subsequently, this court rejected a damage claim finding no regulatory taking and specifically finding that the city has the power to enact zoning moratorium if it follows proper procedures).

\(^{37}\) Id.

\(^{38}\) 549 F.3d 538 (7th Cir. 2008).

\(^{39}\) 475 U.S. 211 (1986).

\(^{40}\) Id. at 224.
Inc. a zoning ordinance which was found to have a rationale basis,\textsuperscript{41} was upheld against a challenge based on a violation of the plaintiffs’ due process, and equal protection rights even though it was “adopted in response to Flying J’s plans….”\textsuperscript{42} The court did not reach the issue of Flying J’s request to be compensated for a regulatory taking since that issue was not raised.\textsuperscript{43} It, like the ordinance in \textit{Pro-Eco}, was generally applicable although also “provoked by the fear of one particular actor.”\textsuperscript{44}

Despite the absolute language of the Contract Clause, the Supreme Court has always recognized limitations on its application and \textit{Lochner} did not change that. In \textit{Stone v. Mississippi},\textsuperscript{45} the Supreme Court stated that “[a]ll agree that the legislature cannot bargain away the police power of a state.”\textsuperscript{46} In \textit{Stone}, the state granted an organization the authority to conduct lotteries.\textsuperscript{47} Mississippi subsequently adopted a constitution forbidding lotteries.\textsuperscript{48} In holding against a Contract Clause challenge the Court stated “[n]o legislature can bargain away the public health or the public morals.”\textsuperscript{49} The Court then quoted an opinion by then Chief Justice Marshall,\textsuperscript{50} “that the framers of the Constitution did not intend to restrain States in the regulation of their civil institutions, adopted for internal government, and that the instrument they have given us is not to be so construed.”\textsuperscript{51} The Court distinguished active and “incident to the exercise of the legitimate function of government” from the very purpose of a government\textsuperscript{52}, which in specifics may “vary

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\item\textsuperscript{41} \textit{Flying J. Inc.}, 549 F.3d at 556.
\item\textsuperscript{42} Id. at 545.
\item\textsuperscript{43} See, Pennsylvania Coal Co. v. Mahon, 260 U.S. 393, 413 (1922)(noting that “Government could hardly go on if to some extent values incident to property could not be diminished without paying for every such change in the general law”).
\item\textsuperscript{44} \textit{Pro-Eco}, 57 F.3d at 513.
\item\textsuperscript{45}101 U.S. 814 (1879).
\item\textsuperscript{46} Id. at 817.
\item\textsuperscript{47} Id.
\item\textsuperscript{48} Id. at 819.
\item\textsuperscript{49} Id.
\item\textsuperscript{50} Trustees of Dartmouth College v. Woodward, 17 U.S. 518 (1819).
\item\textsuperscript{51} \textit{Stone}, 101 U.S. at 820 (quoting \textit{Trustees of Dartmouth College}, 17 U.S. at 629).
\item\textsuperscript{52} \textit{Stone}, 101 U.S. at 820.
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with varying circumstances,” hence, each subsequent legislature is free to exercise its discretion with respect to governmental functions. The court also said that “[t]he contracts which the Constitution protects are those that relate to property rights. [Adding] [i]t is not always easy to tell on which side of the line which separates governmental from property rights a particular case is to be put; but in respect to lotteries there can be no difficulty.” A state government may withdraw a contractual privilege “at will” if it involved a governmental function such as, the protection of morality by limiting gambling. Of similar impact is Hudson Water Co. v. McCarter where the Court stated that “[o]ne whose rights, such as they are, are subject to state restriction, cannot remove them from the power of the State by making a contract about them.” If the state regulates some activity, when a private party enters into a contract with a state, the contract implies an agreement to be regulated in the future. A careful parsing of these cases indicates that the Court, by implication at least, is making a distinction between the exercise of a state’s police power in an emergency and the exercise of its reserved sovereign powers in the absence of an emergency.

Home Bldg. and Loan Ass’n v. Blaisdell, contrary to some commentary, was not a departure from previous case law but rather an evolutionary step in the Court’s disregard of the plain language of the Contract Clause when the Court became convinced that an emergency existed and the impairment was limited and reasonable in light of the circumstances. The Court found that under this law, “[w]hile the mortgagee-purchaser is debarred from actual possession,

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53 Id.
54 Id. at 820-21.
55 Id at 821.
56 209 U.S. 349 (1908).
57 Id. at 357.
58 290 U.S. 398 (1934).
59 Id. at 425.
he has, so far as rental value is concerned, the equivalent of possession during the extended period”\(^{60}\) raising a rights-remedies dichotomy.

Such a dichotomy was suggested in Chief Justice Marshall’s dissent in *Ogden v. Saunders*.\(^{61}\)

In *Energy Reserves Group, Inc. v. Kansas Power and Light Co.*\(^{62}\) the Supreme Court echoing *Stone*\(^{63}\) and citing *Blaisdell*\(^{64}\) stated that “[a]lthough the language of the Contract Clause is facially absolute, its prohibition must be accommodated to the inherent police power of the state ‘to safeguard the vital interests of its people.’”\(^{65}\) What “accommodated to the inherent police power” and what “vital interest of [the state’s] people” actually means according to the Supreme Court’s exercise of its legislative authority are the crucial questions to be analyzed. Rather than simply acquiescing to a state legislative determination that their proposed contractual impairment involves a legitimate state government interest, the Supreme Court listed five factors for consideration in its determination of the state action.\(^{66}\) They are whether the act: (1) was an emergency measure; (2) was one to protect a basic societal interest, rather than particular individuals; (3) was tailored appropriately to its purpose; (4) imposed reasonable conditions; and (5) was limited to the duration of the emergency.\(^{67}\) If, on the other hand, the contract impairment was as a result of the state’s exercise of a purely government function (for example, to protect the health, safety or morals of its citizens) such a complete analysis would be unnecessary.

\(^{60}\) *Id.*

\(^{61}\) 25 U.S. 213, 344, 349 (1827) ("The Law may not enter into the agreement so as to form a constituent part of it, still it acts externally upon the contract, and determines how far the principle of coercion shall be applied to it.” … "The remedy acts upon a broken contract and enforces a pre-existing obligation").


\(^{63}\) *Supra*, note 45.

\(^{64}\) *Supra*, note 58.

\(^{65}\) *Energy Reserves*, 459 U.S. at 409.

\(^{66}\) *Blaisdell*, 290 U.S. at 444.

\(^{67}\) *Id.* at 444-47.
Case law does not suggest the proposition that the Blaisdell factors are, taken in their entirety, prescriptive. For example, the impairment in Stone only included the second factor. In addition, the Stone opinion clearly deferred to the judgment of the Mississippi legislature on what it determined was necessary to protect public morality. Stone was based on the exercise by a sovereign state of its inherent inalienable police power, that is, the exercise of its inherent or reserved governmental power.\(^{68}\) This suggests that there is a distinction between the exercise of a state’s police power in an emergency and its exercise to protect a societal interest generally. Blaisdell was decided after the adoption of the Fourteenth Amendment and the Supreme Court’s use of due process jurisprudence, although the language of the opinion relies heavily on the inherent police power of the state. In upholding a moratorium on foreclosures on the basis that it was a reasonable exercise of the state’s police power during the economic emergency of the Great Depression, the Court in Blaisdell made it plain that it would decide what is reasonable when a state seeks to exercise its reserved powers.\(^{69}\)

Assuming this is so, it would be difficult to justify Stone today, the facts of which indicate that no emergency existed. Rather, the Mississippi legislature decided that gambling was immoral or promoted immoral conduct\(^{70}\) whereas in Blaisdell there was nothing immoral or unreasonable about the underlying mortgage contracts – it was the alleged emergency that validated the state’s impairment of contracts.\(^{71}\)

\(^{68}\) Atlantic Coast Line R.R. b. City of Goldsboro, 232 U.S. 548, 559 (1914)(where the Supreme Court approved the state’s exercise of its police power to “promote the health, comfort, safety, or welfare of the Community”).

\(^{69}\) Blaisdell, 290 U.S. at 439-40.

\(^{70}\) Stone, 101 U.S. at 821.

\(^{71}\) Blaisdell, 290 U.S. at 434-36.
In light of 

Casey and the various right to privacy and abortion opinions, it is difficult to argue that a state has any real authority to act under its reserved powers absent an emergency if its justification is purely one of morality.

In discussing substantive due process and the fall of liberty of contract, Professor David N. Mayer concluded that:

However, a convenient rule of thumb to identify a liberty of contract case—and the definition adopted in this Article—is that it involved use of the Fifth or Fourteenth Amendment’s Due Process Clause to provide substantive limits on legislation curtailing the freedom of persons to enter into lawful contracts of all types. The doctrine of liberty of contract generally held that the freedom of individuals capable of entering into a contract and giving consent to its terms could not be curtailed by government except for “reasonable” legislation narrowly tailored to protect the public health, safety, or morals.

In West River Bridge Co. v. Dix the Court held that states retained the power to modify contract terms which conflicted with “the right and the duty inhering in every political sovereign community of guarding its own existence, and of protecting and promoting the interests and welfare of the community at large.”

In West River Bridge, a state’s authority to exercise its power of eminent domain was at issue. The plaintiffs were granted exclusive privileges in 1795 to construct a bridge over a river in Vermont with the right to collect tolls for 100 years. Subsequently, Vermont authorized local communities to exercise eminent domain over any existing franchise if the “public good” required a public highway. The Court held that the power of eminent domain was “paramount to all private rights vested…” and that such a law did not impair the obligation of contracts

74 47 U.S. 507 (1848).
75 Id. at 531.
76 Id. at 516.
77 Id. at 507-08.
78 Id. at 508.
presumably because such power was known generally.\textsuperscript{79} In comparison, in \textit{Charles River Bridge v. Warren}\textsuperscript{80} the Court found the lack of exclusivity of the proprietors’ charter was fatal to their damage claims.\textsuperscript{81} The plaintiffs in \textit{West River Bridge} did have exclusivity but still lost exclusivity because the exercise of eminent domain was an inherent governmental function.\textsuperscript{82}

In summarizing the opinions through \textit{Blaisdell}, Professor Samuel R. Olken described the doctrine of the inalienable police powers thusly:

[It] operated directly upon the contract rights of private companies, who received through state grants and charters the right to engage in enterprising activities with considerable effects upon the public. It did not derive its authority from language within the public grant or charter reserving the power of amendment or revocation to the state. Instead, it presupposed the paramount existence of certain attributes of sovereign power to which all contracts became subject regardless of whether they contained reservation clauses. This characteristic ultimately made possible through judicial interpretation the abridgment of contract rights otherwise expressly created by charters and grants. In contrast, under the reservation doctrine the terms of these agreements often limited the scope of state regulation, as judges declined to uphold the exercise of local power that either contradicted the express provisions of a contract or exceeded the reserve powers of the state. Moreover, the concept of inalienable police powers permitted the states some measure of control over those aspects of private contractual obligations that affected the public health, morals, and safety.\textsuperscript{83}

Professor Olken then develops how this doctrine evolved despite the Court’s rejection of either the reservation doctrine or the inalienable police power doctrine for the regulation of financial obligations incurred during and immediately after the Civil War.\textsuperscript{84}

The question raised by \textit{Blaisdell} and other cases based on the inherent or inalienable police power for states to act in an emergency leaves open exactly which entity, the state, or the judiciary has the ultimate decision as to what is an emergency. The Court’s opinion in \textit{Blaisdell}

\textsuperscript{79} Id. at 532.
\textsuperscript{80} 36 U.S. 420 (1837).
\textsuperscript{81} Id. at 423.
\textsuperscript{82} \textit{West River Bridge}, 47 U.S. at 535-36.
\textsuperscript{84} Id.
certainly points to the Court’s assumption that it is not the state that ultimately defines what constitutes an emergency. As Professor Olken put it

Hughes [writing for the majority] endorsed [restrictions on the Due Process and Contracts Clauses] … in Blaisdell and quickly concluded that widespread mortgage foreclosures and the depreciation of real estate values compound to an emergency that allowed the state to act on behalf of the public interest.

Not surprisingly, his conception of emergency reflected his conviction that the federal system encouraged responsible activity by local governments within the parameters of state and local constitutions. All of the justices in the Blaisdell majority interpreted the Constitution in a flexible and pragmatic manner.\(^85\)

In commenting on the Blaisdell Court’s statement that “[t]he economic interests of the state may justify [the] exercise of its continuing and dominant protective power not withstanding interference with contracts,”\(^86\) Professor Olken concluded that the Court’s “opinion recognized economic prosperity as an integral part of public welfare and that its protection lay within the fundamental attribute of Minnesota’s sovereign powers.”\(^87\)

In this current time of economic difficulties a number of states have, by legislative action, modified state employee contracts without agreement of the employees. They have done so claiming an economic emergency that left them little choice but to take reasonable action based on their inherent or inalienable police power not-withstanding the Contract Clause and due process concerns.\(^88\)

A review of the case law places the ultimate determination of what is an emergency and what constitutes reasonable action to meet that emergency on the courts. It is not that courts have suddenly decided to second-guess state legislatures when such legislature chooses to act pursuant

\(^{85}\) Id. (Professor Olken convincingly demonstrates that Chief Justice Hughes progressive political views which favored increasing government involvement one might say, interference, in the private sector influenced his opinion in Blaisdell).

\(^{86}\) Blaisdell, 290 U.S. at 437.

\(^{87}\) Supra note 83.

\(^{88}\) See, generally, Supra notes 73-5 and text related thereto.
to its police power. For example, in *Matter of Jacobs* the court, as quoted and commented on by Professor Mayer, stated that:

The court noted that the police power, “however broad and extensive, [was] not above the Constitution,” and “that in its exercise the legislature must respect the great fundamental rights guaranteed by the Constitution.” The court also reaffirmed its judicial review power, maintaining that if the legislature “passes an act ostensibly for the public health, and thereby destroys or takes away the property of a citizen, or interferes with his personal liberty, then it is for the courts to scrutinize the act and see whether it really relates to and is convenient and appropriate to promote the public health.”

In *United States Trust Company of New York v. State of New Jersey* the Supreme Court reinvigorated the Contract Clause. In determining if there is a Contract Clause violation when a state is a party, a court must ascertain if a contract and the accompanying obligations were created by a statute. For a statute to create a contract:

The language and circumstances [must] evince a legislative intent to create private rights of a contractual nature enforceable against the State. In addition, statutes governing the interpretation and enforcement of contracts may be regarded as forming part of the obligation of contracts made under their aegis. The obligations of a contract long have been regarded as including not only the express terms but also the contemporaneous state law pertaining to interpretation and enforcement.

In *United States Trust Co.*, newly passed statutes by New York and New Jersey repealed statutory covenants protecting bondholders who relied on those covenants. As a prerequisite for impairment, the state action must operate retroactively impairing the consideration of the aggrieved party not merely prospectively. This limits the application of the doctrine that when parties enter into a contract, that contract becomes subject to modifications of regulations that

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89 98 N.Y. 98 (1885).
90 *Supra note* 73 at 590, n.124 and text related thereto.
92 *Id.* at 17.
93 *Id.* at 17, n. 14.
94 *Id.* at 19 n. 17.
95 *Id.* at 3.
96 *Id.* at 18 n. 15.
were in force at the time of contracting. This doctrine, however, is subject to the exercise of the sovereign police power and is not applicable when a state exercises its “essential attributes of sovereign power.” Or to put it otherwise, in a contract in which a state is a party, the reserved powers doctrine renders void ab initio a state contract that surrenders “an essential attribute of its sovereignty.” Furthermore a “legislature cannot bargain away the police power of a state.” But the entirety of the police power goes further than the reserved sovereign power and may only be used “if the legislation doing for is reasonable and necessary to serve a legitimate or important public purpose.” This does not mean that, other than for a contract void ab initio, the state cannot be held liable for contract damages.

Contemporary views as to the authority of a state to interfere with contract rights must come to term with Nebbia. In Nebbia, New York State’s price fixing of milk was challenged based on the Equal Protection and Due Process clauses of the Fourteenth Amendment. Legislative findings implicated the economic emergency of the depression and found that the current business practices a threat to “the public health, welfare and reasonable comfort.” The appellant’s equal protection claim was summarily disposed of. The due process claim was discussed as follows:

Under our form of government the use of property and the making of contracts are normally matters of private and not of public concern. The general rule is that both shall be free of governmental interference. But neither property rights nor contract rights are absolute; for government cannot exist if the citizen may at will use his property to the detriment of his fellows, or exercise his freedom of contract to work them harm. Equally fundamental with the private right is that of

97 Id. at 17 n. 13.
98 Blaisdell, 290 U.S. at 435.
100 Stone, 101 U.S. at 817.
103 Id. at 510.
104 Id. at 508.
105 Id. at 509.
the public to regulate it in the common interest. As Chief Justice Marshall said, speaking specifically of inspection laws, such laws form ‘a portion of that immense mass of legislation which embraces everything within the territory of a state, all which can be most advantageously exercised by the states themselves. Inspection laws, quarantine laws, health laws of every description, as well as laws for regulating the internal commerce of a state, are component parts of this mass.\textsuperscript{106}

Quite clearly \textit{Nebbia} in extending the language used in opinions as far back as the license cases cited and discussed in \textit{Thurlow v. Commonwealth of Mass.},\textsuperscript{107} set the stage for the development of the regulatory state. Such development accelerated beginning with the Progressive Era and continues to this day despite the existence of the Fourteenth Amendment Due Process Clause.

In fact, a reading of \textit{Nebbia} leads to the conclusion that a state is virtually unlimited in its authority to regulate \textit{generally} on behalf of what it contends is the public interest to protect the public welfare and health notwithstanding the intended limitations of the Commerce and Contract Clauses.

This view is supported by the following language in \textit{Nebbia}:

But we are told that because the law essays to control prices it denies due process. Notwithstanding the admitted power to correct existing economic ills by appropriate regulation of business, even though an indirect result may be a restriction of the freedom of contract or a modification of charges for services or the price of commodities, the appellant urges that direct fixation of prices is a type of regulation absolutely forbidden. His position is that the Fourteenth Amendment requires us to hold the challenged statute void for this reason alone. The argument runs that the public control of rates or prices is per se unreasonable and unconstitutional, save as applied to businesses affected with a public interest; that a business so affected is one in which property is devoted to an enterprise of a sort which the public itself might appropriately undertake, or one whose owner relies on a public grant or franchise for the right to conduct the business, or in which he

\textsuperscript{106} \textit{Id.} at 510 (footnotes omitted).
\textsuperscript{107} \textit{46 U.S.} 504 (1847)(The plaintiff in error, an importer of foreign spirits, was arrested and convicted for violating a Massachusetts state statute that prohibited the selling of small quantities of alcohol without a license. Plaintiff appealed arguing that the state statute violated the Constitution and acts of Congress, because Congress allowed the importation and selling of alcohol. The Supreme Court affirmed the lower courts decisions, holding that the states did not have to create a market for the sale of alcohol and could enact laws necessary for the health and morals of its citizens).
is bound to serve all who apply; in short, such as is commonly called a public utility; or a business in its nature a monopoly. The milk industry, it is said, possesses none of these characteristics, and, therefore, not being affected with a public interest, its charges may not be controlled by the state. Upon the soundness of this contention the appellant's case against the statute depends.  

Needless to say the court rejected this reasoning saying:

The Constitution does not secure to any one liberty to conduct his business in such fashion as to inflict injury upon the public at large, or upon any substantial group of the people. Price control, like any other form of regulation, is unconstitutional only if arbitrary, discriminatory, or demonstrably irrelevant to the policy the Legislature is free to adopt, and hence an unnecessary and unwarranted interference with individual liberty.

The dissent in Nebbia pointed out that there never was a “definite finding of an emergency….” Nevertheless, the majority assumed an emergency related to an essential public need (cow’s milk), thereby distinguishing the opinion from Wolff Packing v. Court of Industrial Relations of State of Kansas wherein the Court found the attempt to fix the prices and wages involved in non-essential industries was unconstitutional. In both cases the Court was discussing contracts between private parties.

III. IMPAIRMENT AND REDRESS

In Thurlow the Court stated:

But what are the police powers of a State? They are nothing more or less than the powers of government inherent in every sovereignty to the extent of its dominions. And whether a State passes a quarantine law, or a law to punish offences, or to establish courts of justice, or requiring certain instruments to be recorded, or to regulate commerce within its own limits, in every case its

108 Nebbia, 291 at 513.
110 Id. at 519.
111 Id. at 538.
112 262 U.S. 522 (1923).
113 Nebbia, 291 U.S. at 536-37; See also, Wolff Packing Company v. Court of Industrial Relations of State of Kansas, 267 U.S. 552, 569 (1925)(Supreme Court rejected statute again on second appeal).
114 Supra note 107.
exercises the same powers; that is to say, the power of sovereignty, the power to
govern men and things within the limits of its dominion.\textsuperscript{115} The above is an early description of what came to be known as the sovereign acts doctrine.\textsuperscript{116} In Horowitz the federal government was held not liable for damages resulting from the regulatory enactment of a public and general act (an embargo of shipment of certain goods).\textsuperscript{117} Since this exercise was an exercise of a state’s sovereign power, affecting the public at large and not merely directed at one party or one class of private contracting parties, it did not implicate the Contract Clause. So, too, if in the exercise of its sovereign power contracts between private parties are negatively affect, an aggrieved party has neither a cause of action against the benefited party nor against the government.\textsuperscript{118}

Notwithstanding, the sovereign acts defense, “to the extent to which [an act] relieved the Government of its own contractual obligations” the government [in this case the Federal Government] remains liable.\textsuperscript{119} The principles enunciated in that case which involved the Federal Government and private parties are applicable to an analysis under the Contract and Due Process Clause applicable to a state’s actions.

The fact that the passage of legislation arguably making it impossible for a government to perform does not, when such changes were reasonably to be anticipated, relieve a government of its obligation to pay damages resulting from such changes.\textsuperscript{120} The court may provide for a remedy, liquidated damages, for a party aggrieved by a government’s repudiation of its own contract regardless of whether it resulted from a law of general application. This is particularly appropriate if the private party has fully performed.

\textsuperscript{115} Thurlow, 46 U.S. at 583.
\textsuperscript{116} Horowitz v. United States, 267 U.S. 344, 461 (1925).
\textsuperscript{117} Id.
\textsuperscript{118} See, O’Neill v. United States, 231 Ct. Cl. 823, 826 (1982).
\textsuperscript{120} See, Horowitz, 267 U.S. at 461.
As the Court moved away from literal enforcement of the Contract Clause, it increasingly substituted a due process analysis to protect the reasonable economic expectations of a private party who contract with or was granted a charter by a state. For example, in *Chicago, M. & ST. P. Ry. Co. v. State of Minnesota ex rel. Railroad and Warehouse Comm.*\(^{121}\) the Court rejected a Contract Clause challenge to a state’s rate fixing but applied the Due Process Clause to hold that the rate’s fixed deprived the company of property without due process of law.\(^{122}\) The Court protected reasonable economic expectations (as defined by the Court) while not shutting the door to a state’s regulation of rates in the public interest. One might speculate that the Court favored due process analysis over Contract Clause enforcement because it gave greater regulatory discretion to governments as the country entered the Progressive Era.

In *Mugler v. State of Kansas*,\(^{123}\) the court, in exercising judicial review stated that it is the duty of the courts “to look at the substance of things …” to determine if the legislation enacted actually had a relationship to the proper exercise of the state’s police power or was “a palpable invasion of rights secured by the fundamental law.”\(^{124}\) Or, to quote *Lochner*,\(^{125}\) the courts must determine if a statute was “a fair, reasonable and appropriate exercise of the police power” rather then “an unreasonable, unnecessary and arbitrary interference” with contracts.\(^{126}\) *Lochner* judged the exercise of the police power to be appropriate, although not under the facts of *Lochner*,\(^{127}\) in order to protect public health and the health of individuals.\(^{128}\) In *dicta*, the Court stated explicitly that contracts could be impaired and legislation could be struck down in the extraordinary

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\(^{121}\) 134 U.S. 418 (1880).
\(^{122}\) *Id.* at 458; *See*, Allied Structural Steel Co. v. Spannaus, 438 U.S. 234, 98 S. Ct. 2716 (1978) rehearing den. Wherein, in dissent, Justice Brennan stated that the Due Process not the Contract Clause was used to “protect existing economic values” when state legislation created new duties.
\(^{123}\) 123 U.S. 623 (1887).
\(^{124}\) *Id.* at 661.
\(^{125}\) *Supra* note 28.
\(^{126}\) *Lochner*, 198 U.S. at 56.
\(^{127}\) *Id.* at 54.
\(^{128}\) *Id.* at 58.
circumstances where the business at hand is affected with a public interest. To be affected with a public interest a business “must be such as to create a peculiarly close relation between the public and those engaged in it, and … an affirmative obligation on [the business’s] part to be reasonable in dealing with the public.”¹²⁹ Mugler involved an attempt by the Kansas Legislature to fix wages in the fuel, clothing and food preparation industries.¹³⁰ The statute was struck down, as arbitrary, thus, without credible rational.

Adkins v. Children’s Hospital of the District of Columbia¹³¹ carved out yet another exception to liberty of contract. In dicta such statutes are “[s]tatutes relating to contracts for the performance of public work.”¹³² And, similar to Wolff Packing, an additional listed exception was for business “impressed with a public interest.”¹³³

In contrast to those opinions clearly stating or, at least, implying that the courts will decide on whether the police power is properly applied, the Court in Nebbia¹³⁴ was rather ambiguous when applying the Due Process Clause of the Fourteenth Amendment rather than the Contract Clause when it stated:

It is clear that there is no closed class or category of businesses affected with a public interest, and the function of courts in the application of the Fifth and Fourteenth Amendments is to determine in each case whether circumstances vindicate the challenged regulation as a reasonable exertion of governmental authority or condemn it as arbitrary or discriminatory.¹³⁵ The phrase ‘affected with a public interest’ can, in the nature of things, mean no more than that an industry, for adequate reason, is subject to control for the public good. In several of the decisions of this court wherein the expressions ‘affected with a public interest,’ and ‘clothed with a public use,’ have been brought forward as the criteria of the validity of price control, it has been admitted that they are not susceptible of definition and form an unsatisfactory test of the constitutionality of

¹²⁹ Charles Wolff Packing Co. v. Court of Industrial Relations of State of Kansas, 262 U.S. 522 (1923).
¹³⁰ Id. at 524.
¹³² Id. at 547.
¹³³ Id. at 546.
¹³⁴ Supra note 102.
¹³⁵ Wolff Packing Co., 262 U.S. at 535.
legislation directed at business practices or prices. These decisions must rest, finally, upon the basis that the requirements of due process were not met because the laws were found arbitrary in their operation and effect. But there can be no doubt that upon proper occasion and by appropriate measures the state may regulate a business in any of its aspects, including the prices to be charged for the products or commodities it sells.

So far as the requirement of due process is concerned, and in the absence of other constitutional restriction, a state is free to adopt whatever economic policy may reasonably be deemed to promote public welfare, and to enforce that policy by legislation adapted to its purpose. The courts are without authority either to declare such policy, or, when it is declared by the legislature, to override it. If the laws passed are seen to have a reasonable relation to a proper legislative purpose, and are neither arbitrary nor discriminatory, the requirements of due process are satisfied, and judicial determination to that effect renders a court functus officio. ‘Whether the free operation of the normal laws of competition is a wise and wholesome rule for trade and commerce is an economic question which this court need not consider or determine.’\(^{136}\) And it is equally clear that if the legislative policy be to curb unrestrained and harmful competition by measures which are not arbitrary or discriminatory it does not lie with the courts to determine that the rule is unwise. With the wisdom of the policy adopted, with the adequacy or practicability of the law enacted to forward it, the courts are both incompetent and unauthorized to deal. The course of decision in this court exhibits a firm adherence to these principles. Times without number we have said that the Legislature is primarily the judge of the necessity of such an enactment, that every possible presumption is in favor of its validity, and that though the court may hold views inconsistent with the wisdom of the law, it may not be annulled unless palpably in excess of legislative power.\(^{137}\)

All the above rationalized the price fixing of milk to protect dairy farmers from competition.\(^{138}\) The legislature did make specific findings to support its intervention in the market.\(^{139}\) It is difficult to read the rationale used as other than the protection of an influential voting block and as a complete abandonment of the Contract Clause in favor of the regulatory state and, at least, a partial abandonment of the free market such clause was meant to protect.

\(^{137}\) Nebbia, 291 U.S. at 536-538.
\(^{138}\) Id. at 515.
\(^{139}\) Id. at 517.
Professor Stephen F. Befort reviewed the case law associated with the unilateral alteration of public employee contracts. He stated that two factors are important in analyzing the case law. First, the statute under consideration always involved the government and public sector employees who were often represented by a union and had a negotiated collective bargaining agreement. The state does not have the bankruptcy option where a collective bargaining agreement may be rejected. Second, a distinction made by Professor Befort may be made based on whether the financial obligations avoided are those of the legislature itself. Professor Befort’s article “analyzes those judicial decisions that have confronted the rub between public sector collective bargaining agreements and a governmental body’s law-making function. A majority of decisions have appropriately applied Supreme Court precedent to restrict the scope of such legislative modifications to instances where they are reasonable and necessary. A minority of decisions, however, have deferred to the legislative body in spite of that entity’s self-interest.”

_Chastleton Corporation v. Sinclair_ threaded the line. The question presented to the Court was whether the extension of the rent control law of 1922 is a taking if no period of exigency exists? Congress extended the Rent Act of October 22, 1919 stating that an emergency still existed and that the housing and rental conditions required the extension. The Rent Commission passed an order on August 7, 1922 to fix the rental rates from March 1, 1922. Plaintiffs sought to restrain its enforcement, but the Rent Commission filed a motion to dismiss

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141 29 U.S.C. § 152(2)(2006)(Public sector employee are excluded from coverage by the National Labor Relations Act).
142 Supra note 140 at 2.
143 Id. at 2, 3.
144 264 U.S. 543 (1924).
145 Id. at 546.
146 Id.
their bill, which was granted and then affirmed. On further appeal, the Court of Appeals stated that the first and most important ground on appeal was that the emergency that justified interference with the ordinarily existing private rights in 1919 had come to an end in 1922 and no longer could be applied consistently with the Fifth Amendment. The Supreme Court stated that there was a question as to whether the exigency still existed upon which the continued operation of the law depended because the war had ended. In addition, a court “is not at liberty to shut its eyes to an obvious mistake, when the validity of the law depends upon the truth of what is declared.” One of the reasons for the need for rent control was due to the influx of people into Washington working for the government during the war. The court noted that the influx no longer occurred and most of the people had returned home. In reversing, the Court concluded that the facts should have been accurately ascertained and carefully weighed, which could be done more conveniently in the trial court.

Perhaps no other case is more illustrative of the conflicting views of the Supreme Court with regard to the Contract Clause and property rights than Charles River Bridge. The Court’s opinion, over the dissent of Justice Joseph Story, upheld Massachusetts destruction of the economic value of the Charles River Bridge when it violated the spirit, if not the exact words, of its charter for the Warren Bridge. The alleged impairment of a state’s contractual obligation was based on a reading of Trustees of Dartmouth College v. Woodward, which is supportive of the view of vested property rights. Charles River

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147 Id.
148 Id.
149 Id. at 548.
150 Id.
151 Id.
152 Id. at 549.
153 Supra note 23.
154 Id. at 583.
155 17 U.S. 518 (1819).
Bridge while recognizing property rights took a more utilitarian view based upon the changing needs of the community as reasonably determined by a state’s legislature. Essentially Charles River Bridge stands for the proposition that if a state contracts away its power to act on behalf of the welfare of its people generally it must do so unmistakably. Speaking for the Court, then Chief Justice Taney made clear that it was inconsistent with the spirit of our institutions, and dangerous to the best interests of the community if a legislature could bind its successors as to regulatory and legislative changes when the welfare of the community was the issue. Charles River Bridge decisively weakened the Contract Clause as a protection against government interference, for policy reasons, in the economic expectations of contracting parties whether with the state itself or between private parties as long as that interference was prospective.\footnote{156}

It would seem, however, that if the Charles River Bridge Charter had language of exclusivity, then the state might well have had to rely on its inherent power of eminent domain or if a specific contractual provision so provided been obligated to compensate the proprietors. In fact, the state had not entered into a contract not to establish a free bridge. Such a promise could not be implied. Justice Story’s dissent is a tome for the recognition of vested property rights against the claims, however transient, of the needs of the community. Justice Story relied on Fletcher.\footnote{157} Fletcher, however, dealt with a state’s attempt to invalidate contracts between two private parties based on an initial fraudulent charter grant by the state, not on a state’s direct contract with a private party involving an essential function of the state – transportation. Maintaining solvency and complying with a state constitutional mandate to balance the budget seem to be essential functions.

\footnote{156}Charles River Bridge, 36 U.S. at 547-48. 
\footnote{157}Id. at 617, 634.
IV. RECENT CASES

Relatively recent cases have dealt with both Contract Clause and due process challenges to a state’s interference with a contract between itself and a private party and between private parties affected by a change in law or regulation.

In applying the Contract Clause, a court must consider the nature of the alteration between the state and a private party. “[A] State is not free to impose a drastic impairment when an evident and more moderate course would serve its purposes equally well.”\textsuperscript{158} In addition, a court is to examine whether “without modifying the covenant at all, the State could have adopted alternative means of achieving [its]… goals…”\textsuperscript{159} Further, [t]he Contract Clause is not an absolute bar to subsequent modification of a State’s own financial obligations” if the modification is reasonable and necessary.\textsuperscript{160} When a financial obligation of a state is modified, “complete deference to a legislative assessment of reasonableness and necessity is not appropriate because the State’s self-interest is at stake.”\textsuperscript{161}

The economic expectations of a party must be examined to determine if such impairment is substantial. If not, the protection of the Contract Clause is not involved.\textsuperscript{162} Even if substantially impaired a “reviewing court must decide … whether the challenged legislation is reasonable and necessary to serve a legitimate or important public purpose. It is at this level of analysis that a more strict review is necessary to be applied to contracts of a state than to solely private contracts since the state’s self-interest might cause its legislature to make legislative findings and judgments which are not objective but prejudiced in favor of the state.”\textsuperscript{163}

\textsuperscript{158} \textit{United States Trust}, 431 US at 31; See, supra note 88 and text related thereto.
\textsuperscript{159} \textit{Id.} at 30.
\textsuperscript{160} \textit{Id.} at 25.
\textsuperscript{161} \textit{Id.} at 26.
\textsuperscript{162} \textit{Energy Reserves Group}, 459 U.S. at 411; \textit{United States Trust Co.}, 431 U.S. at 19-20 n. 17.
The Due Process Clause is likewise not a bar the fee expansion of the regulatory state. “The Due Process Clause of the Fourteenth Amendment generally does not prohibit retrospective civil legislation, unless the consequences are particularly ‘harsh and oppressive.’”\textsuperscript{164}

In \textit{Pension Benefit Guaranty Corp. v. R.A. Gray Co.}\textsuperscript{165} the Court stated that “[i]t is now well established that legislative Acts adjusting the burdens and benefits of economic life come to the Court with a presumption of constitutionality and that the burden is on the one complaining of a due process violation to establish that the legislature has acted in an arbitrary and irrational way,”\textsuperscript{166} And in shifting from a Contract Clause analysis to a due process analysis the court “further explained that the strong deference accorded legislation in the field of … economic policy is no less applicable when the legislation is applied retroactively. Provided that the retroactive application of a statute is supported by legitimate legislative purpose furthered by rational means, judgments about the wisdom of such legislation remain within the exclusive province of the legislative and executive branches…”\textsuperscript{167} thereby using the Due Process Clause to advance the regulatory state.

In \textit{Matsuda v. City and County of Honolulu},\textsuperscript{168} Honolulu, starting in 1991, provided for the use of eminent domain to condemn condominium units and the appurtenant land when requested to by a threshold member of condominium owners in order to divest the major Hawaiian landowners of their property on which the condominiums were built to “increase the opportunity for land ownership.”\textsuperscript{169} Before the condemnation proceedings began but after the

\textsuperscript{164} \textit{U.S. Trust Co.}, 431 U.S. at 17 n. 13.
\textsuperscript{165} 467 U.S. 717 (1984).
\textsuperscript{166} \textit{Id.} at 729.
\textsuperscript{167} \textit{Id.}
\textsuperscript{168} 512 F.3d 1148 (9th Cir. 2008).
\textsuperscript{169} \textit{Id.} at 1150 (Hawaiian land owners would allow developers to contract condominiums subject to a ground lease rather than sell the real estate in fee simple).
city entered into contracts with the condominium owners, the city repealed the relevant law allowing for the use of eminent domain in this situation.\textsuperscript{170}

The court looked to \textit{United States Trust}\textsuperscript{171} for guidance applying its three part test:

(1) whether the state law has, in fact, operated as a substantial impairment of a contractual relationship, \textit{Energy Reserves Group, Inc. v. Kan. Power & Light Co.}, 459 U.S. 400, 411, 103 S.Ct. 697, 74 L.Ed.2d 569 (1983)(citations and internal quotation marks omitted); (2) whether the state law is justified by a significant and legitimate public purpose, \textit{Id}; and (3) whether the impairment resulting from the law is both reasonable and necessary to fulfill [such] public purpose,” \textit{S. Cal. Gas Co. v. City of Santa Ana}, 336 F.3d 885, 889-90 (9th Cir. 2003)(per curiam) (citations and internal quotation marks omitted).\textsuperscript{172}

The Ninth Circuit rejected a defense by the city based on the reserved power doctrine since it held that the city’s failure to act was not an aspect of sovereignty nor did it violate due process. Rather the Ninth Circuit focused on the “substantial impairment issue.” It treated the dispute as one between a state agency and a private party rather than as an enactment of a law of general application affecting a contract between private parties. It is difficult to defend the court’s reasoning here, since the city in changing the law focused on the public purpose, which motivated the law in the first place. That initial goal had been achieved and the condominium owners were not put in a worse position \textit{ante}. This analysis was supported by \textit{Ching Young v. City and County of Honolulu},\textsuperscript{173} which rejected a damage claim by the condominium owners involved in \textit{Matsuda} holding that the repeal was within the police power of the state. The plaintiffs, then, could not force the municipality to proceed with the condemnation and pursuant to the contract with the condominium owners then transfer the land involved to them.\textsuperscript{174} In essence, the court found that the ordinance was for a public purpose, hence, did not violate the

\begin{itemize}
\item \textsuperscript{170} \textit{Id.}
\item \textsuperscript{171} See supra notes 91-6 and text related thereto.
\item \textsuperscript{172} \textit{Matsuda}, 512 F.3d at 1151.
\item \textsuperscript{173} 639 F.3d 907 (9th Cir. 2011).
\item \textsuperscript{174} \textit{Id.} at 916-17.
\end{itemize}
Contract Clause. The law’s change made the city’s ability to perform its contracts with private parties impossible, yet because the condominium owners were only potentially injured prospectively, no damages were appropriate.

*Buffalo Teachers Federation v. Tobe*\(^{175}\) provides a summary of the issues raised where a “state is sued for allegedly impairing the contractual obligations of one of its political subdivisions even though it is not a signatory to the contract….”\(^{176}\) Holding that a state did not violate the Contract Clause, since the plaintiffs could not meet their burden of proof “that the state’s self interest rather than the general welfare of the public motivated the state’s conduct.”\(^{177}\)

New York State determined that Buffalo was “in a state of fiscal crisis and that the welfare of the inhabitants of the city [was] seriously threatened,”\(^{178}\) hence, passed legislation that resulted in a wage freeze which was contrary to the collective bargaining agreement between the City and the teachers union. In upholding the wage freeze, despite the collective bargaining contract the court cited *Blaisdell* and *Energy Reserves*, the court stated “courts must accommodate the Contract Clause with the inherent police power of the state ‘to safeguard the vital interests of its people.’”\(^{179}\) Citing *United States Trust*, the court further stated “state laws that impair an obligation under a contract do not necessarily give rise to a viable Contract Clause claim.”\(^{180}\)

Although the wage freeze constituted substantial impairment in that it interfered with the reasonable expectations of the teachers,\(^{181}\) the “New York legislatures had a legitimate public
purpose in passing the Act….“

If, such law impairs a contract it must be “specifically tailored to meet the societal ill it is supposedly designed to ameliorate.” This is, of course, the rationale for the passage of emergency legislation that does, in fact, substantially impair a contract, yet is considered necessary and reasonable under the circumstances. In noting that the contract impaired was between a municipality and a private party (the teachers’ union) the court did not mean it could not be self-serving. Even though heightened scrutiny is not appropriate, complete deference to the state isn’t either. The court phrased it as follows:

Ultimately, for impairment to be reasonable and necessary under less deference scrutiny, it must be shown that the state did not (1) “consider impairing the … contracts on par with other policy alternatives” or (2) “impose a drastic impairment when an evident and more moderate course would serve its purpose equally well,” nor (3) act unreasonably “in light of the surrounding circumstances….” U.S. Trust Co., 431 U.S. at 30-31.

The temporary and prospective nature of the wage freeze underscores further its reasonableness. The Supreme Court instructs that the extent of the impairment is “a relevant factor in determining its reasonableness.” U.S. Trust Co., 431 U.S. at 27. Here the impairment is relatively minimal. Under the terms of the Act, the temporary wage freeze must be revisited by the Board on an on-going basis to assure the freeze's continued necessity N.Y. Pub. Auth. Law § 3858(2)(d) (McKinney Supp.2006). Further, the wage freeze operates prospectively. In this respect the present facts are dissimilar to U.S. Trust Co., a case that represents the paradigm of the type of protection that the Contracts Clause was designed to offer: protection “to those who invested money, time and effort against loss of their investment through explicit repudiation.” Local Div. 589, 666 F.2d at 642 (discussing U.S. Trust Co.). The impairment here does not affect past salary due for labor already rendered or money invested. It only suspends temporarily the two percent increase in salary for services to be rendered.185

182 Id.
183 Id. at 369.
184 Id. at 370.
185 Id. at 371-72.
Unlike Association of Surrogates & Supreme Court Reporters v. New York\textsuperscript{186} and Condell v. Bress\textsuperscript{187} where the impairment involved a payroll lag, that is, impaired the obligation of the state for consideration already received, the wage freeze in the instant matter only had a prospective effect.\textsuperscript{188}

V. MAJOR SUPREME COURT OPINIONS REVIEWED

In an attempt to synthesize the various Supreme Court opinions with regard to impairment by a state of contracts between two private parties or where the state is one of the parties, the leading cases will be considered in order to extract their current decisional value. In doing this, it is apparent that the Court has adopted a progressive ideology. The Court has moved away from the enforcement of the Contract Clause,\textsuperscript{189} support for the protection of private property rights and support for the free market towards increasing regulation and decision-making by a progressive elite largely in control of the bureaucracy and the courts. Their motivation or rationale for intervention is based on social concerns, that is, to make the country a fairer or better place according to their then prevailing views.

In Fletcher (1810)\textsuperscript{190} the Court protected the economic expectations of private parties, who engaged in no wrongdoing and would not be compensated if the state invalidated their real estate contracts. A revisionist view of this opinion, might view it as an arbitrary act by a state legislature under political pressure and a denial of due process interfering with a vested property interest. The interests were vested because the private parties had no further obligations.

\textsuperscript{186} 940 F.2d 766 (2nd Cir. 1991).
\textsuperscript{187} 983 F.2d 415 (2nd Cir. 1993).
\textsuperscript{188} Buffalo, 464 F.3d at 372, 375.
\textsuperscript{189} See The Federalist No. 44, at 68-77 (James Madison stated “laws impairing the obligation of contracts, are contrary to the first principles of the social compact, and to every principle of sound legislation”).
\textsuperscript{190} Supra note 14 and text related thereto.
In *Dartmouth* (1819)\(^{191}\) the Court protected the expectations of the original parties to a contract involving the donation of property that did not implicate New Hampshire’s governmental interest.\(^{192}\) The Court stated that:

> If the act of incorporation be a grant of political power, if it create a civil institution to be employed in the administration of the government, or if the funds of the college be public property, or if the state of New Hampshire, as a government, be alone interested in its transactions, the subject is one in which the legislature of the state may act according to its own judgment, unrestrained by any limitation of its power imposed by the Constitution of the United States.\(^{193}\)

This statement hardly stands for the proposition that contracts between private parties are sacrosanct (even if involving vested property interests) and may be seen as an early description of the doctrine of reserved powers.

In *West River Bridge* (1848)\(^{194}\) the Court recognized that a state’s power of eminent domain as an attribute of sovereignty exercised for the public good trumped vested property rights and was not subject to the Contract Clause.\(^{195}\) In *West River Bridge* the state was exercising its sovereign authority to serve the public good in doing something foreseeable.\(^{196}\) If the economic expectations were to be protected as in *Fletcher*, the proprietors of the West River Bridge could have specifically provided for that. They were, however, pursuant to state law entitled to compensation since they had not received what they had paid for.\(^{197}\) It was not until *Chicago, B. & Q. R. CO. v. City of Chicago*\(^{198}\) applied, through the Fourteenths Amendment, the just compensation provisions to the states.\(^{199}\)

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\(^{191}\) Supra note 50.
\(^{192}\) Dartmouth, 4 U.S. at 712-13.
\(^{193}\) Id. at 629-30.
\(^{194}\) Supra note 71.
\(^{195}\) West River Bridge, 47 U.S. at 525.
\(^{196}\) Id.
\(^{197}\) Id. at 514.
\(^{198}\) 166 U.S. 226 (1897).
\(^{199}\) U.S. CONST. amend. XIV.
In *Stone* (1880)\(^{200}\) the Court affirmed the concept of inherent reserved police powers when holding that a state’s legislature could not bargain away its power to protect the public welfare.\(^{201}\) Similarly, the Court upheld a Louisiana provision abolishing grants of monopoly status based on a state’s sovereign power over public welfare.\(^{202}\)

Unlike *Dartmouth*, the two above opinions did not merely involve future economic expectations; rather, they involved issues of direct government concern as sovereign as opposed to being a mere party to a contract. Apparently tax abatements qualify as mere contractual arrangements and contracts granting such as protected by the Contract Clause.\(^{203}\) After all, the aggrieved party has performed.

The Court discussed both the Contract Clause and Due Process issues in *Manigault v. Springs* (1905).\(^{204}\) In 1898, both plaintiff and defendant were adjoining property owners on the Santee River at the mouth of the Kinloch Creek.\(^{205}\) Sometime in 1898, the defendant constructed a dam across the creek for her personal purposes.\(^{206}\) The dam caused many problems for the plaintiff including a lack of water on his property, and a disruption of his mill business. After much negotiation, the parties entered into a contract, whereby the parties agreed that the dam would be removed.\(^{207}\) The dam was removed as contracted, and the river continued to be navigable until 1903.\(^{208}\)

\(^{200}\) Supra note 45.
\(^{201}\) Stone, 101 U.S. at 819.
\(^{204}\) 199 U.S. 473 (1905).
\(^{205}\) Id. at 477.
\(^{206}\) Id.
\(^{207}\) Id.
\(^{208}\) Id.
In 1903, the state legislatures of South Carolina decided to drain low-lying areas down river of the plaintiff and defendants’ properties that are prone to flooding. The decision was in an attempt to raise the value of the land and increase development in the region. Soon after, the legislature adopted a statute in accordance with the plan.

Due to the statute and the construction of the dam on the defendant’s property, the plaintiff commenced this suit claiming that: 1) the statute of 1903 impaired the contract entered into in 1898, by which defendant agreed to remove the dam then existing, and to allow such creek to remain open and unobstructed; and 2) the damming of the creek was a destruction of the property of the plaintiff and a deprivation thereof without due process of law.

While reviewing the plaintiff’s second claim, the Supreme Court referred to Wilson v. Black Bird Creek Marsh Co. where Chief Justice Marshall wrote that unless an abridgment comes in conflict with the Constitution or a law of the United States, the affair is between the government of the state and its citizens, which the Supreme Court can take no cognizance. No conflict occurred in this case; therefore, the plaintiff had no claim against the state. He was still in control of his own property.

According to precedent set by the Supreme Court, “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 good through contracts previously entered into between individuals may thereby be affected.” This power, which is know as the police power, is “an exercise of the sovereign right of the government to protect the lives, health, morals, comfort,
and general welfare of the people, and is paramount to any rights under contracts between individuals”217 and aggrieved parties are not entitled to compensation.

It is also paramount to any rights granted by charter to a private entity.218 Nebbia219 marked the Court’s decisive turn towards allowing increased state interference with property rights. The Court stated that:

So far as the requirement of due process is concerned, and in the absence of other constitutional restriction, a state is free to adopt whatever economic policy may reasonably be deemed to promote public welfare, and to enforce that policy by legislation adapted to its purpose. The courts are without authority either to declare such policy, or when it is declared by the legislature, to override it….220

The public interest exception limited the reach of due process protections as well as the application of the Contract Clause221 beyond the police power sovereignty exceptions seemingly giving carte blanche to states to define for themselves the public interest.

As Professor Mayer wrote:

This meant that substantive due process review of such legislation would follow what is generally now called the “rational basis test”—sometimes called the “minimal rational basis test,” to emphasize the weakness of scrutiny. The test, in effect, seems to function as a presumption in favor of the constitutionality of such legislation. In other words, it reverses the Court’s old Lochner Era presumption in favor of liberty, replacing it with a presumption in favor of governmental action or regulation, or a presumption against liberty. Contrary to the orthodox view, which identifies formalism with judicial protection of liberty of contract and which sees Justice Holmes, Justice Brandeis, and their jurisprudential descendants as the enemies of formalism, the Carolene Products rational basis test, with its presumption of constitutionality, is “the very definition of formalism.” As one scholar has noted, “So long as the government’s action bears some connection to a minimally rational economic policy, the Court refuses to look further, to the real motive or real effect of the policy.”222

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217 Id. (emphasis added).
218 Noble State Bank v. Haskell, 219 U.S. 104, 111, 31 S.Ct. 186 (1910)(wherein the Court upheld a tax on bank deposits to fund the guaranty fund saying reliance on the original bank charter is misplaced when the issue is one of public needs including morality, public welfare generally and commerce).
219 Supra note 102.
220 Nebbia, 291 U.S. at 515; Supra notes 107-109 and text related thereto.
221 See, West Coast Hotel Co. v. Parrish, 300 U.S. 379 (1937) (which effectively repudiated the liberty of contract doctrine); See also, Supra note 73.
222 Supra note 73 at 654.
Although, the Contract Clause was not pronounced dead, by use of the Due Process Clause, courts were permitted to give some protection to the economic interests associated with contracts while at the same time allowing for the growth of the regulatory state.

Proving that the Contract Clause wasn’t completely eviscerated, the Court decided *United States Trust Co.* 223 As a prefatory statement the Court said:

At the time the Constitution was adopted, and for nearly a century thereafter, the Contract Clause was one of the few express limitations on state power. The many decisions of this Court involving the Contract Clause are evidence of its important place in our constitutional jurisprudence. Over the last century, however, the Fourteenth Amendment has assumed a far larger place in constitutional adjudication concerning the States. We feel that the present role of the Contract Clause is largely illuminated by two of this Court’s decisions. In each, legislation was sustained despite a claim that it had impaired the obligations of contracts. 224

The Court cited *Blaisdell* 225 for the proposition that an “emergency may furnish the occasion for the exercise of the police power.” 226 It further stated that the “great clause of the Constitution are to be considered in the light of our whole experience, and not merely as they would be interpreted by its Framers in the conditions and with the outlook of their times.” 227 In other words, the “it is not every modification of a contractual promise that impairs the obligation of contract under federal law.” 228

The states are to be permitted “wide discretion … in determining what is and what is not necessary.” 229 Crucial to the application of the Contract Clause are the retroactive effect of the newly passed legislation, the fact that the state involved had received the benefit of its bargains, and the economic expectations of the private party to the contract. Nevertheless, a state cannot

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223 Supra note 91.
225 Supra note 58.
226 *U.S. Trust Co.*, 431 U.S. at 15.
227 *Id.* at 15-16.
228 *Id.* at 16 (quoting *El Paso v. Simmons*, 379 U.S. 497, 506-507 (1965)).
229 *U. S. Trust Co.*, 431 U.S. at 16.
enter into binding contracts not to exercise its police power or to put it another way “the Contracts Clause does not require a state to adhere to a contract that surrenders an essential attribute of its sovereignty.” Generally, however, contracts involving future taxing and spending are binding.

Financial obligations of a state where the state has received the benefits of its bargain are binding, whereas a future financial obligation where the state has not yet received the benefit can be impaired not-withstanding the Contract Clause.

Yet, the Court still made plain that it, not a state legislature is the ultimate arbiter.

As with laws impairing the obligations of private contracts, an impairment may be constitutional if it is reasonable and necessary to serve an important public purpose. In applying this standard, however, complete deference to a legislative assessment of reasonableness and necessity is not appropriate because the State’s self-interest is at stake. A governmental entity can always find a use for extra money, especially when taxes do not have to be raised. If a State could reduce its financial obligations whenever it wanted to spend the money for what it regarded as an important public purpose, the Contract Clause would provide no protection at all.

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230 Id. at 23 (emphasis added).
231 Id. at 24. (In New Jersey v. Wilson, 7 Cranch 164 (1812), the Court held that a State could properly grant a permanent tax exemption and that the Contract Clause prohibited any impairment of such an agreement. This holding has never been repudiated, although tax exemption contracts generally have not received a sympathetic construction. See B. Wright, The Contract Clause of the Constitution 179-194 (1938). By contrast, the doctrine that a State cannot contract away the power of eminent domain has been established since West River Bridge v. Dix. See Contributors to Pennsylvania Hospital v. Philadelphia, 245 U. S., at 23-24. The doctrine that a State cannot be bound to a contract forbidding the exercise of its police power is almost as old. State laws authorizing the impairment of municipal bond contracts have been held unconstitutional. W. B. Worthen Co. v. Kavanaugh, 295 U.S. 56 (1935); Louisiana v. Pillsbury, 105 U.S. 278 (1882). Similarly, a tax on municipal bonds was held unconstitutional because its effect was to reduce the contractual rate of interest. Murray v. Charleston, 96 U.S. 432, 443-446 (1878). A number of cases have held that a State may not authorize a municipality to borrow money and then restrict its taxing power so that the debt cannot be repaid. Louisiana ex rel. Hubert v. New Orleans, 215 U.S. 170, 175-178 (1909); Wolff v. New Orleans, 103 U.S. 358, 365-368 (1881); Von Hoffman v. City of Quincy, 4 Wall., at 554-555. See Fisk v. Jefferson Police Jury, 116 U.S. 131 (1885)(contract for payment of public officer). See also Wood v. Lovett, 313 U.S. 362 (1941); Indiana ex rel. Anderson v. Brand, 303 U.S. 95 (1938). Id., notes 21, 22.)
232 See, El Paso v. Simmons, 379 U.S. 497 (1965)(quoted with approval in United States Trust Co., wherein the Court stated: the State “has the ‘sovereign right . . . to protect the . . . general welfare of the people’ ” and “‘we must respect the “wide discretion on the part of the legislature in determining what is and what is not necessary…””.
In stating the above, the Court backed off from what is characterized as the “total destruction” test.\(^{234}\) This test had its origin in the rights-remedies dichotomy of certain earlier cases.\(^{235}\) In rejecting such a test, the Court stated that “we cannot sustain the repeal of the 1962 covenant [which potentially reduced the value of the banks by repudiating an express promise] simply because the bondholders’ rights were not totally destroyed.”\(^ {236}\) As an alternative, a state may be able to exercise its power of eminent domain to abrogate [certain] contractual rights upon payment of just compensation.\(^ {237}\) Presumably just compensation would involve a present value analysis of the future value of the bonds taking into account the likelihood of default.\(^ {238}\)

The dissent in *U.S. Trust Company* made clear that the progressive attitude towards the Contract Clause, despite a seemingly partial reinvigoration, still was concerned with the desirability of advancing the regulatory power of the government over economic matters.\(^ {239}\) Justice Brennan wrote:

> Decisions of this Court for at least a century have construed the Contract Clause largely to be powerless in binding a State to contacts limiting the authority of successor legislatures to enact laws in furtherance of the health, safety, and similar collective interests of the polity. In short, those decisions established the principle that lawful exercises of a State’s police powers stand paramount to private rights held under contract. Today’s decision, in invalidating the New Jersey Legislature’s 1974 repeal of its predecessor’s 1962 covenant, rejects this previous understanding and renews the Contract Clause into a potent instrument for overseeing important policy determinations of the state legislature. At the same time, by creating a constitutional safe haven for property rights embodied in a contract, the decision substantially distorts modern constitutional jurisprudence governing regulation of private economic interests. I might understand, though I could not accept, this revival of the Contract Clause were it in accordance with some coherent and constructive view of public policy.\(^ {240}\)

\(^{234}\) Id. at 26-27; *See*, W.B. Worthen Co. Ex rel. Board of Commissioners of Street Improvement Dist. No. 513 of Little Rock, Ark. v. Kavanaugh, 295 U.S. 56 (1935).

\(^{235}\) *See*, Sturges v. Crowninshield, 17 U.S. 122, 200 (1819)(Without impairing the obligation of contract, the remedy may be modified).

\(^{236}\) *U.S. Trust Co.*, 431 U.S. at 27.

\(^{237}\) Id. at 24.

\(^{238}\) *See*, e.g. El Paso v. Simmons, 379 U.S. 497, 515 (1965).

\(^{239}\) *U.S. Trust Co.*, 431 U.S. at 33.

\(^{240}\) Id. at 34.
The opinion in *United States v. Winstar Corp.*\(^{241}\) is instructive as to the Court’s contemporary view of issues that may implicate the Contract Clause and just how far that clause yields to the reserved sovereign powers doctrine. Three financial institutions brought a breach of contract action against the United States which after approving the acquisition of failing thrifts by solvent thrifts pursuant to special accounting rules, changed the rules, leading to the seizure and liquidation of the acquiring thrifts.\(^{242}\)

The issue was stated as follow:

The issue in this case is the enforceability of contracts between the Government and participants in a regulated industry, to accord them particular regulatory treatment in exchange for their assumption of liabilities that threatened to produce claims against the Government as insurer. Although Congress subsequently changed the relevant law, and thereby barred the Government from specifically honoring its agreements, we hold that the terms assigning the risk of regulatory change to the Government are enforceable, and that the Government is therefore liable in damages for breach.\(^{243}\)

The government encouraged “supervisory mergers” wherein relatively healthy thrifts would acquire failing thrifts.\(^{244}\) The inducements given to acquiring institutions were not generally successful.\(^{245}\) “As a result, Congress enacted the Financial Institutions Reform, Recovery, and Enforcement Act of 1989,\(^{246}\) with the objects of preventing the collapse of the industry, attacking the root causes of the crisis, and restoring public confidence.”\(^{247}\)

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\(^{242}\) *Id.* at 839.

\(^{243}\) *Id.* at 843; *See*, Pension Benefit Guaranty Corporation v. R.A. Gray & Co., 467 U.S. 717, 732, n.9. (1984)(stating the Contracts Clause does not apply to the Federal Government but the principles are largely interchangeable).

\(^{244}\) *Winstar Corp.*, 518 U.S. at 848.

\(^{245}\) *Id.* at 856.


\(^{247}\) *Winstar Corp.*, 518 U.S. at 856.
eliminated resulting in the once relatively healthy thrifts that had acquired the failing thrifts to fail. Three acquiring thrifts filed suit on “both contractual and constitutional grounds.”

In affirming the Court of Federal Claims,

The Federal Circuit found that [the then federal agency] had made express contracts with respondents, including a promise that supervisory goodwill and capital credits could be counted toward satisfaction of the regulatory capital requirements. The court rejected the Government's unmistakability argument, agreeing with the Court of Federal Claims that that doctrine had no application in a suit for money damages. Finally, the en banc majority found that [the agency’s] new capital requirements “single[d] out supervisory goodwill for special treatment” and therefore could not be said to be a “public” and “general act” within the meaning of the sovereign acts doctrine.

The Court explained:

We took this case to consider the extent to which special rules, not generally applicable to private contracts, govern enforcement of the governmental contracts at issue here. We decide whether the Government may assert four special defenses to respondents' claims for breach: the canon of contract construction that surrenders of sovereign authority must appear in unmistakable terms, Bowen v. Public Agencies Opposed to Social Security Entrapment, 477 U.S. 41, 52 (1986); the rule that an agent's authority to make such surrenders must be delegated in express terms, Home Telephone & Telegraph Co. v. Los Angeles, 211 U.S. 265 (1908); the doctrine that a government may not, in any event, contract to surrender certain reserved powers, Stone v. Mississippi, 101 U.S. 814 (1880); and, finally, the principle that a Government's sovereign acts do not give rise to a claim for breach of contract, Horowitz v. United States, 267 U.S. 458, 460 (1925).

At this point, it should be noted that the three thrifts fully performed their obligations in acquiring the failing thrifts which as a matter of fact put them out of compliance ab initio with subsequent regulatory changes. All agreements between the government and the acquiring thrifts had integration clauses incorporating the contemporaneous agreements and regulatory

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248 Id. at 857-59.  
249 Id. at 858.  
251 Id. at 1540, 1542–1543.  
252 Id. at 1545–1548.  
253 Winstar Corp., 518 U.S. at 859 (quoting Winstar Corp., 64 F.3d. at 1548–1551).  
254 Winstar Corp., 518 U.S. at 860.  
255 Id. at 864-65.  
256 Id. at 866-67.
inducements.\textsuperscript{257} In short, the bargained for exchange occurred and did not in anyway prevent the government from modifying the regulations in the future. And if such subsequent regulations affect the performance of the private party by denying such party the benefit of its bargain, damages would be appropriate.\textsuperscript{258}

In negating the government’s argument based on the unmistakability doctrine, the Court said both that the government could have expressly reserved the right to change the requirements without responsibility if it so chose\textsuperscript{259} and such doctrine does not insulate a government from paying damages for breach.\textsuperscript{260} This application of the unmistakability doctrine is a gloss on the principle stated in \textit{Manigault v. Springs}\textsuperscript{261} that “a general law … may be repealed, amended or disregarded by the legislature which enacted it” and “is not binding upon any subsequent legislature.”\textsuperscript{262}

The Court then reviewed what it characterized as “early unmistakability cases.”\textsuperscript{263} In considering \textit{Fletcher},\textsuperscript{264} \textit{West River Bridge},\textsuperscript{265} \textit{Charles River Bridge},\textsuperscript{266} \textit{Stone},\textsuperscript{267} \textit{Delaware Railroad Tax},\textsuperscript{268} and \textit{Jefferson Branch Bank v. Shelly},\textsuperscript{269} the Court stated:

\textsuperscript{257} \textit{Id.}
\textsuperscript{258} \textit{Id.} at 869 (citing Restatement (Second) of Contracts § 264, comment a); \textit{See}, Ambase Corp. v. United States,\textsuperscript{261} \_Fed Cl\_ (2011), WL3891942 (2011) wherein the U.S. Court of Federal Claims calculated expectancy damages arising out of the \textit{Winstar} litigation. Unlike other cases claiming expectancy damages, the entire value of the plaintiffs’ property (the thrifts) were destroyed which was a foreseeable result at the time of contracting from a change in the law.
\textsuperscript{259} \textit{Id.} at 890, n. 15 (citing \textit{Guaranty Financial Services, Inc. v. Ryan}, 928 F.2d 994, 999-1000 (11th Cir. 1991)).
\textsuperscript{261} 199 U.S. 473 (1905).
\textsuperscript{262} \textit{Id.} at 487 (cited with approval in \textit{Winstar}, 518 U.S. at 873).
\textsuperscript{263} \textit{Winstar}, 518 U.S. at 873-76.
\textsuperscript{264} \textit{Supra note} 14.
\textsuperscript{265} \textit{Supra note} 74.
\textsuperscript{266} \textit{Supra note} 23.
\textsuperscript{267} \textit{Supra note} 45.
\textsuperscript{268} \textit{The Delaware Railroad Tax}, 18 Wall 206 (1874).
The posture of the government in these early unmistakability cases is important. In each, a state or local government entity had made a contract granting a private party some concession (such as a tax exemption or a monopoly), and a subsequent governmental action had abrogated the contractual commitment. In each case, the private party was suing to invalidate the abrogating legislation under the Contract Clause. A requirement that the government's obligation unmistakably appear thus served the dual purposes of limiting contractual incursions on a State's sovereign powers and of avoiding difficult constitutional questions about the extent of state authority to limit the subsequent exercise of legislative power.\textsuperscript{270}

Those cases may be construed under the reasoning of \textit{Winstar} to stand for the proposition that the Contract Clause is effective to give a private party protection if the state has already gotten its benefit of the bargain (the private party’s right had vested), unless the agreement implicated the reserved powers which could not be contracted away (health, safety, eminent domain) or the unmistakability doctrine didn’t apply since “nothing can be taken against the state by presumption or inference.”\textsuperscript{271}

The Court citing, among others, \textit{Providence Bank}\textsuperscript{272} and \textit{Charles River Bridge},\textsuperscript{273} stated that:

Their collective holding is that a contract with a sovereign government will not be read to include an unstated term exempting the other contracting party from the application of a subsequent sovereign act (including an Act of Congress), nor will an ambiguous term of a grant or contract be construed as a conveyance or surrender of sovereign power. The cases extending back into the 19th century thus stand for a rule that applies when the Government is subject either to a claim that its contract has surrendered a sovereign power (\textit{e.g.}, to tax or control navigation), or to a claim that cannot be recognized without creating an exemption from the exercise of such a power (\textit{e.g.}, the equivalent of exemption from Social Security obligations). The application of the doctrine thus turns on whether enforcement of the contractual obligation alleged would block the exercise of a sovereign power of the Government.\textsuperscript{274}

A distinction is made between a power peculiar to a government which is fully subject to its

\textsuperscript{270} \textit{Winstar Corp.}, 518 U.S. at 875.
\textsuperscript{271} \textit{Id.} at 874.
\textsuperscript{273} \textit{Supra} note 23.
\textsuperscript{274} \textit{Winstar Corp.}, 518 U.S. at 878-79.
sovereign reserved powers and the unmistakability doctrine, and one that merely finds the sovereign in the position of a private contracting party wherein ordinary risk allocation would be applied.\textsuperscript{275} Although, “[t]he Government cannot make a binding contract that it will not exercise a sovereign power, but it can agree in a contract that if it does so, it will pay the other contracting party the amount by which its costs are increased by the Government’s sovereign act”.\textsuperscript{276}

Quoting Justice Brandeis, the Court stated that “[punctilious fulfillment of contractual obligations is essential to the maintenance of the credit of public as well as private debtors.”\textsuperscript{277} In the ordinary course of events, the government as a contracting party “agreed to do something that did not implicate its sovereign powers, …”\textsuperscript{278} unlike the situation where a legislature attempts to bargain away an essential attribute of its sovereignty\textsuperscript{279} such as the power to legislate or regulate for the public welfare.

In rejecting the government’s insistence that the sovereign acts doctrine applied\textsuperscript{280} the Court in \textit{Winstar} distinguished between the government as a contractor as opposed to its acts as a sovereign.\textsuperscript{281} The award of damages in \textit{Winstar} had no effect on the government’s power to regulate or legislate. The fact that the regulatory changes caused the plaintiff’s business to fail did not render the government’s act subject to Contract Clause or Due Process Clause invalidation although it did subject the government to a damage claim as if it were a private party. After all, the government had contracted with the very plaintiffs it caused to fail.\textsuperscript{282} Crucial to the decision was whether the effect on a contract was “merely incidental to the

\textsuperscript{275} Id. at 880.
\textsuperscript{276} Id. at 882 (citing \textit{Amino Bros. Co. v. U.S.}, 372 F.2d 485, 491, Cert denied 389 U.S. 846, 88 S.Ct. 98 (1967)).
\textsuperscript{277} \textit{Winstar Corp.}, 518 U.S. at 885.
\textsuperscript{278} Id. at 886-87.
\textsuperscript{279} See, \textit{Stone}, supra note 45 and text related thereafter.
\textsuperscript{280} See, \textit{Horowitz}, supra notes 116-19 and text related thereto.
\textsuperscript{281} \textit{Winstar}, 518 U.S. at 892-93.
\textsuperscript{282} Id. at 895.
accomplishment of a broader objective"\textsuperscript{283}, whether the burden of the government action falls disproportionately on one class of persons for the benefit of others including the government itself\textsuperscript{284}, and whether the government’s actions were directed at the plaintiffs.\textsuperscript{285} “One might say that a governmental action was not ‘public and general’ under Horowitz if its predominate purpose or effect was an avoidance of the Government’s contractual commitments.”\textsuperscript{286} Such was the purpose in Winstar making the government liable.\textsuperscript{287}

The sovereign acts doctrine is not meant to relieve a government’s liability for its contractual obligations on the basis that some subsequent change in the law or regulations rendered the government’s performance impossible unless, “the Government, like any other defending party in a contract action, must show that passage of the statute rendering its performance impossible was an event contrary to the basic assumptions on which the parties agreed, and, ultimately, that the language or circumstances do not indicate that the Government should be liable in any case.”\textsuperscript{288} Based upon the realities attendant in the modern regulatory state, the subsequent changes rendering the governments consideration valuables, were reasonably within the contemplation of the parties, and could have been allocated if the parties had chosen to do so.\textsuperscript{289} “[Government] contracts routinely include provisions shifting financial responsibility to the Government for events which might occur in the future. That some of these events may be triggered by sovereign government action does not render the relevant contractual provisions any less binding than those which contemplate third party acts, inclement weather and other force

\textsuperscript{283} Id. at 898.
\textsuperscript{284} Id.
\textsuperscript{285} Id.
\textsuperscript{286} Id. at 899, n. 46.
\textsuperscript{287} Id. at 902.
\textsuperscript{288} Id. at 904-907.
\textsuperscript{289} Id.
This applies whenever the contracting private party has not yet received the benefit of its bargain, that is, to be made whole, damages need be awarded.

VI. PROSPECTIVE IMPAIRMENT AND THE CONTRACT CLAUSE

The contract alleged to be impaired pursuant to the Contract Clause in *Maryland State Teachers Assoc. v. Hughes* is “one dealing with the level of compensation to be paid State employees and teachers for their services to the State. Such a contract is not one as to which one legislature can bind subsequent legislatures for work to be performed…in the future.”

The legislature was free to alter its contracts with the state employees regarding future performance and required adjustments in the amount of contributions required for the maintenance of the pensions plan as long as the changes did not start retroactively.

Quite clearly the rule applicable to a contract between the state and a private party including employees is different from the rule applicable to legislation that impairs contracts between private parties. In the former, the private party is entitled to the benefit of the bargain based on that party’s consideration to the point of alteration. In the second situation, as long as the state acts pursuant to its reserved powers (inherent police powers), the effect on private parties does not implicate the Contract Clause and damages are not compensable by the state.

In *Buffalo Teachers Federation v. Tobe* the plaintiffs claimed that the imposition of a wage freeze violated the Contract and Takings Clauses. In rejecting this claim, the Second Circuit found that the wage freeze was imposed due to a financial crisis, was temporary and

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290 Id. at 908-909 (quoting *Hughes Communications Galaxy, Inc. v. United States*, 998 F.2d 953, 958–959 (C.A.Fed.1993)).
292 Id. at 1362 (emphasis added)(citing *Newton v. Commissioners*, 100 U.S. 548, 559 (1879)(under the police power a state may “increase or diminish the salary or change the mode of compensation”); *Butler v. Pennsylvania*, 10 How. 402, 416 (1851)(regulation of compensation is part of the “class of powers and obligations by which governments are enabled, and are called upon, to foster and promote the general good; functions, therefore, which governments cannot be presumed to have surrendered….”)).
293 Id. at 1364-65.
294 464 F.3d 362 (2nd Cir. 2006)
crucially did not affect wages for which services had already been rendered. Citing *Allied Structural Steel Co. v. Spannaus*, the Second Circuit held that the Contract Clause does not trump the police power of a state to protect the general welfare of its citizens, after agreeing that the wage freeze constituted a substantial impairment in that the reasonable expectations of the teachers were disrupted. However, Buffalo had a “legitimate public purpose” since it “[continued] to suffer, a fiscal crisis.”

“[The] prospective and temporary quality of the wage freeze [convinced the court] of its reasonableness.” In addition, other options had been tried (layoffs) and were potentially more Draconian (suspend essential services, raise taxes).

In *Pendergraph v. North Carolina Dept. of Revenue* plaintiffs allege “that a contractual relationship was formed between themselves and the State when Plaintiffs began their employment; and therefore, the State's post-hiring attempt to change the taxability terms of Plaintiffs' retirement benefits is an unconstitutional impairment of contract and deprivation of property without due process of law.” The court pointed out that in North Carolina employees with vested rights in the retirement system have a contractual relationship with the state. Since vesting did not occur until after the complained of law changed, there could be no contract impairment.

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296 Buffalo Teachers Federation, 464 F.3d at 367.
297 Id.
298 Id. at 368; In accord, *In re Subway-Surface Supervisors Ass’n v. New York City Transit Auth. (Subway-Surface)*, 44 N.Y.2d 101, 112-14 (1978)(statute freezing municipal wages held to be constitutional given fiscal emergency afflicting New York City).
299 Buffalo Teachers Federation, 464 F.3d at 372.
300 Id.
302 Id. at 2.
303 Id. at 3.
304 Id.
In *Spannaus*\(^{305}\) the Court considered the effect of Minnesota’s Private Pension Benefits Protection Act.\(^{306}\) It found that the law effected a substantial impairment by increasing the obligation of the plaintiff/employer retroactively\(^{307}\) without a showing that the “severe disruption of contractual obligations [of the employer] was necessary to meet an important general societal problem.”\(^{308}\)

The Court then pointed out that

This Minnesota law simply does not possess the attributes of those state laws that in the past have survived challenge under the Contract Clause of the Constitution. The law was not even purportedly enacted to deal with a broad, generalized economic or social problem. Cf. *Home Building & Loan Assn. v. Blaisdell*, 290 U.S., at 445, 54 S.Ct., at 242. It did not operate in an area already subject to state regulation at the time the company’s contractual obligations were originally undertaken, but invaded an area never before subject to regulation by the State. Cf. *Veix v. Sixth Ward Building & Loan Assn.*, 310 U.S. 32, 38, 60 S.Ct. 792, 794, 84 L.Ed. 1061. It did not effect simply a temporary alteration of the contractual relationships of those within its coverage, but worked a severe, permanent, and immediate change in those relationships—irrevocably and retroactively. Cf. *United States Trust Co. v. New Jersey*, 431 U.S., at 22, 97 S.Ct., at 1517. And its narrow aim was leveled, not at every Minnesota employer, not even at every Minnesota employer who left the State, but only at those who had in the past been sufficiently enlightened as voluntarily to agree to establish pension plans for their employees.\(^{309}\)

In short, the Minnesota law acted retroactively, was not in response to an emergency, had unexpected severe economic consequences, and seemed directed at a narrow class for political reasons.

In *American Express Travel Related Services Co., Inc. v. Kentucky*\(^{310}\) Kentucky reduced the presumptive abandonment of travelers checks that were unused by customers from 15 to 7 years whereupon American Express was to escheat the funds represented in un-cashed checks to

\(^{305}\) *Supra note* 295.

\(^{306}\) *Spannaus*, 438 U.S. at 246.

\(^{307}\) *Id.* at 247.

\(^{308}\) *Id.*

\(^{309}\) *Id.*

\(^{310}\) 641 F.3d 685 (6th Cir. 2011).
In applying the rationale basis test to the plaintiff’s due process claim, the Sixth Circuit quoted *United States v. Carolene Products Company* wherein the Court stated “regulatory legislation affecting ordinary commercial transactions is not to be pronounced unconstitutional unless in the light of the facts made known or generally assumed it is of such a character as to preclude the assumption that it rests upon some rational basis within the knowledge and experience of the legislators.” Since Kentucky’s purpose in passing this legislation was to raise revenue by seizing abandoned property, its action passed constitutional muster. Under the rationale basis test, American Express needed to negate “every conceivable basis which might support [Kentucky’s] change of law.” This it could not do. The court did not reach Contract Clause and Takings Clause challenges to the Kentucky legislations.

VII. CONCLUSION

As set forth in the opening paragraph, many states are insolvent or close to insolvency with substantial budget deficits which are not likely to be covered by increasing tax revenues. According to a recently published study, the United States is experiencing negative job growth and without job growth both consumer spending and tax revenue are likely to remain depressed. Without increasing revenues, States cannot meet their obligations, particularly the obligations to

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311 *Id.* at 687.
312 304 U.S. 144 (1938).
313 *Id.* at 689; *See also, American Express Travel Services*, 641 F.3d at 691 (quoting *Williamson v. Lee Optical of Okla., Inc.*, 348 U.S. 483, 488 (1955)(“The day is gone when this Court uses the Due Process Clause of the Fourteenth Amendment to strike down state laws, regulatory of business and industrial conditions, because they may be unwise, improvident, or out of harmony with a particular school of thought.”)).
314 *American Express Travel Services*, 641 F.3d at 693.
315 *Id.* at 694.
316 *Id.* at 694-95.
their public sector employees. As pointed out in an article by Ryan Preston Dahl\footnote{318} dealing with municipal bankruptcies, “[p]ublic sector unions have successfully obtained comparatively generous compensation and benefits packages even as the fortunes of American labor have continued to decline. In particular, municipal pensions may jeopardize the fiscal survival of many public sector employers.”\footnote{319} The states being without the option of Chapter 9 of the Bankruptcy Code must rely on their inherent police powers.

The basis for a state’s invalidation of a contract may be summarized as follows:

1. If state legislation impairs a contract between private parties, the state is not liable if the legislation is of general application and is within the inherent power of the state. The inherent power is based on a reaction to an emergency, or law protecting health or welfare, the exercise of eminent domain or right or promulgation of a regulation known to the private parties when they contracted. If an emergency, the legislation must be a reasonable reaction to it, must not be effective beyond the emergency, and may implicitly be limited to an impairment of the remedy without a direct effect on the underlying obligation if such underlying obligation involves a property interest other than a contract right standing alone. In none of the circumstances would an alleged aggrieved part be entitled to compensation from the state although if the impairment was of vested property rights, the state may have to provide an alternative remedy.

2. If the state impairs its own contract with a private party it can do so without invalidating the legislation or regulation if the law is of general application. A private party would be entitled to compensation if the state is exercising its eminent domain authority, or if the private party has fully performed its part of the bargain. A state may impair its collective bargaining agreements with prospective modifications only without compensation. If the impairment has a retroactive


\footnote{319} \textit{Id.} at 296-97.
effect, it would seem that the rights-remedies dichotomy might apply with the state providing an alternative remedy or money damages or even invalidating the law itself. This later situation would most generally apply as a result of an emergency.

The courts increasingly defer to a state’s judgment of what constitutes an emergency and what is necessary for the public welfare effectively limiting the reach of the Contract Clause to protect liberty of contract and the free market. Rather, a reliance on the Due Process Clause allows courts to award compensation without impeding the growth of the regulatory state and without having to consider the Contract Clause at all. And even if the legislation is directed at a distinct class such as public employees, it is to be upheld as long as the public at large is the beneficiary. For example, compliance with a state’s constitutional requirement to balance its budget and a state’s attempt to avoid insolvency are legitimate ends.

Based upon the forgoing analysis, there are virtually no limits on the state’s exercise of its police powers to impair contracts including those with public employee unions if the public welfare rationale can pass the low level scrutiny the courts give it. For public employees and others who may be similarly situated there is little recourse outside the political arena for protection of their future economic expectations based upon previously negotiated agreements.