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United States Trust Company of New York v. New Jersey—The Contract Clause in a Complex Society

Robert A. McTamaney

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Cover Page Footnote

Member, New York and New Jersey Bars. The author is associated with counsel for plaintiff in United States Trust.

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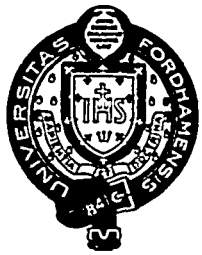

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UNITED STATES TRUST COMPANY OF NEW YORK V. NEW JERSEY

THE CONTRACT CLAUSE IN A COMPLEX SOCIETY

*ROBERT A. McTAMANEY**

I. INTRODUCTION

THE contract clause of our Federal Constitution[1] prompts thoughts of *Dartmouth College,*[2] corporate charters with helpful grandfather provisions,[3] and the Supreme Court cases in the 1930's which invalidated President Roosevelt's economic legislation through a literalistic application of a "freedom of contract" under the due process clauses.[4] To business lawyers dealing specifically with municipal bond finance, the contract clause has had an importance basic to their practice in that it traditionally has been considered to protect promises to creditors by governments, muncipal subdivisions, and public authorities against abrogation by subsequent legislative bodies. This tenet of municipal finance has been such a foundation of this area of the law that few if any practitioners seriously questioned its application.

On April 27, 1977, the United States Supreme Court, in *United States Trust Company of New York v. New Jersey*,[5] considered the application of the contract clause to municipal bond covenants for the first time in almost thirty-five years.[6] *United States Trust* prompted an unparalleled interest in the municipal finance community, and the Court's holding that

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* Member, New York and New Jersey Bars. The author is associated with counsel for plaintiff in *United States Trust.*

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

2. Trustees of Dartmouth College v. Woodward, 17 U.S. (4 Wheat.) 518 (1819).

3. *See* H. Henn, Handbook of the Law of Corporations and Other Business Enterprises § 340 (2d ed. 1970).

4. *See* 1 The Constitution and the Supreme Court 298-300 (L. Pollak ed. 1966).

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

6. *See* Faitoute Iron & Steel Co. v. City of Asbury Park, 316 U.S. 502 (1942). State Courts had considered the application of the contract clause to municipal bond covenants prior to *United States Trust. E.g.,* First Nat'l Bank v. Maine Turnpike Auth., 153 Me. 131, 136 A.2d 699 (1957). *See generally* Flushing Nat'l Bank v. Municipal Assistance Corp., 40 N.Y.2d 731, 358 N.E.2d 848, 390 N.Y.S.2d 22 (1976); Ruano v. Spellman, 81 Wash. 2d 820, 505 P.2d 447 (1973) (en banc). At least one state court has since cited it with approval. *See, e.g.,* Patterson v. Carey, 41 N.Y.2d 714, 363 N.E.2d 1146, 395 N.Y.S.2d 411 (1977).

a unilateral retroactive cancellation of a material bond covenant contravened the contract clause was hailed by municipal investors and obligors alike.[7] This article will detail the fascinating history of *United States Trust* (from the point of view of counsel for plaintiff) and its trip through the courts and consider the modern relevance and application of the contract clause to a society two centuries more complex than the one in which it was conceived.

II. BACKGROUND

A. *The Port Authority of New York and New Jersey*

In 1917 the States of New York and New Jersey established study commissions to cooperate in making a thorough investigation of the conditions of the Port of New York, to submit a comprehensive report recommending the proper policy to be pursued for the development of the Port, and to determine what legislation was necessary "to the end that said port shall be efficiently and constructively organized and furnished with modern methods of piers, rail and water and freight facilities, and adequately protected in the event of war."[8] The two state commissions then organized themselves into the New York, New Jersey Port and Harbor Development Commission (the "Commission") and on December 16, 1920, issued a joint report (the "1920 Report")[9] summarizing its work, discussing Port conditions, and setting forth a proposed compact and comprehensive plan.

The 1920 Report outlined the chaotic, diverse, inadequate, and congested Port facilities existing in 1920 restricting the flow of goods by railroad, steamship, and motor truck in the Port area. Freight handling problems of carriers were discussed extensively as were recommended proposed solutions to the problems involved in the movement of freight and commodities brought into, out of, and through the Port District. Nevertheless, the 1920 Report did not deal with plans for passenger transportation facilities.

The 1920 Report advocated the adoption of a compact between the two states, establishing a Port District and creating a Port Authority. It included an extensive discussion of the legal precedents concerning congressional and state powers over interstate commerce and concluded: "It is hoped, of course, by securing congressional approval of any plan which may be adopted, to avoid future conflict with the Federal authority

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7. *E.g.*, Wall St. J., Apr. 29, 1977, at 12, col. 1; American Banker, Apr. 28, 1977, at 1, col. 3; Daily News, Apr. 28, 1977, at 3, col. 1.

8. Ch. 130, 1917 N.J. Laws; *accord*, ch. 426, 1917 N.Y. Laws (substantially the same).

9. N.Y., N.J. Port & Harbor Dev. Comm'n, Joint Report with Comprehensive Plan and Recommendations (Dec. 16, 1920).

over interstate unification and control of the Port. But for the present the States *may* act alone."[10]

In response to the recommendations of the 1920 Commission, commissioners of both states were appointed with authorization to enter into an agreement or compact in the form specified in the statute and to seek the consent of Congress in respect of the agreement.[11] On April 30, 1921, the Compact between the two states (the "Compact") relating to the Port Authority of New York and New Jersey (the "Port Authority")[12] was actually signed.[13] Congressional consent to "each and every part and article" of the Compact was obtained effective August 23, 1921.[14]

Certain provisions of the Compact were to be of importance in *United States Trust,* particularly those which emphasized the character of the new agency as an independently financed entity without call on the tax power or credit of either state. The preamble of the Compact stated that "[t]he future development of such terminal, transportation and other facilities of commerce will require the expenditure of large sums of money, and the cordial cooperation of the states of New York and New Jersey in the encouragement of the investment of capital, and in the formulation and execution of the necessary physical plans . . . ."[15] Article II of the Compact created the Port of New York District comprising an area of about 1500 square miles in both states centering about the Statue of Liberty in New York harbor.[16] Article III established the Port Authority as "a body corporate and politic, having the powers and jurisdiction hereinafter enumerated, and such other and additional powers as shall be conferred upon it by the legislature of either state concurred in by the legislature of the other, or by act or acts of congress . . . ."[17] Article VI of the Compact vested in the Port Authority "full power and authority to purchase, construct, lease and/or operate any terminal or transportation facility within" the Port District and authorized the Port Authority "to borrow money and secure the same by bonds or by mortgages

10. *Id.* at 446.

11. Ch. 151, 1921 N.J. Laws; ch. 154, 1921 N.Y. Laws.

12. Originally named "The Port of New York Authority," the agency's name was changed to "The Port Authority of New York and New Jersey" effective July 1, 1972. Ch. 69, 1972 N.J. Laws; ch. 531, 1972 N.Y. Laws.

13. N.J. Stat. Ann. §§ 32:1-1 to 24 (West 1963); N.Y. Unconsol. Laws §§ 6401-6423 (McKinney 1961).

14. Pub. Res. No. 17, 42 Stat. 174, 180 (1921).

15. N.J. Stat. Ann. § 32:1-1 (West 1963); *accord,* N.Y. Unconsol. Laws § 6401 (McKinney 1961) (substantially the same).

16. N.J. Stat. Ann. § 32:1-3 (West 1963); N.Y. Unconsol. Laws § 6403 (McKinney 1961).

17. N.J. Stat. Ann. § 32:1-4 (West 1963); N.Y. Unconsol. Laws § 6404 (McKinney 1961).

. . . ."[18] Article VII provided that the Port Authority "shall have such additional powers and duties as may hereafter be delegated to or imposed upon it from time to time by the action of the legislature of either state concurred in by the legislature of the other" and further provided: "The port authority shall not pledge the credit of either state except by and with the authority of the legislature thereof."[19] Article XV of the Compact provided that "[u]nless and until . . . revenues . . . are adequate to meet all expenditures, the legislatures . . . shall appropriate . . . such sum or sums as shall be recommended by the port authority . . . but each state obligates itself hereunder only to the extent of one hundred thousand dollars in any one year."[20]

In 1922 a Comprehensive Plan for the development of the Port of New York was adopted by the New Jersey and New York legislatures[21] and received the consent of Congress.[22] The Comprehensive Plan set forth the development program initially envisioned for implementation by the Port Authority. Unification of terminals, consolidation of shipments, adaptation and coordination of existing facilities, improvement of commercial facilities, and other freight handling improvements were set forth as principles to govern the development of the Port District. The Comprehensive Plan proposed to establish direct freight connections between New Jersey and Manhattan to furnish "the most expeditious, economical and practicable transportation of freight, especially meat, produce, milk and other commodities comprising the daily needs of the people."[23] Section 8 of the Comprehensive Plan denied the Authority the power to levy taxes or assessments. It provided, however, that the bonds or other securities issued by the Port Authority would "at all times be free from taxation by either state,"[24] an important inducement for potential investors.

Pursuant to the Compact, Comprehensive Plan, and subsequent amendments and supplements thereto, the Port Authority operates all of the interstate vehicular tunnels and bridges in the Port District, the metropolitan area's three international airports, and many freight, marine and bus terminals. The Port Authority also owns and operates

18. N.J. Stat. Ann. § 32:1-7 (West 1963); N.Y. Unconsol. Laws § 6407 (McKinney 1961).
19. N.J. Stat. Ann. § 32:1-8 (West 1963); N.Y. Unconsol. Laws § 6408 (McKinney 1961).
20. N.J. Stat. Ann. § 32:1-16 (West 1963); N.Y. Unconsol. Laws § 6416 (McKinney 1961). The states paid the expenses of the Port Authority through 1934; not until 1935 did the Port Authority become self-supporting.
21. Ch. 9, 1922 N.J. Laws; ch. 43, 1922 N.Y. Laws.
22. Pub. Res. No. 66, 42 Stat. 822 (1922).
23. N.J. Stat. Ann. § 32:1-29 (West 1963); N.Y. Unconsol. Laws § 6455 (McKinney 1961).
24. N.J. Stat. Ann. § 32:1-33 (West 1963); N.Y. Unconsol. Laws § 6459 (McKinney 1961).

the Port Authority Trans-Hudson system ("PATH") and the World Trade Center.[25]

B. *Port Authority Participation in Rail Transit Prior to 1962*

The modern vision of the Port Authority as an agency intended since its inception to assume passenger transit duties[26] does not survive historical analysis. Throughout the first forty years of the agency's existence, the states made various efforts to solve the passenger transit problem without reference to the Port Authority. As early as 1921 New York created a commission to prepare "a preliminary plan and report, including estimates, for the combination, improvement and extension of existing rapid transit railroads, street surface railroads, and . . . omnibus lines and any railroad used for local service, operating between a point or points within the city of New York and a point or points within the county of Westchester."[27]

In 1922 New Jersey established a commission to study and report upon plans for providing a comprehensive scheme of rapid transit between various communities in northern New Jersey and the City of New York. The legislation which established the commission acknowledged that the Port Authority's Comprehensive Plan "in its consideration of transportation problems does not include the problem of passenger traffic in the territory covered by said port development plan . . . ."[28]

In 1926, the New Jersey Legislature continued the existence of the North Jersey Transit Commission and authorized this body to negotiate and study in cooperation with New York authorities the legal, financial and interstate aspects of a rapid transit plan.[29] On February 20, 1928, the North Jersey Transit Commission issued its 1927 report to the New Jersey Legislature. The Commission stated: "[G]rave questions arise whether [the Port Authority], already charged with the important work of coordinating freight operations of the Port

25. [1976] Port Auth. of N.Y. & N.J. Ann. Rep. The Holland Tunnel was constructed by separate state commissions pursuant to a compact between the states which received the consent of Congress. Chs. 49, 50, 1918 N.J. Laws; ch. 178, 1919 N.Y. Laws. In 1930 the Holland Tunnel was transferred to the Port Authority to enable it to honor its obligations to bondholders in the face of deficits incurred in connection with the Arthur Kill, George Washington, and Bayonne Bridges and Inland Terminal No. 1. Ch. 247, 1930 N.J. Laws; ch. 421, 1930 N.Y. Laws.

26. *See* United States Trust Co. v. State, 69 N.J. 253, 265-66; 353 A.2d 514, 520-21 (1976) (Pashman, J., concurring in part and dissenting in part), *rev'd*, 431 U.S. 1 (1977).

27. Ch. 591, 1921 N.Y. Laws.

28. Ch. 104, 1922 N.J. Laws.

29. Ch. 157, 1926 N.J. Laws.

District and in addition with the detailed labor of financing and constructing no less than four interstate bridges, can bring to the study of the passenger transit situation the requisite time and attention."[30] With respect to the financing of the proposed rapid transit system, the Commission recommended public financing backed by the full faith and credit of the transit district coupled with a benefits assessment for local improvements.[31]

In 1927 the New Jersey Legislature, purportedly acting "[u]nder and pursuant to the provisions of the [Port Authority] compact," authorized and directed the Port Authority "to make such plans . . . as will provide adequate interstate and suburban transportation facilities for passengers traveling to and from one State to the other within the said district, and from one part of the said district to another, sometimes referred to as commuter or suburban passenger traffic. . . ."[32] The Port Authority was also directed to "submit, as part of its report, a legal plan for the financing of the said improvements through the Port of New York Authority as the corporate municipal instrumentality of the two States or otherwise . . . ."[33] This legislation was signed by Governor Moore of New Jersey and was approved in 1928 by the New York Legislature but was vetoed by Governor Alfred E. Smith, who said in support of his veto: "I am entirely unwilling to give my approval to any measure which at the expense of the solution of the great freight distribution problem will set the Port Authority off on an entirely new line of problem connected with the solution of the suburban passenger problem."[34]

As was later found by the trial court, despite repeated studies,[35] the Smith veto "to all intents and purposes ended any legislative effort to involve the Port Authority in an active role in commuter transit for the next 30 years."[36]

In the 1958 session of the New Jersey State Legislature, Assembly Bill No. 16 was introduced which provided that the Port Authority would take over and financially develop, improve, and operate interstate passenger rail transportation between New Jersey and New

30. North Jersey Transit Comm'n Ann. Rep. 5 (1927).

31. *Id.*

32. Ch. 277, 1927 N.J. Laws.

33. *Id.*

34. N.Y. State, Public Papers of Alfred E. Smith 188 (1938).

35. The studies are summarized in Stipulation at 1-15, United States Trust Co. v. State, 134 N.J. Super. 124, 338 A.2d 833 (L. Div. 1975), *aff'd per curiam*, 69 N.J. 253, 353 A.2d 514 (1976), *rev'd*, 431 U.S. 1 (1977) [hereinafter cited as Stipulation].

36. United States Trust Co. v. State, 134 N.J. Super. 124, 149, 338 A.2d 833, 846 (L. Div. 1975), *aff'd*, 69 N.J. 253, 353 A.2d 514 (1976), *rev'd*, 431 U.S. 1 (1977).

York. In response to this bill, the Port Authority submitted a statement by its Commissioners on November 24, 1958, which argued that prospective investors

> would conclude that the subsidized Port Authority operation was only a first step in a process of involvement, and that an attempt to divert the reserves and revenues of the Authority would be certain to follow. No investment counsellor who has heretofore advised his clients to purchase Port Authority bonds on the basis of its record of self-support could so counsel them again in the face of this threat.[37]

This summary was made with reference to the statement by the Commissioners of the Port of New York Authority dated November 24, 1958, which said in part:

> Obviously, [the] market analysts would regard any Port Authority involvement in rapid transit as a financial disaster. If the Port Authority can be compelled to assume a deficit operation of any sort, even one not approaching the rail transit deficit in size, investors would have a right to assume that the Authority was becoming the dumping ground for deficit operations of all types. The Authority's credit could not survive such a breach of its investors' present confidence that the Port Authority will restrict its operations to facilities which it believes can eventually be made self-supporting. The importance of this lies in the fact that it transcends arguments as to the size of the present transit deficit. To investors it would make no difference whether the proposal was to force a $2,000,000 or a $12,000,000 or a $20,000,000 annual deficit on the Port Authority. Confidence is the essence of credit and it would be gone.[38]

In 1959, with congressional consent,[39] the states of New Jersey and New York entered into a compact which created the New York-New Jersey Transportation Agency to "serve as a public agency of the states of New York and New Jersey dealing with matters affecting public mass transit within and between the two states."[40] This seemed to acknowledge once again that no extant agency such as the Port Authority had that responsibility.

In the same year the legislatures of the two states provided that "[u]pon the election by either State . . . the Port Authority shall be authorized and empowered" to purchase and own railroad cars for the purpose of leasing them to commuter railroads within the electing state.[41] The statutes expressly prohibited the Authority from borrowing money for the purchase of such cars until the electing state

37. Letter from Port of New York Authority to Hon. Martin Kesselhaut & Hon. J. Edward Crabiel (Nov. 24, 1958).

38. Port of N.Y. Auth., Statement by Commissioners of the Port of New York Authority with Respect to Assembly No. 16 Before the Committee on Federal and Interstate Relations and Committee on Highways, Transportation and Public Utilities of the House of Assembly of the State of New Jersey 4, 9-10 (Nov. 24, 1958).

39. Ch. 13, 1959 N.J. Laws; ch. 420, 1959 N.Y. Laws.

40. Ch. 420, 1959 N.Y. Laws; *accord,* ch. 13, 1959 N.J. Laws (substantially the same).

41. Ch. 25, 1959 N.J. Laws; ch. 638, 1959 N.Y. Laws.

guaranteed payment of both principal and interest on the obligations issued for that purpose.[42]

New York immediately chose to have the Port Authority proceed on its behalf to purchase railroad cars for lease to its commuter railroads.[43] The Port Authority has presently outstanding over $90 million in New York State-guaranteed railroad car bonds and has purchased for lease to commuter railroads within the state 467 air-conditioned passenger cars and 8 locomotives.[44] The State of New Jersey has not taken legislative action to participate in this commuter car program, which involved the Port Authority in the mass transit problems of the Port District without any adverse effect on its credit.

C. *The Port Authority's Financial Structure Prior to 1962*

Port Authority participation in deficit rail mass transit must be viewed against the background of its financial structure as it developed following the 1921 Compact. Under the Compact and Comprehensive Plan the Port Authority was denied the power to levy taxes or to pledge the credit of either state.[45] Thus by definition the Port Authority's financing was self-contained; it was to issue bonds to public investors and pay debt service through revenues from its facilities. As a result the agency historically limited itself to facilities which would, perhaps not immediately, but eventually, be self-supporting and in time contribute net revenues to the Port Authority's overall debt service requirements. Further, it would protect its revenue stream by entering into contractual undertakings with its third-party creditors to establish financial safeguards intended to assure that revenues would continue in amounts sufficient to handle debt service and provide a comfortable cushion.

The Port Authority's modern financial structure has as its foundation the General Reserve Fund statutes of 1930, which provided for the pooling of all surplus revenues from the agency's facilities into a general reserve fund in an amount equal to 10% of par of all outstanding bonds.[46] The General Reserve Fund is pledged as security for the payment of principal and interest on the bonds, and as a result of the pooling provision revenues from one facility could be applied to pay

42. *Id.*
43. Ch. 639, 1959 N.Y. Laws.
44. [1973] Port Auth. of N.Y. & N.J. Ann. Rep. 11, 72.
45. *See* notes 15-19 *supra* and accompanying text.
46. Ch. 5, 1931 N.J. Laws; ch. 48, 1931 N.Y. Laws.

debt service arising from bonds issued to construct or improve another facility.[47]

The next step in the development of the Port Authority's modern financial structure came in 1948, when the Commissioners by resolution promised to retain in reserve amounts equal to at least the next two years' debt service on outstanding Port Authority bonds.[48] In 1952 the Commissioners ended the prior financing practice of setting aside specific facility revenues as security for outstanding bonds. Instead they adopted the Consolidated Bond Resolution which authorized the issuance of consolidated bonds as general Port Authority obligations equally and ratably secured by a pledge of the net revenues of all of the agency's facilities and any additional facilities financed in whole or in part by the issuance of consolidated bonds.[49]

The Consolidated Bond Resolution of 1952 contains a number of protections for bondholders which were to be of significance in *United States Trust*. The "1.3 test" contained in section 3 of the Resolution forbids the issuance of new consolidated bonds unless the best 12 months' net revenues (of the preceding 36 months) of all of the Port Authority's facilities equal or are greater than 1.3 times the prospective debt service for the calendar year in the future during which the debt service on all outstanding and the proposed new bonds secured by the General Reserve Fund would be at a maximum.[50]

Beginning with the twelfth series of consolidated bonds the Port Authority included in the Resolutions establishing each series of such bonds a provision which prohibits the use of any consolidated bond reserve funds to pay the operating deficits of a facility acquired unless it is acquired through the issuance of an obligation secured by the General Reserve Fund and the proceeds are used for that additional facility. The second part of section 7 requires a certification by the Commissioners prior to the issuance of consolidated bonds for a new purpose. The Commissioners must certify that the issuance of the bonds would not "materially impair the sound credit standing of the Authority or the investment status of Consolidated Bonds," or the agency's ability to fulfill its commitments to bondholders.[51]

47. D. Goldberg, A History of the Port of New York Authority Financial Structure 3-7 (1964) [hereinafter cited as Goldberg History].

48. Port of N.Y. Auth., Gen. Res. 149 (Nov. 13, 1948).

49. Port of N.Y. Auth., Consolidated Bond Resolution (Oct. 9, 1952), *reprinted in* Port Auth. of N.Y. & N.J., Official Statement, $100,000,000 Consolidated Bonds, Forty-first Series Due 2008 (First Installment) app. v (Oct. 1, 1973) [hereinafter cited as CBR].

50. CBR, *supra* note 49, § 3.

51. *E.g.*, Port Auth. of N.Y. & N.J., Resolution Establishing Forty-first Series of Consolidated Bonds Due 2008, § 7 (Sept. 13, 1973), *reprinted in* Port Auth. of N.Y. & N.J., Official

These financial tests, and their adequacy as protection for bondholders, were to be the subject of dispute during the conduct of *United States Trust*. Whatever their adequacy, the Port Authority's Commissioners and investors found that the provisions of the Consolidated Bond Resolution, designed as protections, and the statutes passed as contracts with bondholders were not adequate protections when it was seriously proposed that the Port Authority involve itself financially in the deficit rail mass transit problems of the Port District. This came with the proposed acquisition of the Hudson and Manhattan Railroad by the Port Authority in 1962.

D. *The Takeover of the Hudson and Manhattan and the Enactment of the 1962 Covenant*

In 1908, the Hudson and Manhattan Railroad Company (the "H&M"), a privately owned concern, began operating a railroad facility between Hoboken and Manhattan. Service between Hudson Terminal and Jersey City commenced in 1909 and the service was extended to Newark in 1911. The railroad was in financial difficulty for many years, and although formal bankruptcy proceedings against it did not commence until 1954, it had been insolvent since the early 1930's.

In 1959 the United States District Court for the Southern District of New York approved a reorganization plan which left the H&M with enough cash to continue operations for two years but without funds to provide needed capital improvements.[52]

By 1960 the financial prospects for rail mass transit operations in the Port District were disastrous. The Pennsylvania, Erie Lackawanna, Reading, and Central of New Jersey Railroads estimated 1960 passenger deficits of $32 million, $8.1 million, $7 million, and $6 million, respectively, and all but the Reading expected overall losses.[53] In 1960 the New York City Transit System had an operating deficit in excess of $20 million, exclusive of annual debt charges of $87 million. The aggregate deficit from commuter operations of the New York Central, New Haven, and Long Island Railroads, and the Staten Island Rapid Transit Railway was estimated at between $10 million and $15 mil-

Statement, $100,000,000 Consolidated Bonds, Forty-first Series Due 2008 (First Installment) app. vi (Oct. 1, 1973) [hereinafter cited as Resolution Establishing Forty-first Series of Consolidated Bonds].

52. *In re* Hudson & Manhattan R.R., 174 F. Supp. 148, 170 (S.D.N.Y. 1959), *aff'd sub nom.* Spitzer v. Stichman, 278 F.2d 402 (2d Cir. 1960).

53. Pub. Hearings Before Senate Comm'n Created Under N.J. Sen. Res. No. 7 (1960) and Reconstituted Under N.J. Sen. Res. No. 7 (1961) to Study the Financial Structure and Operations of the Port of N.Y. Auth. 17-22 (Jan. 26, 1961).

lion for the year. New York City's taxpayers' subsidies of the Staten Island Ferry operations were approximately $6 million.[54] Thus, in 1960, the total of commuter railroad and rail transit deficits in the New York-New Jersey area approached $128 million.

In 1960, the New Jersey Senate created a committee under the chairmanship of Senator Frank S. Farley (the "Farley Committee") to conduct "a full and unlimited investigation" of the Port Authority. The Committee was authorized and directed to study "the entire financial structure and operations" of the Port Authority and to determine "whether or not said Port of New York Authority is fulfilling its statutory duties and obligations."[55] The Farley Committee's Report[56] which, together with the related hearings, constitutes the principal legislative history of the 1962 Covenant, said in part:

COMMUTER RAPID TRANSIT

. . . .

At the September 27 hearing, the Port Authority suggested that:

"The Port Authority might be able to sell bonds for the acquisition and modernization of the Hudson & Manhattan Railroad and continue the financing of the States' vital port development program,

(a) if investors could be given contractual assurance, with statutory protection, that the Port Authority's responsibilities in the field of commuter rail transit would be confined to the present and existing interstate Hudson & Manhattan Railroad system . . . ."

. . . .

During 1961, the New York State Legislature enacted legislation which empowered the Port Authority to proceed with the acquisition, modernization and operation of the Hudson and Manhattan Railroad and coupled in the same bill an authorization for the Authority to undertake the development of a World Trade Center on the east side of lower Manhattan. The bill contained no statutory covenant to protect Port Authority credit against future transit responsibilities which would divert its railroad deficits to revenues and reserves pledged to its bondholders. This legislation proved unacceptable to New Jersey because of the manner in which these two projects were "packaged" in one statute and because the absence of such a statutory covenant, in our judgment, endangered the future utility of the Port Authority to the 2 States. Accordingly, an impasse developed in 1961 between the States of New York and New Jersey on the appropriate form of legislation for these two projects.

This Committee was convinced that the credit problem which had been pointed out by the Port of New York Authority was a valid and real one and that the Port Authority could not assume responsibility for the complete burden of the deficit-ridden commuter railroad problem in the area of northern New Jersey and New York. If the Port Authority were to receive such unrestricted responsibility, there is no question but that its sound credit position would be seriously impared [*sic*], if not destroyed, and it

54. United States Trust Co. v. State, 134 N.J. Super. 124, 150 n.22, 338 A.2d 833, 847 n.22 (L. Div. 1975), *aff'd per curiam*, 69 N.J. 253, 353 A.2d 514 (1976), *rev'd*, 431 U.S. 1 (1977).

55. 1960 N.J. Sen. Res. No. 7; *accord*, 1961 N.J. Sen. Res. No. 7 (substantially the same).

56. Report of Special Investigating Comm. Under S. Res. No. 7, N.J. Sen. (Comm. Print 1961).

would become impossible for the Authority to continue to move forward either with such a rail program or with other vital transportation and terminal facilities and other facilities of commerce desired by the 2 States in continuing the Port Authority's tradition as a public agency.

As a result of lengthy discussions and firm insistence by the New Jersey division of Railroad Transportation that Port Authority operation of the Hudson & Manhattan Railroad must extend beyond the main stem, which was concurred in by New York State conferees, the following program was adopted as acceptable to the States of New York and New Jersey:

. . . .

3. Limiting by a constitutionally-protected statutory covenant with Port Authority bondholders the extent to which the Port Authority revenues and reserves pledged to such bondholders can in the future be applied to the deficits of possible future Port Authority passenger railroad facilities beyond the original Hudson & Manhattan Railroad system . . . .[57]

On February 13, 1962, both houses of the legislature passed this bill by unanimous votes (with one abstention in each house) and Governor Hughes signed the bill on the same day. Soon thereafter New York enacted the same legislation. This legislation, which authorized the Port Authority to construct the World Trade Center and to take over the Hudson & Manhattan Railroad as a unified project, contained as an integral part the Covenant limiting the agency's future involvement in deficit rail mass transit:

> The 2 States covenant and agree with each other and with the holders of any affected bonds, as hereinafter defined, that so long as any of such bonds remain outstanding and unpaid and the holders thereof shall not have given their consent as provided in their contract with the port authority, . . . (b) neither the States nor the port authority nor any subsidiary corporation incorporated for any of the purposes of this act will apply any of the rentals, tolls, fares, fees, charges, revenues or reserves, which have been or shall be pledged in whole or in part as security for such bonds, for any railroad purposes whatsoever other than permitted purposes hereinafter set forth.[58]

"Affected bonds" were defined by the 1962 Covenant to include in effect all Port Authority consolidated bonds.[59] "Permitted purposes" were defined to include (i) the H&M as authorized and limited on the effective date of the Covenant, (ii) railroad freight transportation or terminal facilities, (iii) railroad tracks and facilities on vehicular

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57. *Id.* at 21, 23-26.

58. N.J. Stat. Ann. § 32:1-35.55 (West 1963); *accord,* N.Y. Unconsol. Laws § 6606 (McKinney 1961) (substantially the same). Governor Rockefeller's statement issued in connection with this legislation provided in part: "To preserve the Port Authority's credit strength the bill includes a covenant by the two States that additional deficit financing of future railroad projects will only be undertaken within the financial limits set forth in their covenant." 1962 N.Y. Legis. Ann. 324.

59. N.J. Stat. Ann. §§ 32:1-35.55 (West 1963).

bridges owned by the Port Authority, and (iv) any other railroad facility acquired or constructed by the Port Authority (including but not limited to H&M extensions) regarding which the Port Authority made the appropriate certifications. The Port Authority was to certify either that the facility was self-supporting or, if not, that the General Reserve Fund at the end of the preceding calendar year was at its statutory level (1/10 of the par value of outstanding bonds) and that the new rail facility and all other rail facilities would not produce deficits in excess of "permitted deficits."[60]

With respect to this fourth permitted purpose a passenger railroad facility would be "self-supporting" if the estimated average annual net income for the next ten years (without deducting debt service) "derived from or incidental to such facility equals or exceeds the amount estimated by the port authority for such 10 years to be the average annual debt service upon bonds for purposes in connection with such proposed facility."[61] In other words, the facility's income would have to carry its debt service.

If a passenger railroad facility (other than the H&M, as defined in the statute, or a facility situated upon a vehicular bridge owned by the Port Authority) was not "self-supporting," then none of the revenues or reserves of the Port Authority could be used for that railroad beyond the "permitted deficits" of the facility. "Permitted deficits" were defined to mean that the total estimated deficit (after including estimated debt service) for "the ensuing 10 years" as certified in writing by the governors of the two states, of the H&M as authorized and existing at the time of the 1962 legislation, and of any additional non-self-supporting passenger railroad facility could not exceed one-tenth of the General Reserve Fund as of the calendar year prior to the certification.[62]

On September 1, 1962, following enactment of the 1962 Covenant legislation, the Port Authority, through a wholly-owned subsidiary (the Port Authority Trans-Hudson Corporation, or "PATH"), assumed ownership and operation of the H&M.

The Commissioners' section 7 certification[63] made with respect to the acquisition of the H&M was made on the basis of an opinion of A. Gerdes Kuhbach, then Director of Finance of the Port Authority, which was prepared at the request of the Commissioners. His opinion analyzed and reviewed the financial aspects and data relating to the

60. *Id.*
61. *Id.*
62. *Id.*
63. *See* text accompanying note 51 *supra.*

proposed acquisition, rehabilitation, and operation of the PATH system and concluded that the section 7 certification could be made since the anticipated net loss after debt service for the years 1969 through 1991 would level off at approximately $6,575,000 per year, an amount that would not impair the "sound credit rating" of the Port Authority.[64]

Promptly upon the enactment of the legislation embodying the 1962 Covenant it was attacked as unconstitutional on the theory that it required, but did not receive, additional congressional consent. This attack was unsuccessful,[65] but litigation regarding the Covenant did not end there.[66]

The latest challenge to the constitutional validity of the Covenant, *Gaby v. Port Authority,*[67] was still pending at the time the Covenant was retroactively repealed. The plaintiff in *Gaby* alleged that when New Jersey and New York restricted the Port Authority's mass transit duties by enacting the Covenant they in effect concluded a new compact which was void since it did not receive the consent of Congress, and asked that the agency be directed to formulate a mass transit plan.[68] Consideration of *Gaby* was deferred by the New Jersey court when repeal became likely.[69]

E. *Path Operations and Extensions*

PATH losses did not level off at $6,575,000 annually as expected by the Port Authority, the states, and the bondholders.[70] Instead PATH's annual losses by 1973 were almost five times that amount.[71] A principal contributing factor to PATH's increasing deficits was the refusal of the Governors of New Jersey and New York to allow PATH to increase its fares to modern levels. Because of the significant losses incurred by the PATH system because of increased operating costs the Commissioners, in June 1973, voted unanimously to apply to the Interstate Commerce Commission for an increase in the PATH fare

64. Opinion of A. Gerdes Kuhbach, Director of Finance of Port Authority (June 14, 1961) (on file with the Fordham Law Review).

65. *See* Courtesy Sandwich Shop, Inc. v. Port Auth., 12 N.Y.2d 379, 190 N.E.2d 402, 240 N.Y.S.2d 1, *appeal dismissed,* 375 U.S. 78 (1963).

66. *See, e.g.,* Kheel v. Port Auth., 331 F. Supp. 118 (S.D.N.Y. 1971), *aff'd,* 457 F.2d 46 (2d Cir.), *cert. denied,* 409 U.S. 983 (1972).

67. 134 N.J. Super. 124, 338 A.2d 833 (L. Div. 1975), *aff'd per curiam,* 69 N.J. 253, 353 A.2d 514, *appeal dismissed,* 427 U.S. 901 (1976).

68. *Id.*

69. *See* discussion of the ultimate disposition of this case at text accompanying notes 227 to 230 *infra.*

70. *See* Port Auth. Trans-Hudson Corp., Report to Interstate Commerce Commission (1973).

71. *Id.*

from 30 to 50 cents.[72] This fare increase would have been the first one permitted to PATH in 12 years. Although neither Governor exercised his veto over the proposed fare increase, Governor Rockefeller, in September 1973, in return for political support for a 1973 New York transportation bond issue, announced that the fare increase should be limited to five cents.[73] At a meeting of Commissioners some five days after the Rockefeller announcement, all of the New York Commissioners reversed themselves and unanimously voted to limit the increase to five cents. Since, however, the New Jersey Commissioners were not, at that time, subject to the pressures being exerted upon the New York Commissioners, they voted unanimously against limiting the fare increase to five cents.[74] In 1974, however, at the ICC hearing on the proposed 20-cent increase, Commissioner Sagner, an appointee of newly elected Governor Byrne, announced his and Governor Byrne's opposition to the increase. The Commissioners promptly voted to rescind the PATH fare increase request.[75]

While the PATH fare has remained at 30 cents for almost 14 years, an equivalent ride between Newark and Manhattan on the federally subsidized AMTRAK as of 1974 was $1.00, as was the Penn Central fare. By 1973 the total cumulative operating deficit of PATH for a little over 11 years of operation amounted to over $125 million.[76] Furthermore, in contrast to the 1962 estimates of $85 million, Port Authority capital investments in PATH through December 31, 1973, totalled almost $221 million.[77]

Despite these financial problems the PATH system under Port Authority control became a modern and efficient rail mass transit system. PATH carries 70% of all passengers entering New York City from New Jersey by rail.[78]

Governors Cahill and Rockefeller, in April 1970, jointly sought increased Port Authority participation in mass transit and the Governors consequently reached an agreement in November 1972 providing for a PATH extension to Plainfield via Newark Airport,[79] direct rail service for Erie Lackawanna riders into Penn Station in New York,

72. N.Y. Times, Sept. 28, 1973, at 37, col. 4.

73. *Id.*

74. *Id.*

75. N.Y. Times, Feb. 13, 1974, at 43, col. 6; Newark Star-Ledger, Feb. 13, 1974, at 7, col. 2.

76. [1973] Port Auth. of N.Y. & N.J. Ann. Rep. 11.

77. *Id.*

78. [1975] Port Auth. of N.Y. & N.J. Ann. Rep. 13.

79. The 1970 program contemplating a PATH extension to Cranford was amended to extend the line to Plainfield, thus eliminating competition from the Central Railroad of New Jersey and bringing that project financially within the terms of the 1962 Covenant.

and direct rail service from Kennedy Airport to Manhattan. The plan anticipated a Port Authority investment of between $250 and $300 million out of a total projected cost of $650 million. It was also proposed to eliminate the 1962 Covenant with respect to bonds issued after the enactment of that legislation.[80]

In December 1972, the New Jersey Senate held an information session to consider the Governors' proposals. At that session, Port Authority officials stated that the PATH extension to Plainfield via Newark Airport was deemed "doable" on a self-supporting basis. It was therefore within the 1962 Covenant because of an anticipated $150 million in federal grants, $50 million in Port Authority bonds, and a $40 million advancement from the State of New Jersey, which would be repaid by the Port Authority from the project's net operating revenues.[81]

The Governors' 1972 program was enacted into law and the legislation embodying the 1962 Covenant was amended effective May 10, 1973, to repeal the 1962 Covenant with respect to bonds issued *after* the date of the legislation.[82]

It soon became apparent that the 1973 prospective repeal of the Covenant was, for all practical purposes, irrelevant to any plan to expand the Port Authority's participation in deficit rail mass transit beyond the Covenant's formula. This was so because, as we have seen, the Covenant protected all "affected" bonds, which were defined to include, at the least, consolidated bonds[83] issued following the Covenant's enactment and prior to its prospective repeal. The period from 1962 through 1974 represented the most intensive capital finance program in the history of public authorities, and the Port Authority issued almost $1.3 billion in bonds directly protected by the 1962

80. Information Sess. of N.J. Sen. on Assembly Bills 1564 and 1565 (Port Authority Mass Transit Bills), 194th Leg., 2d Sess. 5, 7 (Dec. 11, 1972)

81. *Id.* at 14. On August 10, 1973, the Governor of New Jersey committed the state to advance up to $40,000,000 for New Jersey's share of the capital cost of the PATH Extension Project. This advance would have been repaid to the state through net project revenues after satisfaction of operation, maintenance costs, and debt service charges. Letters from Governor William T. Cahill to James C. Kellogg, Chairman, The Port Authority of New York and New Jersey (Aug. 10, 1973). This commitment was made to enable the Port Authority to construct the PATH extension to Plainfield within the terms of the 1962 Covenant.

82. Chs. 207, 208, 1972 N.J. Laws; ch. 1003, 1972 N.Y. Laws; Port Auth. of N.Y. & N.J., Official Statement, $100,000,000 Consolidated Bonds, Forty-first Series Due 2008 (First Installment) 17 (Oct. 1, 1973). The introductory statement appended to the New Jersey bill said that the bill would prevent the 1962 Covenant from being applied to those who held bonds issued after the Act became effective. It would, however, maintain the rights of those holding bonds issued after March 27, 1962, but before the Act was effective.

83. *See* text accompanying note 59 *supra*.

Covenant.[84] Since these bonds would not mature finally until the year 2007, the Covenant remained in effect notwithstanding its prospective repeal.[85] Between the date of the prospective repeal of the Covenant in May 1973 and its retroactive repeal in June 1974, the Port Authority sold another $200 million of Consolidated Bonds.[86] The last sale was in October 1973, an issue of $100 million with an interest coupon of 5-1/2%.[87] This was to be the Port Authority's last long-term financing for almost three years, since upon the Covenant's retroactive repeal the credit markets were closed to the agency.[88]

III. RETROACTIVE REPEAL AND THE BONDHOLDER LITIGATION

A. *The Repeal Legislation and the Institution of Litigation*

The bill to repeal the 1962 Covenant retroactively was introduced in the New Jersey Legislature on February 15, 1974.[89] In contrast to the extensive hearings, reports, and findings surrounding the passage of the Covenant in 1962 and its prospective repeal in 1973, the repealer in New Jersey was enacted without legislative fact finding, without extensive contemporaneous legislative debate, without public hearings to allow opponents or bondholders to express their positions, without committee reports, and without amendments to the original bill. Some legislative colloquy did take place in New York State, when the sponsor of New York's repealer legislation gave the following clearly erroneous response to a question raised by one legislator as to the wisdom of the repealer:

> MR. STRELZIN: Mr. Farrell, I am under the impression that the New York Port Authority Charter provided that if there was a shortage of funds to make necessary payments to bond holders that money would be supplied by the State of New York on application to the governmental Comptroller. Am I right, sir?
> MR. FARRELL: Both states.[90]

On April 30, 1974, Governor Byrne of New Jersey signed into law

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84. *See* Port Auth. of N.Y. & N.J., Official Statement, $100,000,000 Consolidated Bonds, Forty-first Series Due 2008 (First Installment) 17, 24-25, 52 (Oct. 1, 1973).

85. *Id.* at 16-17.

86. *Id.*; [1976] Port Auth. of N.Y. & N.J. Ann. Rep. 33.

87. *Id.*

88. The next bond issue by the agency was on July 8, 1976, at an interest coupon of 8.20% and a net interest cost to the Port Authority of 8.27%. Daily Bond Buyer, July 9, 1976, at 1, col. 2.

89. A. 1304, 196th N.J. Leg., 1st Sess. (1974).

90. N.Y. Assembly Transcript 6486, 6496 (1974).

that state's legislation retroactively repealing the 1962 Covenant.[91] On the same day the United States Trust Company of New York instituted an action in the Superior Court of New Jersey, Law Division, for a declaratory judgment that the New Jersey repeal legislation was unconstitutional. Counsel for United States Trust instituted the suit in that court with the intention that it would be referred to Judge George Gelman, who had been hearing the *Gaby* case, discussed above,[92] and had deferred action on that case pending a resolution of the pressures for a retroactive repeal of the Covenant.

United States Trust's complaint was brought in three capacities: as trustee for the fortieth and forty-first series of Port Authority consolidated bonds, on its own behalf, and as a class representative of all holders of consolidated bonds of the Port Authority.[93] As of July 13, 1974, the Trust Company held approximately $96,780,000 principal amount of the Port Authority's consolidated bonds of the approximately $1,600,000,000 total amount of such bonds then outstanding. The bonds held by United States Trust were held for its own account and in its several fiduciary capacities, including its capacity as trustee or investment manager for hundreds of individual accounts.[94]

As discussed above,[95] concurring bi-state legislation was necessary to repeal the 1962 Covenant. United States Trust's action in New Jersey was begun on the day that state's repeal legislation was signed, on the theory that even one state's retroactive repeal of the Covenant damaged the secondary market for Port Authority bonds.[96]

Efforts by the financial community to convince Governor Wilson not to sign New York's repealer were unsuccessful, and on June 15, 1974, the last day on which he could approve the bill, at one minute before midnight,[97] Governor Wilson signed New York's repeal legislation, issuing as he did so a remarkable statement:

> It is with great reluctance that I approve a bill that overturns a solemn pledge of the State. I take this extraordinary step only because it will lead to an end of the existing controversy over the validity of the statutory covenant, a controversy that can only

91. Ch. 25, 1974 N.J. Laws.

92. *See* text accompanying note 67 *supra*.

93. Complaint ¶¶ 1, 5, 7, United States Trust Co. v. State, 134 N.J. Super. 124, 338 A.2d 833 (L. Div. 1975), *aff'd per curiam*, 69 N.J. 253, 353 A.2d 514 (1976), *rev'd*, 431 U.S. 1 (1977) [hereinafter cited as Complaint].

94. Affidavit in Support of Motion for Direct Certification and Expedition, by J. Sinclair Armstrong ¶ 4 (May 16, 1975), United States Trust Co. v. State, 134 N.J. Super. 124, 338 A.2d 833 (L. Div. 1975), *aff'd per curiam*, 69 N.J. 253, 353 A.2d 514 (1976), *rev'd*, 431 U.S. 1 (1977) [hereinafter cited as Affidavit by J. Sinclair Armstrong].

95. *See* text accompanying note 15 *supra*.

96. Complaint, *supra* note 93, ¶ 30.

97. N.Y. Daily News, June 17, 1974, at 3, col. 1.

have an adverse effect upon the administration and financing of the Port Authority, and because it will lead to a speedy resolution by the courts of the questions and issues concerning the validity of the statutory covenant. Because it is the province of the courts to decide questions of constitutionality, I will not prevent the covenant issue from being brought before them, especially where it is the unanimously expressed desire of the members of both houses of the New York State Legislature as well as the expressed will of the Governor and both houses of the Legislature of the State of New Jersey to do so.[98]

On June 17, 1974, the next business day following Governor Wilson's approval of the New York repealer, United States Trust instituted litigation in New York seeking a declaration that that state's repeal violated the federal contract and due process clauses and the New York due process clause.[99]

The existence of parallel lawsuits in both states prompted an almost immediate problem of whether to press one action over the other or to prosecute both cases simultaneously. In light of Judge Gelman's familiarity with the complexities of the Port Authority's financial structure through the *Gaby* case and upon consideration of the New Jersey cases which had considered impairment of bond contracts,[100] it was determined to press the New Jersey litigation while holding the New York case in readiness to be activated when and if necessary.

The New Jersey defendants answered the United States Trust complaint on July 15, 1974, denying that the 1974 legislation constituted an unconstitutional impairment of contract or taking of property and raising several affirmative defenses. Defendants also counterclaimed for a declaratory judgment that the 1974 legislation was in all respects valid and constitutional.[101]

United States Trust answered the counterclaim on August 2, 1974, and denied the substantive allegations of the defendants' affirmative defenses and counterclaims and set up affirmative defenses, based on estoppel, laches, and waiver, to the state's challenge to the validity of the 1962 Covenant.[102]

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98. Governor's Message on Bills Approved, 1974 N.Y. Legis. Ann. 416.

99. United States Trust Co. v. State, Index No. 09128/74 (Sup. Ct. N.Y. Cty., June 17, 1974).

100. *E.g.*, New Jersey Sports & Exposition Auth. v. McCrane, 61 N.J. 1, 292 A.2d 545, *appeal dismissed sub nom.* Borough of East Rutherford v. New Jersey Sports & Exposition Auth., 409 U.S. 943 (1972); New Jersey Highway Auth. v. Sills, 109 N.J. Super. 424, 263 A.2d 498 (Ch. Div.), *supplemented,* 111 N.J. Super. 313, 268 A.2d 308 (Ch. Div. 1970), *aff'd per curiam,* 58 N.J. 432, 278 A.2d 489 (1971).

101. Answer and Counterclaim (July 15, 1974), United States Trust Co. v. State, 134 N.J. Super. 124, 338 A.2d 833 (L. Div. 1975), *aff'd per curiam,* 69 N.J. 253, 353 A.2d 514 (1976), *rev'd,* 431 U.S. 1 (1977).

102. Answer to Counterclaim (Aug. 2, 1974), United States Trust Co. v. State, 134 N.J.

On October 24, 1974, the superior court ordered that the United States Trust action could be maintained and defended as a class action under New Jersey Rule 4:32-1(b) (1) and (b) (2) by United States Trust as representative of a class consisting of all holders of all series of consolidated bonds of the Port Authority. It was further ordered that the widespread publicity already given to the litigation be deemed sufficient notice to the class.[103]

On December 10, 1974, the superior court ordered that the *Gaby* case be consolidated with United States Trust Company's action, subject to the conditions that (i) the issues raised by the pleadings in the United States Trust action would be first determined and only thereafter, if appropriate, would the court determine the issues raised by the *Gaby* litigation and (ii) participation by counsel for plaintiff in *Gaby* in the United States Trust case would be limited to those issues raised by plaintiff in the *Gaby* litigation which were common to the United States Trust litigation.[104]

B. *The Stipulation*

As a result of negotiations between counsel for United States Trust and special counsel for New Jersey, a 366-page stipulation of fact was agreed upon and submitted to the superior court on December 20, 1974.[105] The stipulation first set forth a history of the Port Authority,[106] then contained a long summary of New Jersey's public transportation requirements, with discussions of the 1973-1974 energy crisis and the health and environmental problems in the Port District which, the state would argue, would be alleviated to some degree by improved rail mass transit.[107] Next came a broad survey of rapid transit in the Port District, detailing the countless studies of the problem, the Port Authority's participation, the takeover of the H&M in 1962, and the 1971-1972 Governors' Agreement to expand the agency's mass transit obligations and repeal the Covenant prospectively.[108]

Super. 124, 338 A.2d 833 (L. Div. 1975), *aff'd per curiam*, 69 N.J. 253, 353 A.2d 514 (1976), *rev'd*, 431 U.S. 1 (1977).

103. Consent Order, United States Trust Co. v. State, 134 N.J. Super. 124, 338 A.2d 833 (L. Div. 1975), *aff'd per curiam*, 69 N.J. 253, 353 A.2d 514 (1976), *rev'd*, 431 U.S. 1 (1977).

104. Order of Consolidation (Dec. 10, 1974), United States Trust Co. v. State, 134 N.J. Super. 124, 338 A.2d 833 (L. Div. 1975), *aff'd per curiam*, 69 N.J. 253, 353 A.2d 514 (1976), *rev'd*, 431 U.S. 1 (1977).

105. Stipulation, *supra* note 35.

106. *Id.* at 1-14.

107. *Id.* at 15-69.

108. *Id.* at 70-272.

The stipulation also put before the superior court the status at the time of the various federal mass transit programs and the critical mass transit situation in the Port District.[109] It concluded with an overview of the financial position of the Port Authority, a survey of outstanding Port Authority bonds, and the history of the repeal legislation.[110]

Eight lengthy exhibits were submitted to the superior court with the stipulation of fact: (1) New Jersey's then current transit program,[111] (2) the latest Port Authority Official Statement,[112] (3) the latest Port Authority Annual Report,[113] (4) a 1970 Audit Report of the agency,[114] (5) a speech detailing the Port Authority's financial structure,[115] (6) a 1971 report regarding the Newark and Cranford extensions,[116] (7) selected materials from a 1971 hearing regarding the Port Authority,[117] and (8) the 1972 Information Session held with respect to the proposed PATH extension.[118]

C. *The Mini-Trial*

In addition to the massive record submitted via the stipulation, two issues in *United States Trust* were the subject of a mini-trial. Counsel for defendants were unwilling to stipulate regarding the issues of the reliance by purchasers of consolidated bonds of the Port Authority on the 1962 Covenant and the damage to the bondholders in the secondary market for Port Authority consolidated bonds resulting from the repeal legislation. Accordingly, a trial was held in February 1975 to secure expert testimony and documentary evidence on these two issues.

That bondholders relied on the Covenant was, it was felt, almost a foregone conclusion. Following the enactment of the Covenant, the

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109. *Id.* at 272-94.

110. *Id.* at 294-366.

111. N.J. Dep't of Transp., Transit Development Program, 1974-1979 (1973).

112. Port Auth. of N.Y. & N.J., Official Statement, $100,000,000 Consolidated Bonds, Forty-first Series Due 2008 (First Installment) (Oct. 1, 1973).

113. [1973] Port Auth. of N.Y. & N.J. Ann. Rep.

114. Division of Audits & Accounts, Office of State Comptroller, Audit Report on Analysis of Financial Operations, Port of New York Authority, New York, New York (Rep. No. N.Y. Auth. 8-70).

115. Goldberg History, *supra* note 47.

116. Temple, Barker & Sloane, Inc., The Ability of the Port of New York Authority to Finance and Operate a PATH Extension to Newark Airport and Cranford, New Jersey (prepared for Comm'r, N.J. Dep't of Transp.) (Dec. 1971).

117. Selected Materials from Public Hearings Before the Autonomous Authorities Study Commission of the New Jersey State Legislature and the New York State Assembly Committee on Corporations, Authorities and Commissions (Mar. 1971).

118. Information Sess. of N.J. Sen. on Assembly Bills 1564 and 1565 (Port Authority Mass Transit Bills), 194th Leg., 2d Sess. (Dec. 11, 1972).

Port Authority issued and sold to the public $1,260,000,000 principal amount of consolidated bonds. In connection with these financings, the Port Authority repeatedly emphasized the importance of the Covenant's protection for bondholders to induce potential investors to purchase consolidated bonds. The Covenant, described to the investment community as a legally enforceable contract,[119] was discussed in detail in every official statement after its enactment. It was discussed at information sessions held to acquaint the investment community with the protections of the Covenant and the other aspects of proposed consolidated bond issues.[120] Annual reports of the Port Authority after 1962 also often referred to the Covenant and its protection for Port Authority bondholders. The Covenant was discussed extensively in municipal credit reports published by Standard & Poor's, Moody's and other analysts.[121]

Each of the trial witnesses was an acknowledged leader in his area of the municipal bond business: John F. Thompson (investment banking and investment advisory), Lester Murphy and Austin Fitzgerald (bond dealers), and Gordon Fowler (institutional investors). Thus, United States Trust supplied testimony from each of the four major areas of the municipal bond business.

Gordon Fowler's testimony, for example, as to whether he would have purchased Port Authority bonds without the Covenant, was as follows:

> Q. With respect to all the purchases you described [approximately $9-1/2 million of Port Authority bonds], would you have purchased any of those bonds without the protection of the covenant?
>
> A. I can't say for certain we would not have purchased them, but if we had, it would have been at a much lower price for the given coupons.[122]

John F. Thompson testified that the Covenant "was an important and significant part"[123] of what he presumed he was buying for his clients, and that he would not have recommended purchase of Port Authority bonds if he knew the Covenant would later be repealed.[124]

The importance of the existence of the 1962 Covenant for purchasers

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119. Stenographic Transcript, vol. 1, at 58-59, United States Trust Co. v. State, 134 N.J. Super. 124, 338 A.2d 833 (L. Div. 1975), *aff'd per curiam*, 69 N.J. 253, 353 A.2d 514 (1976), *rev'd*, 431 U.S. 1 (1977) [hereinafter cited as Record].

120. *Id.* at 61-64; Stipulation, *supra* note 35, at 216, 330-35.

121. *See, e.g.*, Plaintiff's Exhibits P-1, P-2, United States Trust Co. v. State, 134 N.J. Super. 124, 338 A.2d 833 (L. Div. 1975), *aff'd per curiam*, 69 N.J. 253, 353 A.2d 514 (1976), *rev'd*, 431 U.S. 1 (1977).

122. Record, *supra* note 119, vol. 4, at 765.

123. *Id.* vol. 1, at 82.

124. *Id.* vol. 1, at 83.

of the fortieth and forty-first series of consolidated bonds (issued following the 1973 prospective repeal) was also testified to by Gordon Fowler, who stated that Connecticut General purchased $3,000,000 of the Fortieth Series in reliance on the 1962 Covenant even though it had been prospectively repealed:

> Q. Now, with respect to the 1973 purchase of bonds, did you purchase those bonds with the knowledge of the 1973 prospective repeal of the 1962 covenant?
> A. Yes, I did.
> Q. Would you explain that decision?
> A. Well, the 40th series bonds which we purchased were not covered by the covenant. However, of [*sic*] approximately a billion seven, thereabouts, of outstanding Port Authority bonds, were protected by the covenant and it to me was unreasonable to expect that these bonds would be fully retired in the immediate future or even the foreseeable future and therefore the 40th series bonds were indirectly protected by the covenant.[125]

The deposition of J. Sinclair Armstrong, Executive Vice President of United States Trust, was taken prior to the mini-trial. An exhibit to Mr. Armstrong's deposition[126] was a memorandum dated April 27, 1961, from an investment officer of United States Trust to all officers and account executives of the investment division, which raised the question of future marketability of Port Authority bonds in light of attempts to involve the Port Authority in deficit rail mass transit. The memorandum referred to the 1961 New York legislation under which the Port Authority would have acquired the H&M and specifically noted:

> The act passed by the New York State Legislature provides for no limits on either the revenues or the General Reserve Fund balances for use in the Hudson and Manhattan Railroad acquisition. Without such a provision, the present security behind Port bonds is weakened to a considerable degree. It is prudent to assume that even with the acquisition by a capable group of administrators such as the Port Commissioners, the Hudson and Manhattan Railroad will operate at a deficit until some major improvement in use of this facility occurs.
>
> It is further disturbing to note that the Governor of the State of New York in his memorandum of approval leaves little doubt that it is his thinking and that of his advisers that no guarantee be given to the bondholders of Port Authority obligations. There is further indication that suggests the Governor is contemplating future additional acquisitions of other commuter railroads by the Port Authority.[127]

The memorandum concluded with the announcement of a change in policy—no additional Port Authority bonds were to be purchased.[128]

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125. *Id.* vol. 4, at 764-65.

126. Plaintiff's Exhibit S-3, United States Trust Co. v. State, 134 N.J. Super. 124, 338 A.2d 833 (L. Div. 1975), *aff'd per curiam*, 69 N.J. 253, 353 A.2d 514 (1976), *rev'd*, 431 U.S. 1 (1977).

127. *Id.*

128. *Id.*

Thus, the largest single purchaser of Port Authority bonds ceased to purchase any more bonds solely as a result of the possibility that the Port Authority might be directed to become involved in deficit rail operations without any limitation.

The damage to the secondary market caused by the retroactive repeal of the 1962 Covenant was evidenced by the "thinness" of the market for Port Authority bonds and by the decline in prices for Port Authority bonds following repeal. Where Port Authority bonds prior to repeal were readily marketable in large amounts at the generally quoted bid prices, after the repeal the market for Port Authority bonds became "extremely thin" and "sensitive" so that a sale of a large block of the bonds could not be made at the current bid price but only at a price substantially below it.[129] Also as a result of repeal, the price of Port Authority bonds fell dramatically in the secondary market relative to other bonds formerly considered comparable in quality and intrinsic security.[130]

Mr. Thompson testified:

> The market has been adversely effected [*sic*] by the repeal. It is not possible to measure the adverse effect simply by comparing market prices I believe.
>
> There was a time before the repeal when Port Authority bonds traded in the market very much as some of the other Authorities, major Authorities [or] State bonds do. And if a bank or insurance company with a five million dollar holding of those bonds came to a dealer and said: I want to sell these; what will you bid? He could get a bid that would be pretty much in line with the quoted market.
>
> What we have now is a market that is unusually thin . . . .[131]
>
> . . . .
>
> You could get a flow into the market by one of two things. One would be a brand new issue coming into the market. The other would be some investor who decided not to go along with this type of advice, but to sell his five or ten million dollar holdings. In my opinion in either one of those events the bid for the bonds would be substantially below the market as it is quoted today.[132]

Mr. Thompson further testified that if the market were confronted with "large volume sales" of Port Authority bonds the prices for such bonds "would dip considerably further."[133] Finally, Mr. Thompson agreed with the trial court's observation that:

> THE COURT: With such a thin market for these bonds as you have described it

129. Record, *supra* note 119, vol. 1, at 92-94, 128, 153. The expert witnesses testified that the market for Port Authority bonds since the repeal was "unusually thin" (Mr. Thompson, Record, *supra* note 119, vol. 2, at 407, 438), and "very thin and very sensitive" (Mr. Fitzgerald, Record, *supra* note 119, vol. 4, at 728).

130. *Id.* vol. 1, at 117, 130, 162.

131. *Id.* vol. 1, at 92-93.

132. *Id.* vol. 1, at 93-94.

133. *Id.* vol. 1, at 128.

after the repeal of the covenant, wouldn't the offer of a relatively small quantity of bonds have a greater effect upon the price that [*sic*] would otherwise be the case?

THE WITNESS: I suspect that is true, yes.[134]

Mr. Murphy's testimony on this point was to the same effect: "[W]e found that subsequent to this repeal of the covenant, that most of the major institutions that we did business with, and I wouldn't say most, I don't know of any that would then buy Port Authority bonds. They crossed it off their list."[135]

Repeal of the Covenant also had an indirect adverse effect on the market for other obligations of agencies of the states of New Jersey and New York.[136] In fact, several large institutions refused to purchase any bonds of any agencies of either of the two states as a result of the repeal of the Covenant.[137]

On the eve of the mini-trial Judge Gelman had requested that a Port Authority financial expert be made available to testify with respect to the relative importance of the Covenant as protection for bondholders as compared to the other bondholder covenants which remained unimpaired. In response to this request Michael Zarin, Esq., Chief of the Finance Division of the Law Department of the Port Authority,

134. *Id.* vol. 1, at 153.

135. *Id.* vol. 2, at 399. Mr. Murphy's characterization of repeal had the eloquence of the marketplace: "No, I think that the fears, I think I've previously testified to, is that it's a—it's an abrogation of an agreement, it's a contract. It's as if I went and bought a car from General Motors and had a twelve month warranty, and all of a sudden they announced that it's only good for six months. I don't think that I'd buy another General Motors car. And I think this is the feeling in the investment community." *Id.* vol. 2, at 435.

136. *Id.* vol. 1, at 87; vol. 2, at 411-12; vol. 4, at 767. Mr. Thompson testified in part: "The repeal of the covenant was recommended by the Governor of New Jersey approximately one week after sale of the $300 million Sports Complex issue. That issue was saleable at the time only because the Legislature had added the so-called moral obligation to its commitment.

"In my opinion—and I have heard no professional investment person who disagreed with this; in my opinion if that recommendation by the Governor had been made one week before the sale of the Sports Complex bonds instead of one week after, the bonds would not have been saleable, because the investment community was saying about the repeal of the covenant, and has said about it: If a legal covenant can be repealed by the States, what confidence can we place in their moral obligation?

"We have run onto this in an even broader field. My firm was the number two manager in a syndicate which last week underwrote $150 million and sold them of Power Authority bonds of the State of New York.

"Now the Power Authority is not dependent upon a moral obligation. It is dependent on its own revenues which are from the sale of electric power. It is about as far removed from any emotional, or as far removed from the feeling I just stated as anything could be. And yet we found in several parts of the country that there were many institutional investor portfolio managers who had themselves adopted or their investment committees had adopted a rule that there be no further investment in anything in New York State or New Jersey due to the repeal of the covenant." *Id.* vol. 1, at 86-87.

137. *Id.* vol. 1, at 87; vol. 4, at 767.

after reviewing the history of the Port Authority's financial structure, outlined the objective importance of the Covenant vis-à-vis the other tests and agreements contained in relevant statutes, in the Consolidated Bond Resolution, and in the resolutions establishing each series of consolidated bonds.

Mr. Zarin first discussed the so-called "1.3 test" contained in section 3, condition 3 of the Consolidated Bond Resolution.[138] He testified to the effect that considering *only* the 1.3 test it would be possible for the Port Authority to issue bonds to finance a takeover of a new facility which was certain to suffer massive operating deficits, because the expected deficits of the facility would *not* be included in the 1.3 calculation. Mr. Zarin said:

> [T]he 1.3 test may be protective in certain very limited cases, but as I have examined it, I do not believe that it is protective against operating deficits. It is not protective in the situation . . . outlined initially, namely the assumption of operation of a new facility and if I take protection to mean . . . protection of the security [of] bondholders, therefore it would not be protective in that situation and it would not be protective in my judgment in the event of the takeover [of] an existing facility, if one were to approach that facility with the objective of bringing that facility within what we would call the general reserve fund family.[139]

In addition, it should be recalled that section 7 of the series resolutions (since the 12th series) prohibits the use of any consolidated bond reserve funds to pay the operating deficits of a facility acquired unless such a facility is acquired or constructed through the issuance of an obligation secured by the General Reserve Fund and the proceeds are used for that additional facility.[140]

The second part of section 7 contains the so-called "section 7 certification," which must be made by the Commissioners of the Port Authority at or prior to the time of the issuance of consolidated bonds for a new purpose. The section 7 certification need *only* be made in connection with an issuance of bonds to finance a *new facility*. For example, the recent Newark Airport improvements, requiring Port Authority expenditures of over $400,000,000, did not require a section 7 certification since no "additional" facility was involved.[141] Further-

138. CBR, *supra* note 49, section 3, condition 3. The 1.3 test applies only when a series of consolidated bonds is issued by the Port Authority. It prohibits such issuance unless the best twelve months' net revenues (of the preceding thirty-six months) of all of the Port Authority's facilities are equal to or greater than 1.3 times the prospective debt service for the calendar year in the future during which the debt service of all outstanding and proposed new bonds secured by the General Reserve Fund would be at a maximum. *Id.; see* text accompanying note 50 *supra*.

139. Record, *supra* note 119, vol. 3, at 543.

140. *E.g.*, Resolution Establishing Forty-first Series of Consolidated Bonds, *supra* note 51, § 7.

141. This example was felt to have additional importance since the definition of "air

more, the section 7 certification requires only a certification of the *opinion* of the Commissioners. This opinion must only say that there will be no *material* impairment of the Port Authority's credit standing, or the investment status of its bonds, or its ability to fulfill its commitments to bondholders. It does not block *any* impairment; it blocks only an impairment which is *material* in the *opinion* of the Port Authority's Commissioners.[142] The 1962 Covenant, by contrast, does not contain the words "opinion" or "material."

Unlike the section 7 certification, the 1962 Covenant required certification of an ascertainable *amount* and not merely an opinion of the Commissioners of the Port Authority. Because of PATH's losses, authorization in compliance with the Covenant was limited only to "self-supporting" rail mass transit facilities. Self-supporting was defined by the statute to mean that revenues should be at least equal to operating and maintenance expenses and debt service.[143]

An important distinction between a section 7 certification and a Covenant certification is that the latter requires considerably more precision. The section 7 certification permits a general certification as to whether the Port Authority can support a proposed facility by utilizing the projected revenues from its whole family of facilities. There is thus a great deal of room for a range in the projections under section 7; the 1962 Covenant certification relates solely to the projected net revenues from a single proposed facility leaving considerably less leeway for error.

As Mr. Thompson testified:

> THE WITNESS: The covenant is that they must certify that the project will, one, be self supporting . . . .[144]
>
> . . . .
>
> Now, self supporting, your Honor—although it sounds as though it can be a qualitative phrase is not, at least not in our business.
>
> Self supporting means that the revenues shall be estimated to be at least as much as the operating expenses plus the debt service which is a mathematical requirement that does not appear in Section 7, which only requires certification that it will not materially impair and that's what I meant by more precise.[145]

For example, under the section 7 certification the Commissioners

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terminals" had been amended by the legislature to include rail mass transit connections between Port Authority airports and New York City. Stipulation, *supra* note 35, Ex. II, at 17. It was thus arguable that the proposed rail links to Kennedy Airport and Newark Airport and beyond to Plainfield would not require any certification under section 7.

142. "To us, this [the section 7 certification] was merely a contractual codification of an agreement and obligation which we had anyhow . . . ." Goldberg History, *supra* note 47, at 23.

143. *See* text accompanying note 61 *supra*.

144. Record, *supra* note 119, vol. 1, at 78.

145. *Id.* vol. 1, at 80-81.

could certainly look to an anticipated growth in revenues of existing facilities to determine whether issuance of the consolidated bonds for an additional facility would be a material impairment of the sound credit standing of the Port Authority. Under the Covenant test, however, the Commissioners would be required to examine but a *single* facility and would *not* be allowed to speculate regarding increased revenues from the other facilities operated by the Port Authority.

D. *Post-Trial Briefs and Oral Argument*

The parties exchanged post-trial briefs on March 10, 1975. United States Trust's brief,[146] after reviewing the history of the case and the trial, began its legal argument with the contract clause analysis by stating the two constitutional provisions involved: the contract clause of the Federal Constitution,[147] and of the New Jersey Constitution.[148]

The brief then reviewed the creation of the Covenant as a binding obligation of the states. The Covenant by its terms created a contract between the states of New York and New Jersey and the holders of Port Authority bonds.[149] Furthermore, each consolidated bond states that it is issued "in conformity with the compact . . . and the various statutes of [New Jersey and New York] amendatory thereof and supplemental thereto," which included the 1962 legislation by which the Covenant was enacted. Finally, the adoption of the 1962 legislation and the reliance upon it by bondholders in purchasing their bonds was sufficient to create a contract between the states and the bondholders even absent the express language of the Covenant.[150]

146. Brief for Plaintiff, United States Trust Co. v. State, 134 N.J. Super. 124, 338 A.2d 833 (L. Div. 1975), *aff'd per curiam*, 69 N.J. 253, 353 A.2d 514 (1976), *rev'd*, 431 U.S. 1 (1977) [hereinafter cited as United States Trust's Trial Brief]; Post-Trial Memorandum for Defendants, United States Trust Co. v. State, 134 N.J. Super. 124, 338 A.2d 833 (L. Div. 1975), *aff'd per curiam*, 69 N.J. 253, 353 A.2d 514 (1976), *rev'd*, 431 U.S. 1 (1977) [hereinafter cited as Defendants' Post-Trial Memorandum].

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

148. "The Legislature shall not pass any . . . law impairing the obligation of contracts, or depriving a party of any remedy for enforcing a contract which existed when the contract was made." N.J. Const. art. IV, § 7, ¶ 3; *see* Trustees of Dartmouth College v. Woodward, 17 U.S. (4 Wheat.) 518 (1819); Fletcher v. Peck, 10 U.S. (6 Cranch) 87 (1810); New Jersey Sports & Exposition Auth. v. McCrane, 61 N.J. 1, 292 A.2d 545, *appeal dismissed sub nom.* Borough of East Rutherford v. New Jersey Sports & Exposition Auth., 409 U.S. 943 (1972); New Jersey Highway Auth. v. Sills, 109 N.J. Super. 424, 263 A.2d 498 (Ch. Div.), *supplemented*, 111 N.J. Super. 313, 268 A.2d 308 (Ch. Div. 1970), *aff'd per curiam*, 58 N.J. 432, 278 A.2d 489 (1971).

149. N.J. Stat. Ann. § 32:1-35.55 (West 1963); N.Y. Unconsol. Laws § 6606 (McKinney 1961).

150. United States Trust's Trial Brief, *supra* note 146, at 48-55; *see, e.g.*, Indiana v. Brand,

That the 1962 Covenant would be binding upon future legislatures was specifically recognized by both New Jersey and New York when it was enacted in 1962. The Farley Committee concluded that the Covenant would be a "constitutionally-protected" statutory agreement.[151] Governor Rockefeller of New York, in approving the 1961 New York legislation authorizing the takeover of the H&M by the Port Authority *without* a statutory covenant protecting bondholders, said:

> It was urged by some persons that this bill incorporate a guarantee to bondholders of the Port Authority either prohibiting or severely restricting any future action by the two states to authorize any railroad operations by the Port Authority other than the Hudson Tubes. In support of the proposal it was argued that it would insure the sound credit of the Port Authority. Its effect, however, would have been to tie the hands of the Legislatures of New York and New Jersey for all future time, or at least until the retirement of the bonds to which the guarantee was applicable.
>
> . . . .
>
> Such a guarantee or fence is undesirable because it is based upon the premise that we are here and now qualified to predict what will be sound policy decades in the future—and with such self-assurance that we are willing to make irrevocable decisions for the future absolutely binding upon our successors. The events of the last three decades confirm the unsoundness of any such premise.
>
> Article VI of the Port Compact of 1921 provides that the Port Authority "shall constitute a body, both corporate and politic, with full power and authority to purchase, construct, lease and/or operate any terminal or transportation facility" within the Port of New York District. I see no reason for New York and New Jersey to place an irrevocable limitation at this time upon such power and authority.[152]

The next year, New York changed its position and approved the legislation containing the 1962 Covenant. Governor Rockefeller evidently was willing to bind "our successors" in order to save the H&M which was deemed "essential to prevent the economic strangulation of metropolitan New York."[153]

United States Trust then argued that the obligation of a contract was impaired by any change in its terms, citing *Planters' Bank v. Sharp*,[154] where the Supreme Court said:

> One of the tests that a contract has been impaired is, that its value has by legislation been diminished. It is not, by the Constitution, to be impaired at all. This is not a question of degree or manner or cause, but of encroaching in any respect on its obligation, dispensing with any part of its force.[155]

303 U.S. 95, 100 (1938); Butchers' Union Slaughter-House & Livestock Landing Co. v. Crescent City Live-Stock Landing & Slaughter-House Co., 111 U.S. 746, 750 (1884); New Jersey v. Yard, 95 U.S. 104, 115 (1877); New Jersey v. Wilson, 11 U.S. (7 Cranch) 164, 165 (1812); Fletcher v. Peck, 10 U.S. (6 Cranch) 87, 135-39 (1810).

151. *See* text accompanying note 57 *supra*.

152. Governor's Memorandum, 1961 N.Y. Legis. Ann. 421, 423-24.

153. Governor's Memorandum, 1962 N.Y. Legis. Ann. 310, 323.

154. 47 U.S. (6 How.) 300 (1848).

155. *Id.* at 326-27 (footnote omitted); *accord*, Louisiana v. Pilsbury, 105 U.S. 278 (1881)

New Jersey's courts had also interpreted broadly the concept of "impairment,"[156] and it was primarily because of two New Jersey Supreme Court cases that counsel for United States Trust had determined to press the New Jersey case in preference to the parallel litigation in New York. In *New Jersey Highway Authority v. Sills*,[157] the New Jersey Highway Authority had sold bonds to finance construction of its toll roads, pledging the revenues as security for the bonds. Subsequently, the legislature exempted certain members of the National Guard and the United States Armed Forces from the payment of tolls when going to or returning from active duty.

The Highway Authority and two banks which were trustees for bondholders under the Authority's bond resolutions attacked the toll exemption statutes as an unconstitutional impairment of the bondholders' contract and a deprivation of their property without just compensation. Authority bonds were outstanding in the amount of approximately $327,000,000; annual net revenues from highway operation were $33,312,885 and total bond service costs were $17,816,740. The annual revenue loss from the free passage of guardsmen and reservists was estimated at $27,300, which the trial court observed was very small when contrasted with the margin of about $15,500,000 left from net revenues the previous year, after providing for bond service costs. The trial court also stated that it did not foresee any possibility that the statutory toll-free passage would ever cause a default on outstanding bonds, but it found some disadvantageous impact from the reduction of the means to retire bonds each year by call or open market purchase.[158] The trial court concluded that the resulting deterioration in the position of every bondholder constituted a sufficient conflict with the constitutional prohibitions against impairment to render the statutes void. The Supreme Court of New Jersey adopted the holding and unanimously affirmed the judgment of the trial court.[159]

In the second case, *New Jersey Sports & Exposition Authority v. McCrane*,[160] the Supreme Court of New Jersey reaffirmed its decision

(bond contract); Wolff v. City of New Orleans, 103 U.S. 358 (1880) (bond contract); Von Hoffman v. City of Quincy, 71 U.S. (4 Wall.) 535 (1866) (bond contract); Hawthorne v. Calef, 69 U.S. (2 Wall.) 10 (1864); Green v. Biddle, 21 U.S. (8 Wheat.) 1 (1823).

156. *E.g.*, Vanderbilt v. Brunton Piano Co., 111 N.J.L. 596, 599, 169 A. 177, 178 (E.&A. 1933); Baldwin v. Flagg, 43 N.J.L. 495, 503 (Sup. Ct. 1881).

157. 109 N.J. Super. 424, 263 A.2d 498 (Ch. Div.), *supplemented*, 111 N.J. Super. 313, 268 A.2d 308 (Ch. Div. 1970), *aff'd per curiam*, 58 N.J. 432, 278 A.2d 489 (1971).

158. 111 N.J. Super. at 315-16, 268 A.2d at 309-10.

159. 58 N.J. 432, 278 A.2d 489 (1971).

160. 61 N.J. 1, 292 A.2d 545, *appeal dismissed sub nom.* Borough of East Rutherford v. New Jersey Sports & Exposition Auth., 409 U.S. 943 (1972).

in *Sills* and emphasized the importance of the duty of the judiciary to protect from impairment covenants relating to bonds of public authorities. There, revenue bonds were to be issued by the Sports Authority under a statutory pledge for their payment out of revenues generated solely by the Authority's operation, which revenues were to remain in a special fund for that purpose until the bonds were fully paid. In discussing the obligation created by the bonds, the court said:

> The principles applied in *Sills* are equally applicable here, and it may be stated definitively that the bonds of the Authority in the hands of purchasers constitute valid contracts binding on the State according to their terms, and are entitled to the same constitutional protection against impairment at the hands of subsequent Legislatures as are the bonds of the Educational Facilities Authority, *N.J.S.A.* 18A: 72A-10, 19, of the New Jersey Mortgage Finance Agency, *N.J.S.A.* 17:1B-10(g), 17, and of any other similarly constituted agency created for the performance of a public purpose whose bonds are supported by a like pledge of the State. Moreover, aside from the strict applicability of constitutional principles, having in mind our form of government, we believe the integrity of the legislative branch to be such that a succeeding Legislature would not undertake to impair in any material fashion a solemn pledge made in good faith to bondholders by a predecessor Legislature.
>
> . . . And if the constitutionally acceptable device of modern day progressive government, *i.e.*, the financially independent authority, is to succeed in the expeditious accomplishment of public purpose projects, and in persuading investors to buy the authority's bonds, the good faith covenant of the Legislature for itself and its successors to refrain from adopting later enactments which will materially impair the obligation of the authority's bonds must be respected. Otherwise the device becomes an empty formula. The judicial branch of government, which has given its imprimatur to the constitutionality of the device, has the duty to declare invalid attempts at material subversion of the covenant.[161]

The United States Trust brief argued that the fears of the court in *Sports Authority* as to the damage to bondholder confidence by subsequent legislation materially impairing an obligation of contract had actually been realized, not only in the decline in the secondary market for Port bonds but also in the change of attitude of members of the financial community toward the "moral obligation" bonds of the two states.[162] The brief also countered the expected argument by the state that the 1974 legislation repealing the 1962 Covenant did not impair any obligation of contract because the legislation did not repeal the primary obligation of the Port Authority to its bondholders, the obligation to pay interest and principal when due, and did not affect the other security provisions relating to protection for bondholders.[163]

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161. *Id.* at 28-29, 292 A.2d at 558-59.

162. United States Trust's Trial Brief, *supra* note 146, at 67-68; Record, *supra* note 119, vol. 1, at 87; vol. 2, at 411-12; vol. 4, at 767.

163. United States Trust's Trial Brief, *supra* note 146, at 68-69; *see, e.g.*, W.B. Worthen Co. v. Kavanaugh, 295 U.S. 56 (1935); First Nat'l Bank v. Maine Turnpike Auth., 156 Me. 131, 136

Assuming for the sake of argument that the police power applied to contracts of the type of the 1962 Covenant, United States Trust's trial brief then contended that repeal could not be justified as an exercise of the police power under applicable federal[164] and New Jersey cases.[165] In this connection, several basic arguments were made by United States Trust. There was the evident distinction between public and private contracts, with courts traditionally devoting more care and attention to the former.[166] The brief then sought to distinguish the three leading Supreme Court cases which had upheld a contractual impairment as a proper exercise of the police power. The first, *Home Building & Loan Ass'n v. Blaisdell,*[167] is the modern foundation of contract clause adjudication. In *Blaisdell* the Minnesota Mortgage Moratorium Law, a depression remedy which allowed judicial extensions of foreclosure redemption periods, was upheld because it was a temporary measure prompted by great emergency, required compensation to the aggrieved mortgagee, and was the only means to accomplish the objective. All of these factors, it was argued, were absent from the case in issue.[168]

The second leading case, *Faitoute Iron & Steel Co. v. City of Asbury Park,*[169] sustained a creditor-approved composition plan for a

A.2d 699 (1957); Ruano v. Spellman, 81 Wash. 2d 820, 505 P.2d 447 (1973); *cf.* Jacksonville Port Auth. v. State, 161 So. 2d 825 (Fla. Sup. Ct. 1964) (1963 statute directing city to transfer to port authority all dock and terminal facilities and accept in payment the authority's bonds held not to impair obligation of contract of city with holders of 1941 bonds exchanged for 1913 bonds issued to acquire or construct the facilities); City of New Bedford v. New Bedford, Woods Hole, Martha's Vineyard & Nantucket Steamship Auth., 336 Mass. 651, 148 N.E.2d 637, *appeal dismissed sub nom.* Boston Five Cents Savings Bank v. City of New Bedford, 358 U.S. 53 (1958) (act creating steamship authority did not create such a contract between the state and the authority that its impairment would violate the contract clause).

164. United States Trust's Trial Brief, *supra* note 146, at 84-92; *see, e.g.,* City of El Paso v. Simmons, 379 U.S. 497 (1965); Faitoute Iron & Steel Co. v. City of Asbury Park, 316 U.S. 502 (1942); Veix v. Sixth Ward Bldg. & Loan Ass'n, 310 U.S. 32 (1940); Perry v. United States, 294 U.S. 330 (1935); Home Bldg. & Loan Ass'n v. Blaisdell, 290 U.S. 398 (1934).

165. United States Trust's Trial Brief, *supra* note 146, at 81-84; *see, e.g.,* New Jersey Sports & Exposition Auth. v. McCrane, 61 N.J. 1, 292 A.2d 545, *appeal dismissed sub nom.* Borough of East Rutherford v. New Jersey Sports & Exposition Auth., 409 U.S. 943 (1972); New Jersey Highway Auth. v. Sills, 109 N.J. Super. 424, 263 A.2d 498 (Ch. Div.), *supplemented,* 111 N.J. Super. 313, 268 A.2d 308 (Ch. Div. 1970), *aff'd per curiam,* 58 N.J. 432, 278 A.2d 489 (1971); P.T. & L. Constr. Co. v. Comm'r, Dep't of Transp., 60 N.J. 308, 288 A.2d 574 (1972); Hourigan v. Township of North Bergen, 113 N.J.L. 143, 150-51, 172 A. 193, 197 (E.&A. 1934).

166. *See, e.g.,* New Orleans Gas Co. v. Louisiana Light Co., 115 U.S. 650, 661 (1885); Binghamton Bridge, 70 U.S. (3 Wall.) 51 (1865); Bridge Proprietors v. Hoboken Co., 68 U.S. (1 Wall.) 116 (1863). *Compare* Home Bldg. & Loan Ass'n v. Blaisdell, 290 U.S. 398 (1934), *with* Perry v. United States, 294 U.S. 330 (1935).

167. 290 U.S. 398 (1934).

168. United States Trust's Trial Brief, *supra* note 146, at 87-90.

169. 316 U.S. 502 (1942).

bankrupt city and was distinguished since it involved a ratification of a debt, not its repudiation.[170]

The third case, *City of El Paso v. Simmons*,[171] cut short the right of defaulting land purchasers to reinstate their ownership rights, a practice which lead unexpectedly to rampant speculative abuse and uncertainty with respect to land titles. There, unlike *United States Trust*, the promise was not a sine qua non of the investment and the case involved an unforeseeable change in circumstances.[172]

The basic point of the United States Trust brief was that the repeal was inherently unreasonable. Money, and only money, was at stake, and evident alternatives existed for the states to realize their goals without so crushing an intrusion on the rights of bondholders.[173]

Defendants had quite a different view of the matter. The state first reviewed in great detail the 1973-74 energy crisis, the health and environmental situation in the Port District, and the urgent need for more and improved public transportation in the area,[174] all facts which no one seriously could contest. They then argued that the 1962 Covenant in effect added nothing to the protections for bondholders which preceded its enactment, and that credit rating agencies and analysts had paid little heed to the Covenant in assessing Port Authority security.[175]

Defendants' key factual argument, with which their legal argument was irrevocably intertwined, was based on a hypothetical supposition as of the date of their trial brief. They made the appealing argument that the Port Authority could be delegated responsibility for capital costs of rail projects such as the PATH extension to Plainfield (with the state assuming responsibility for operating losses) and raise the revenues necessary to cover debt service on the construction bonds by a modest increase in tolls on the Port Authority's Hudson River crossings.[176] No one supposed then that this was exactly what the Port

170. United States Trust's Trial Brief, *supra* note 146, at 91-92.

171. 379 U.S. 497 (1965).

172. United States Trust's Trial Brief, *supra* note 146, at 92-98.

173. The brief concluded with the point that the repeal was a taking of property in violation of the federal and New Jersey due process clauses. United States Trust's Trial Brief, *supra* note 146, at 122; *see* Lynch v. United States, 292 U.S. 571, 579 (1934); Hale, *The Supreme Court and the Contract Clause: III*, 57 Harv. L. Rev. 852, 890-91 (1944); *cf.* City of El Paso v. Simmons, 379 U.S. 497, 517, 533-35 (1965) (Black, J., dissenting) (a state should compensate an individual for impairing his contract right); 51 Va. L. Rev. 692 (1965). Finally, the brief distinguished the *Gaby* case and argued that the Covenant was constitutional in all respects. United States Trust's Trial Brief, *supra* note 146, at 117-21.

174. Defendants' Post-Trial Memorandum, *supra* note 146, at 3-30.

175. *Id.* at 31-76.

176. *Id.* at 26-30.

Authority would agree to do on the eve of the trial court decision.

Based on their view of the facts, defendants concluded that repeal of the Covenant, on balance, was a patently reasonable exercise of the police power. To them there was no diminution in security, since the remaining bondholder protections adequately grounded the "basic" obligation to pay principal and interest.[177] The market damage, they argued, was due to many causes and only resulted from a lack of understanding of how little the Covenant added to bondholder protection.[178] Balanced against the need for mass transit to solve the critical energy and environmental problems the Covenant, to defendants, had to give way.[179]

On April 1, 1975, the parties exchanged reply briefs,[180] which summarized the case as follows:

For United States Trust:

> The heart of defendants' argument is that, on balance, the interests of the State outweigh the interests of Bondholders. On the State's side, defendants point to the purported energy and environmental problems which the repeal of the Covenant will allegedly solve. We have already demonstrated that consideration of these problems played no part in the repeal of the Covenant and that the problems would not be solved by the repeal. As for the mass transportation problem, we have demonstrated that (a) the repeal of the Covenant will be ineffectual in the solution of the problem, and (b) there were other means available to the State for approaching a solution to the problem which would not have involved any impairment of Bondholder security.
>
> On the Bondholders' side, it has been clearly demonstrated that they have suffered substantial damage as a result of the repeal of the Covenant, which was a primary inducement for their purchase of Consolidated Bonds, and that they have been deprived of a protection guaranteed to them by a solemn promise of the State.
>
> It is clear from the foregoing that the interest of the State in the repeal of the Covenant is miniscule and misplaced, and the interest of the Bondholders, actual and substantial. The balance clearly lies in favor of the Bondholders. It is submitted further that the interest of the State must be found to be overpowering before the Court should permit it to repudiate its own statutory pledge.[181]

177. *Id.*

178. *Id.* at 104-13. Since there was, to defendants, no impairment of contract, there was no taking of property in contravention of the due process clauses.

179. *Id.* The remainder of defendants' brief was devoted to an argument that the Covenant was void ab initio as in conflict with the Port Authority Compact and that it should be declared invalid as inconsistent with superseding federal law. *Id* at 119-44. Since the superior court upheld repeal, it never reached this issue. United States Trust Co. v. State, 134 N.J. Super. 124, 198, 338 A.2d 833, 875 (L. Div. 1975), *aff'd per curiam,* 69 N.J. 253, 353 A.2d 514 (1976), *rev'd,* 431 U.S. 1 (1977).

180. Reply Brief for Plaintiff, United States Trust Co. v. State, 134 N.J. Super. 124, 338 A.2d 833 (L. Div. 1975), *aff'd per curiam,* 69 N.J. 253, 353 A.2d 514 (1976), *rev'd,* 431 U.S. 1 (1977) [hereinafter cited as Reply Brief of United States Trust]; Defendants' Reply Memorandum, United States Trust Co. v. State, 134 N.J. Super. 124, 338 A.2d 833 (L. Div. 1975), *aff'd per curiam,* 69 N.J. 253, 353 A.2d 514 (1976), *rev'd,* 431 U.S. 1 (1977) [hereinafter cited as Defendants' Reply Memorandum].

181. Reply Brief of United States Trust, *supra* note 180, at 76-77 (footnotes omitted).

And for the state:

> No hard and fast distinction is appropriate between legislative power over State contracts and power over private ones, and the Supreme Court has never drawn one. The reality is that in many cases, including this one, the practical necessity for on-going relationships with the community arguably disadvantaged by legislative modification of prior State promises assures that their claims receive especially close attention. Precisely because the legislature has to weigh the competing interests of the bondholder community closely in deciding whether repeal is necessary, the judgment is one warranting maximum judicial respect. In summary, on this point, under the balancing test applicable here, the repeal of the covenant, a matter collateral to the obligation of the bonds, does not materially impair any obligation of the contract.[182]

On April 8 and 9, 1975, the case was argued before Judge Gelman.[183] At various points during the argument it became evident that Judge Gelman seemed satisfied, as a practical matter, with the basic bondholder protections and viewed the Covenant as arguably superfluous to the basic objective of protection of principal and interest.[184] It seemed then that the court would be unwilling to find any blow less than mortal an impairment of contract. Once again defendants raised the hypothetical supposition of a fare increase, with the "new" revenues going to mass transit, as a rational plan which the Covenant precluded.[185] It was also clear that the court had the greatest interest in *W.B. Worthen Co. v. Kavanaugh*[186] and its application.[187]

On April 10, 1975, the day following conclusion of oral argument, the Port Authority made an announcement that turned the case around in mid-stream. It proposed a toll increase on the Hudson crossings expected to net $39 million in additional annual revenues to the agency, to be used for four mass transit-related projects: (1) the expansion of the Port Authority Bus Terminal; (2) the extension of PATH to Plainfield; (3) the rail link to Kennedy Airport; and (4) direct rail service for Erie Lackawanna trains into Penn Station, New York.[188] The agency almost seemed to be quoting from the state's briefs in its press release announcing the toll increases: "The new toll structure is in line with efforts to reduce inefficient and unnecessary

182. Defendants' Reply Memorandum, *supra* note 180, at 41.

183. Transcript of Proceedings, vols. 1 & 2, United States Trust Co. v. State, 134 N.J. Super. 124, 338 A.2d 833 (L. Div. 1975), *aff'd per curiam*, 69 N.J. 253, 353 A.2d 514 (1976), *rev'd*, 431 U.S. 1 (1977) [hereinafter cited as Trial Argument Transcript].

184. *See id.* vol. 1, at 18-30, 45, 61-63, 66-72, 76-82, 89-96; vol. 2, at 4-6.

185. *See id.* vol. 1, at 116, 131-33, 136-37, 153-54; vol. 2, at 14-16.

186. 295 U.S. 56 (1935).

187. Trial Argument Transcript, *supra* note 183, vol. 1, at 161-73. Most of the second day's argument was devoted to the *Gaby* case, which the court never reached. *Id.* vol. 2, at 43-234.

188. Port Auth. of N.Y. & N.J., News Release 1-2 (Apr. 10, 1975).

automobile usage, highway congestion, air pollution, and to conserve fuel."[189]

What had been mere supposition and hypothesis in the state's briefs[190] was now reality. Where before diversions of revenues for rail purposes in violation of the Covenant clearly would have required diversion of current revenues, now the state was free to argue, as it did hypothetically in its trial briefs, that only "new" revenues would be called on to finance the proposed rail projects.

E. *The Superior Court Decision*

One month following announcement of the toll increases the superior court upheld the retroactive repeal of the 1962 Covenant.[191] In its ninety-five page decision the court combined its findings of fact from the February trial with its resulting conclusions of law.

With respect to bondholders' reliance on the Covenant the superior court, apparently with an eye to dicta in *City of El Paso v. Simmons*,[192] found that the Covenant was not the "primary consideration" for the purchase of the bonds, "for no witness testified that purchases would *not* have been made without the covenant, but only that they would not have purchased or recommended the purchase of the bonds 'at the price which they were then offered.' "[193]

With respect to secondary market damage, the court found a problem in the proofs presented by plaintiff in that "they [did] not show that the adverse effect attributable to the covenant repeal was permanent,"[194] since it happened that the spread between the comparison bonds at the time of trial had closed to where it stood just prior to repeal.[195] The court also found that certain newspaper articles adverse to the Port Authority which had been entered into evidence by defendants "unquestionably" contributed to the adverse price differential.[196] The court concluded:

> The bottom line of plaintiff's proofs on this issue is simply that the evidence fails to demonstrate that the secondary market price of Authority bonds was adversely

189. *Id.* at 2.

190. *See* text accompanying notes 176 & 185 *supra*.

191. United States Trust Co. v. State, 134 N.J. Super. 124, 338 A.2d 833 (L. Div. 1975), *aff'd per curiam*, 69 N.J. 253, 353 A.2d 514 (1976), *rev'd*, 431 U.S. 1 (1977).

192. 379 U.S. 497, 514 (1965).

193. 134 N.J. Super. at 179, 338 A.2d at 864. This conclusion was flatly contradicted by the record. John F. Thompson had testified in part: "Q. If you knew that the covenant would later be repealed would you have recommended the Port Authority bonds during the '60s? A. No." Record, *supra* note 119, at 86.

194. 134 N.J. Super. at 180, 338 A.2d at 865.

195. *Id.* at 180-81, 338 A.2d at 865.

196. *Id.* at 181, 338 A.2d at 865.

affected by the repeal of the covenant, except for a short-term fall-off in price, the effect of which has now been dissipated insofar as it can be related to the enactment of the repeal.[197]

Notwithstanding its conclusions with respect to reliance and secondary market damage, on the issue of impairment the court agreed that "[t]o the extent that the repeal of the covenant authorizes the Authority to assume greater deficits for such purposes, it permits a diminution of the pledged revenues and reserves and may be said to constitute an impairment of the states' contract with the bondholders."[198] Thus finding an impairment in the potential diminution in security, but also concluding that the Covenant was not the "primary inducement" for the purchase of the bonds and that the secondary market damage was ephemeral, the superior court set forth an analysis of the origins and development of the contract clause.[199] As indicated during oral argument,[200] the court placed primary reliance on *W.B. Worthen Co. v. Kavanaugh*,[201] reading the case as follows:

> As the language of the court in the cases cited above makes manifest, not every impairment of a contract obligation or security for its performance runs afoul of the Contract Clause; a state acting under its reserved police powers may alter its remedial processes and thereby diminish contractual security provided it does not destroy its quality as "an acceptable investment for a rational investor."[202]
>
> . . . .
>
> The line of demarcation between *Blaisdell* and *Kavanaugh* may be expressed as one of degree: The states' inherent power to protect the public welfare may be validly exercised under the Contract Clause even if it impairs a contractual obligation so long as it does not destroy it.[203]
>
> . . . .
>
> Conceding the existence of some impairment of bondholder security as a result of the repeal, has the action of the states destroyed the quality of their security as an "acceptable investment for a rational investor"?[204]
>
> . . . .
>
> It is the judgment of this court that the repeal legislation was a reasonable and hence valid exercise of the states' police power which is not prohibited by the Contract Clause of either the Federal or the State Constitution.[205]

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197. *Id.* at 181-82, 338 A.2d at 866.

198. *Id.* at 183, 338 A.2d at 866 (footnotes omitted).

199. *Id.* at 184-93, 338 A.2d at 867-72.

200. *See* text accompanying note 187 *supra*.

201. 295 U.S. 56 (1935).

202. 134 N.J. Super. at 187, 338 A.2d at 869.

203. *Id.* at 190, 338 A.2d at 170-71.

204. *Id.* at 195-96, 338 A.2d at 873-74.

205. *Id.* at 197, 338 A.2d at 874. Since it upheld the repeal, the court never reached the issue of the constitutional validity of the Covenant. The *Gaby* complaint was dismissed. 134 N.J. Super. at 198, 338 A.2d at 875 (citing Wagner v. Ligham, 37 N.J. Super. 430, 117 A.2d 516 (App. Div. 1955)).

IV. The New Jersey Supreme Court

The day following the superior court decision the secondary market for Port Authority 6% consolidated bonds fell by more than three points ($30 per $1,000 principal amount of bonds); this one day of market loss represented six months' interest on the bonds.[206] The Port Authority, which had been considering its first bond issue since October of 1973, put those plans back on the shelf, thus continuing the longest period in modern Port Authority history without a long-term debt issuance.[207]

On May 16, 1975, counsel for United States Trust filed a motion and supporting papers with the New Jersey Supreme Court seeking to skip the intermediate appellate level and secure direct and expedited review of the superior court decision by the Supreme Court of New Jersey.[208] It was felt that the court which decided the *New Jersey Sports*[209] and the *Sills*[210] cases would not stand for the abrogation of an important bond covenant.

Only hours after the papers requesting direct certification and expedition were filed, the New Jersey Supreme Court met in an emergency session in Morristown, New Jersey, where the justices were attending a judicial conference, and granted the speedy review requested.[211] Chief Justice Hughes announced at that time that he would recuse himself since he was Governor of New Jersey when the Covenant was enacted.[212]

The swift action of the supreme court had a decidedly calming effect on the market for Port bonds, and it was widely thought that the quick decision on the appeal procedure was a sure sign that the court was disposed toward reversal. One interested bondholder was so optimistic that it published a rave analysis of the Port Authority on the eve of filing of the appellate briefs. This was Barr Brothers, the municipal bond dealer firm from which United States Trust had chosen one of its expert witnesses, Lester Murphy. On June 12, 1975, Barr Brothers published a Port Authority investment analysis titled *The Reports of My Death are Greatly Exaggerated,*[213] which said, in part, that not-

206. Affidavit by J. Sinclair Armstrong, *supra* note 94, at 4.

207. *See* Letter from Patrick J. Falvey to Hon. Robert B. Meyner (May 15, 1975).

208. Newark Star-Ledger, May 16, 1975, at 1, col. 1.

209. 61 N.J. 1, 292 A.2d 545 (1972).

210. 58 N.J. 432, 278 A.2d 489 (1971).

211. N.Y. Times, May 16, 1975, at 41, col. 1.

212. Newark Star-Ledger, May 17, 1975, at 1, col. 1.

213. Barr Brothers & Co., Inc., The Reports of My Death are Greatly Exaggerated (June 12, 1975), *reproduced in* Brief for Defendants-Respondents-Cross-Appellants, State's Supplemental Exhibit A, United States Trust Co. v. State, 69 N.J. 253, 353 A.2d 514 (1976), *rev'd*, 431 U.S. 1 (1977).

withstanding the superior court decision the Port Authority continued to be "one of the finest revenue credits in the country"[214] and that "[a]t these depressed levels, . . . [the bonds presented] an outstanding and secure value for the investor."[215]

To one familiar with the municipal bond industry the Barr Brothers report was wholly understandable since the supreme court had just acted so quickly on the appeal papers and Barr Brothers, as a Port bond dealer, had in-house massive inventories of the bonds with heavy paper losses—it had to act to bolster the market or see its position continue to decline. But to an outsider unfamiliar with the day-to-day operations of the market the report seemed to be directly contradictory to the expert trial testimony with respect to the importance of the Covenant to bondholder security.

The state reacted to the Barr Brothers report as one might expect. A copy was attached as Exhibit A to the state's appeal brief[216] and the brief itself was sprinkled liberally with references to it.[217]

United States Trust's brief on appeal took issue with many of the superior court's findings, but the key concept which the brief attempted to impress on the court was the trial court's apparent misreading of the *Worthen*[218] case:

> Thus, although in *Kavanaugh* the Court was careful to state that the *destruction* of the quality of a security "as an acceptable investment for a rational investor" constituted the "outermost limits" of the bounds of which a state may not transgress, the Trial Court adopted these outer limits as its sole standard for determining the constitutionality of the 1974 Legislation. According to the Trial Court, any transgression by the State which falls short of the "outermost limits," is constitutionally valid. The Trial Court has turned what to the Supreme Court was an unconstitutional maximum into a required minimum demonstration.[219]

For some reason the state did not make any reference to *Worthen* in its main brief on appeal and in its reply brief referred to *Worthen* only in a footnote,[220] making no attempt to justify the superior court's interpretation of the case. This tactic proved to be well-founded, since after a desultory oral argument on October 7, 1975, the New Jersey Supreme Court, on February 25, 1976, affirmed the judgment, per curiam, "substantially for the reasons set forth in the opinion of Judge

214. *Id.*

215. *Id.*

216. *Id.*

217. *Id.* at 2, 50, 75.

218. 295 U.S. 56 (1935).

219. Brief for Appellant at 68, United States Trust Co. v. State, 69 N.J. 253, 353 A.2d 514 (1976), *rev'd*, 431 U.S. 1 (1977) (citations omitted).

220. Reply Brief for Defendants-Respondents and Cross-Appellants at 20, United States Trust Co. v. State, 69 N.J. 253, 353 A.2d 514 (1976), *rev'd*, 431 U.S. 1 (1977).

Gelman."[221] Justice Pashman dissented in part, not with respect to the validity of the repealer, which he heartily endorsed, but because he thought the court should go even further, as requested by the *Gaby* plaintiff, and order the Port Authority to formulate a plan for development of mass transit facilities.[222]

V. THE UNITED STATES SUPREME COURT

United States Trust announced immediately that it would appeal the affirmation to the U.S. Supreme Court.[223] The jurisdictional statement was filed May 21, 1976.[224] The state moved to dismiss the appeal[225] and the Court noted probable jurisdiction on June 28, 1976.[226]

At this point the *Gaby* case fell by the wayside.[227] Both United States Trust[228] and the Port Authority[229] urged the Court to reach the merits in *Gaby* and finally settle the issue of the Covenant's constitutional validity, but the Court dismissed the appeal for want of jurisdiction, apparently because the *Gaby* issues had not been reached below. Thus, the "final judgment" element of a section 1257 appeal[230] was absent.

Main briefs were filed over the summer of 1976, with United States Trust continuing to argue that the case was wrongly decided because of an unwarranted expansion of *Worthen*:

> If only those acts of the State which resulted in the destruction of a contract as an acceptable investment were constitutionally impermissible, virtually no covenant or combination of covenants in a bond resolution or statute would be safe from abrogation. There are innumerable covenants and provisions in bond resolutions and statutes, the abrogation of which would not "destroy" the bond's security, but which obviously would result in material impairment of it. Even measured by the "outermost limits" of *Kavanaugh* repeal of the Covenant is constitutionally offensive. There the

221. 69 N.J. 253, 256, 353 A.2d 514, 515 (1976) (per curiam). The New Jersey court was a full panel composed of Justices Mountain, Sullivan, Clifford, and Pashman and three judges, called up from the appellate division (Judges Conford, Carton, and Halpern) to bring the bench to full strength for the case in light of one vacancy and two recusals.

222. *Id.* at 265-66, 353 A.2d at 520-21 (Pashman, J., dissenting in part).

223. Daily Bond Buyer, Feb. 26, 1976, at 1, col. 3

224. The appeal was as of right rather than through certiorari, as it was an appeal from a final judgment of the highest court of a state upholding a state statute in the face of a federal constitutional claim. 28 U.S.C. § 1257(2) (1970).

225. Appellees' Motion to Dismiss for Want of a Substantial Federal Question, United States Trust Co. v. New Jersey, 431 U.S. 1 (1977).

226. United States Trust Co. v. New Jersey, 427 U.S. 903 (1976).

227. Gaby v. Port Auth., 427 U.S. 901 (1976).

228. Intervenor-Appellee's Motion to Dismiss Appeal, Gaby v. Port Auth., 427 U.S. 901 (1976).

229. Defendants' Motion to Dismiss Appeal, Gaby v Port Auth., 427 U.S. 901 (1976).

230. 28 U.S.C. § 1257 (1970).

basic legislation remained; here the States' pledge has been unilaterally wiped from the statute books. Further, the "rational investors" who testified below all said that to them and their customers Port Authority bonds without the Covenant were not an acceptable investment.[231]

As it did in the New Jersey Supreme Court, the state all but ignored *Worthen* in its main brief in the U.S. Supreme Court, saying only:

In addition, the legislation must not reveal a "studied indifference" to the interests of persons seeking to enforce contractual obligations. *W.B. Worthen Co. v. Kavanaugh,* 295 U.S. 56 (1935).

While appellant tries at length to read error into the trial court's discussion of *Worthen v. Kavanaugh, supra,* A.B. 58-59, that court's treatment is perfectly consistent with this Court's analysis in *Faitoute Iron & Steel Co. v. City of Asbury Park,* 316 U.S. 502, 515 (1942), where the Court inquired whether the legislature had been guilty of "studied indifference" to private interests.[232]

Oral argument before the U.S. Supreme Court is invariably a fascinating scene, and it was no different on November 10, 1976, when *United States Trust* was called. The first few moments of argument were discouraging when Justices Stewart and Powell, whose judicial philosophy was thought to be favorable to the United States Trust side, left the bench. Justice Stewart returned almost immediately and heard argument, but did not take part in the decision.

Devereux Milburn, for United States Trust, led off with a factual history of the case[233] and then discussed the traditional predicate of an emergency to ground an exercise of the police power:

Now, what justifies the use of the police power?

In such a case as we have here, if it can be justified— . . . *Blaisdell* and its progeny established that it must be an emergency.

Now, *Blaisdell* had a real emergency. They had mobs in the Middle West. They had—

QUESTION: You mean something like the *Minnesota Mortgage* moratorium?

MR. MILBURN: This was it, yes. That was the statute in *Blaisdell,* and there

231. Brief for Appellant at 59, United States Trust Co. v. New Jersey, 431 U.S. 1 (1977). The Securities Industry Association, a trade association of investment bankers, underwriters, brokers, dealers, and bond departments of banks, filed an amicus curiae brief in support of the Supreme Court's hearing the appeal. Securities Industry Association's Motion for Leave to File Brief Amicus Curiae (Aug. 12, 1976) at 1-2, United States Trust Co. v. New Jersey, 431 U.S. 1 (1977); Securities Industry Association's Brief of Amicus Curiae (June 4, 1976), United States Trust Co. v. New Jersey, 431 U.S. 1 (1977). The Association also filed an amicus curiae brief on the merits and moved for leave to file an amicus curiae reply brief, but the motion was denied. Securities Industry Association's Brief of Amicus Curiae (Aug. 12, 1976), United States Trust Co. v. New Jersey, 431 U.S. 1 (1977); Securities Industry Association's Motion for Leave to File Reply Brief Amicus Curiae at 2, United States Trust Co. v. New Jersey, 431 U.S. 1 (1977).

232. Brief for Appellees at 85, United States Trust Co. v. New Jersey, 431 U.S. 1 (1977).

233. Transcript of Oral Argument at 3-12, United States Trust Co. v. New Jersey, 431 U.S. 1 (1977).

were riots and there were mobs, and something had to be done. The statute was passed, and Mr. Justice Hughes' opinion in that case refers again and again and again to emergency. He also refers to temporary.[234]

. . . .

QUESTION: So—well, was there an emergency about mass transit? I guess you would say there isn't any more than there always had been?

MR. MILBURN: Well, I go back to 1921, if you'd like, and come all the way through, there's always been an emergency—well, why use that word? Because I don't think it's as chronic a situation.

An emergency to me is a house on fire.

. . . .

If you came around a corner, you were the mayor of the town, and you see a house on fire, what are you going to do? You will put it out. You're not going to go to your desk and draft legislation to get a new fire department, which is going to come into existence ten years from now, and put the next fire out. The emergency is—an emergency to us is something immediate.

And here we have a drop in the bucket, even when it works, all the Port Authority could do is a drop in the bucket of the transit problem on the Eastern Seaboard.[235]

Counsel for the state opened his argument with eloquence: "Of all the hundreds of cases alleging contract impairment that have come before this Court in two centuries, none has involved public ends as vital as those sought to be served by the State here, and few have involved contract infringements so inconsequential."[236]

The Court then went straight to the heart of the case—questioning counsel for the state closely with respect to the nexus between repeal of the Covenant and the emergency conditions it was allegedly intended to alleviate:

QUESTION: Well, are there any methods of, just if you concentrate on that one feature, limiting the amount of traffic coming across the bridge—are there any ways that that could be done without tampering at all with the New York Port Authority? With the bond holder structure.

Couldn't you close the bridge for a couple of hours a day?

[ANSWER]: You could, Your Honor. I do believe Mr. Milburn would be here maintaining that that was a violation of covenants with bond holders. I do believe that the police power does entitle the State to do that.

. . . .

QUESTION: Is it possible . . . that closing the bridges down and doing some of these other things that were suggested by Justice Stevens were politically unpalatable?

[ANSWER]: Well, there's no question about that, Your Honor, that neither Legislature—

QUESTION: The voices of those people would be heard more widely than the voices of the bond holders in the public arena, wouldn't they?

[ANSWER]: Well, there's no question about it [237]

The Court was also evidently concerned in its questions to counsel

234. *Id.* at 14-15.

235. *Id.* at 18-20.

236. *Id.* at 24.

237. *Id.* at 27, 32.

for the state with the possible alternatives to repeal which would have been less intrusive on bondholders' rights but politically less popular:

QUESTION: —I understand. But, nevertheless, if the State had wanted to—if the States had wanted to commit their own credit rather than the Port Authority's, they could have had the Port Authority go into mass transit as a separate single venture.

. . . .

QUESTION: Yes, Well, that's what I'm asking you. Wasn't this some—this certainly was a feasible and less intrusive way of going about it.

[ANSWER]: I'm afraid it wasn't feasible. And it—

QUESTION: Well, it wasn't feasible, but it was less intrusive, as far as the bond holders go.

[ANSWER]: No question the bond holders would have been happier had the States done it that way.[238]

Justice Marshall was clearly willing to look down the road to the future losses which a mass transit operation would produce:

QUESTION: Well, mass transit is not going to bring in any profit.

[ANSWER]: That's absolutely correct, Your Honor, but lots of other projects are. And this enterprise has always operated a number of deficit facilities, and—

QUESTION: And it's always stayed out of mass transit.

[ANSWER]: Well, that's not true, Your Honor. One of the fascinating things is their peculiar belief that—

QUESTION: Did anything in the record come up about San Francisco's mass transit brainstorm?

[ANSWER]: There's nothing in the record, Your Honor.

QUESTION: Okay.

[ANSWER]: The recent—I saw a recent report that suggests it isn't doing so well, but, of course, it wasn't running very well, either. Everybody agrees that the PATH is a very well-run railroad.[239]

The Chief Justice was also concerned with future losses in his questions to counsel for the state:

QUESTION: Well, I suppose the change in the risk here is not an immediate risk, it's rather the risk that after the several years that are required to build the extension of the railroad, they finally get it done and, like they did out in Oakland and all, that then you start losing larger sums of money than were anticipated, instead of it being a $5 million deficit, it's $100 million deficit.

That's the kind of risk that I suppose is at stake here.

[ANSWER]: But it is a very hypothetical risk, Your Honor. The arrangement between the Port—

QUESTION: Well, isn't there some factual basis for assuming that it can happen?

[ANSWER]: Oh, that it is possible? Yes, Your Honor.

QUESTION: Well, don't you have experience with this one railroad that you've taken over, that its losses were much greater than anticipated?

[ANSWER]: Yes, but this deal does not contemplate the Port Authority paying operating deficits. The arrangements that have been made will use the Port—

238. *Id.* at 34.

239. *Id.* at 44-45.

QUESTION: Well, but the covenant would permit you to do—I mean, the repeal would permit you to do so, wouldn't it?

[ANSWER]: The repealer would, but the State's legislation, and the implementing administrative actions, have provided that the Port Authority is responsible only for the debt service: a knowable defined figure—

QUESTION: But those various actions could be changed, if things get a little worse and you need more money some place else, you change things one at a time, wouldn't you?

[ANSWER]: Well, conceivably yes, Your Honor; although it is—the Port Authority has, on many occasions, made its own promises to bond holders, without State—

QUESTION: It has no obligation to keep them, apparently.

. . . .

QUESTION: What do you suppose a referendum among the bond holders, on whether the covenant should be repealed, would bring?

[ANSWER]: Well, I have no doubt, Your Honor, that they don't like it.

. . . .

QUESTION: But you're just saying that they can still sell some bonds, but the people buying bonds now are taking their risk.

[ANSWER]: What I'm suggesting to Your Honor—

QUESTION: The old bond holders didn't think they were taking any risk.[240]

On rebuttal counsel for United States Trust summed up the bondholders' case:

Why can't the States do something, except abrogate out [*sic*] contract? That's what I would like to know. I don't know the answer to that kind of question.

Now, Mr. Justice Marshall, you mentioned a new deficit going into PATH. We've got a beauty, we'll all admit that. We've got one running about $28 million. It was supposed to run six, it's running 28.

Let's put another one in there, and let's say that the Commissioners are wrong again, are wrong by a factor of five again, and let's say we've got another $30 million deficit in there, and, in the meantime, PATH has gone up. We're talking about $70 million deficit. Let's have a little depression, let's have our airports slack off a little bit, and they are going to default on the bonds.

That's why we don't want a tremendous new deficit into the Port Authority, and you can't stop it because it comes in as a baby and it grows into a giant.[241]

All the hard questions had been asked, and the feeling was that the Court expressed a sense of dissatisfaction with the repeal, almost a sense of outrage, that would never be apparent from the pages of the transcript. Justice Marshall was thought to be one of the Justices most upset by the repeal; some of his questions to counsel for the state bordered in tone on sarcastic. The Chief Justice seemed equally unhappy with the failure of the state to examine any course but outright repeal, and Justice White repeatedly asked whether less intrusive alternatives could not have accomplished the states' objectives, a concern shared by Justices Stevens and Rehnquist and, to a

240. *Id.* at 47-48, 50, 51.

241. *Id.* at 55-56.

lesser extent, by Justice Blackmun. The two imponderables were Justices Brennan and Stewart, who took little part in the argument, but were thought to be on opposite sides of the issue because of their positions in other cases.

United States Trust is thus an excellent example of the fact that you cannot tell very much from oral argument.

VI. THE SUPREME COURT DECISION

On April 27, 1977, the U.S. Supreme Court, 4-3, reversed the New Jersey Supreme Court and struck down the repeal of the 1962 Covenant as violative of the contract clause of the Federal Constitution.[242] Mr. Justice Blackmun wrote the majority opinion,[243] concurred in by Justices Rehnquist and Stevens and by the Chief Justice, who also filed a concurring statement.[244] Justice Brennan dissented, joined by Justices Marshall and White. Justice Stewart took no part in the decision, and Justice Powell took no part in the consideration or decision of the case.

Justice Blackmun first reviewed the establishment of the Port Authority "as a financially independent entity, with funds primarily derived from private investors,"[245] and referred to the trial court's finding that the agency was not originally intended to assume passenger transit responsibilities.[246] He then outlined the fiscal policy of the Port Authority, noting the trial court finding that after the Consolidated Bond Resolution of 1952 the agency's self-supporting facility concept "ceased to have the significance previously attached to it."[247]

Reviewing the renewed interest in mass transit, Justice Blackmun characterized as a "retaliation" to mass transit proposals the institution of the section 7 certification by the agency and also referred to the 1959 commuter car program.[248] Then the Court summarized the H&M takeover, quoting the trial court conclusion that "it was necessary to place a limitation on mass transit deficit operations to be undertaken by the Authority in the future so as to promote continued investor

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

243. *Id.* This had been expected by veteran Court-watchers who know that Justice Blackmun is one of the slower authors on the Court. By April, five months after argument, he was running several opinions behind his pace of a year earlier and it was concluded that United States Trust was one of the cases occupying his time.

244. *Id.* at 32.

245. *Id.* at 4.

246. *Id.* at 5 n.6.

247. *Id.* at 7 n.8 (quoting 134 N.J. Super. at 143, 338 A.2d at 843).

248. *Id.* at 8.

confidence in the Authority."[249] The Court then described the Covenant, concluding:

> The terms of the covenant were self-evident. Within its conditions the covenant permitted, and perhaps even contemplated, additional Port Authority involvement in deficit rail mass transit as its financial position strengthened, since the limitation of the covenant was linked to, and would expand with, the general reserve fund.[250]

The Court then discussed the increasing PATH deficits in the face of static tolls, despite recommended increases,[251] and the 1973 prospective repeal of the Covenant,[252] which did not result in the expected transit improvements:

> It soon developed that the proposed PATH expansion would not take place as contemplated in the Governors' 1972 plan. New Jersey was unwilling to increase its financial commitment in response to a sharp increase in the projected cost of constructing the Plainfield extension. As a result the anticipated federal grant was not approved.[253]

Finally, the Court briefly recounted the retroactive repeal of the Covenant and the subsequent toll increases to augment the agency's mass transit financing abilities.[254]

At the threshold of his legal discussion Justice Blackmun acknowledged the preeminence of the contract clause as a significant limit on state power during our nation's first century and the fourteenth amendment's preeminence during the second.[255] The Court then reviewed *Blaisdell* and *El Paso* as representing the Court's view of the "present role of the Contract Clause,"[256] concluding:

> Both of these cases eschewed a rigid application of the Contract Clause to invalidate state legislation. Yet neither indicated that the Contract Clause was without meaning in modern constitutional jurisprudence, or that its limitation on state power was illusory. Whether or not the protection of contract rights comports with current views of wise public policy, the Contract Clause remains a part of our written Constitution.

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249. *Id.* at 9 (quoting from 134 N.J. Super. at 178, 338 A.2d at 863-64).

250. *Id.* at 11. The Court noted without comment the unsuccessful constitutional attack on the legislation containing the Covenant: Courtesy Sandwich Shop, Inc. v. Port Auth., 12 N.Y.2d 379, 190 N.E.2d 402, 240 N.Y.S.2d 1, *appeal dismissed*, 375 U.S. 78 (1963); *see* Kheel v. Port Auth., 331 F. Supp. 118 (S.D.N.Y. 1971), *aff'd*, 457 F.2d 46 (2d Cir.), *cert. denied*, 409 U.S. 983 (1972). The Court then went on to say that "[w]ith the legislation embracing the covenant thus effective" the Port Authority took over the H&M. 431 U.S. at 11. This is a strong indication that the *Gaby* issue, if ever reached by the Court, would be disposed of summarily.

251. 431 U.S. at 11-12.

252. *Id.* at 13.

253. *Id.* at 13.

254. *Id.* at 13-14.

255. *Id.* at 14-15.

256. *Id.* at 14-16.

We therefore must attempt to apply that constitutional provision to the instant case with due respect for its purpose and the prior decisions of this Court.[257]

This expressed the first tenet of *United States Trust:* there is no per se rule of contract clause application—no automatic invalidation of an impairment of any specific type of contract, no matter how carefully conceived or callously abrogated. The post-Civil War depression cases,[258] which were thought not to survive *Blaisdell,* clearly do not survive *United States Trust* insofar as they suggest literal constitutional protection of bond covenants.

Justice Blackmun then turned to the basic claim that a contract had been impaired, saying on the one hand that the contract clause applies to state as well as private contracts[259] and on the other that the clause did not affect the states' general power to repeal or amend statutes or to give legislation retroactive effect.[260] Finding that the 1962 Covenant "has been properly characterized as a contractual obligation of the two States"[261] the Court considered the arguments made with respect to the value of the Covenant to bondholders, concluding:

The fact is that no one can be sure precisely how much financial loss the bondholders suffered. Factors unrelated to repeal may have influenced price. In addition, the market may not have reacted fully, even as yet, to the covenant's repeal, because of the pending litigation and the possibility that the repeal would be nullified by the courts.

In any event, the question of valuation need not be resolved in the instant case because the State has made no effort to compensate the bondholders for any loss sustained by the repeal. As a security provision, the covenant was not superfluous; it limited the Port Authority's deficits and thus protected the general reserve fund from depletion. Nor was the covenant merely modified or replaced by an arguably comparable security provision. Its outright repeal totally eliminated an important security provision and thus impaired the obligation of the States' contract.[262]

Thus the Court found that because a material security device was cancelled there was no need to reach the further issue of claimed damage to the secondary market.

At this point the second principal teaching of *United States Trust* is expressed in a footnote.[263] Contract rights, notwithstanding the literal

257. *Id.* at 16.

258. *See* note 155 *supra* and accompanying text.

259. 431 U.S. at 17 (citing Fletcher v. Peck, 10 U.S. (6 Cranch) 87, 137-39 (1810), and Dartmouth College v. Woodward, 17 U.S. (4 Wheat.) 518 (1819)).

260. *Id.* at 17.

261. *Id.* at 18.

262. *Id.* at 19 (footnotes omitted). This was precisely the same ground of impairment found by the trial court. *See* text accompanying note 198 *supra.*

263. 431 U.S. at 19 n.16 (citing Contributors to the Pa. Hosp. v. City of Philadelphia, 245 U.S. 20 (1917), and City of El Paso v. Simmons, 379 U.S. 497, 533-34 (1965) (Black, J., dissenting)).

phrasing of the contract clause, are a form of property which, as with other property, can "be taken for a public purpose provided that just compensation is paid."[264]

In a municipal bond case the compensation issue raises enormously complex problems. If a security device is "taken for a public use" how is compensation to be determined? By reference to the value of the investment without it? By reference to whether the obligation to pay principal and interest has been materially affected? By reference to market reaction? As part of the "compensation" element one presumably would have to consider comparable alternative security devices or additional security pledged in lieu of the cancelled promise. These issues will have to await another day.

Now that the Court had a contract and an impairment it considered "whether that impairment violated the Contract Clause,"[265] and promptly discarded, as noted above, any concept of a per se rule:

> Thus, a finding that there has been a technical impairment is merely a preliminary step in resolving the more difficult question whether that impairment is permitted under the Constitution. In the instant case, as in *Blaisdell,* we must attempt to reconcile the strictures of the Contract Clause with the "essential attributes of sovereign power," necessarily reserved by the States to safeguard the welfare of their citizens.
>
> The trial court concluded that repeal of the 1962 covenant was a valid exercise of New Jersey's police power because repeal served important public interests in mass transportation, energy conservation, and environmental protection. Yet the Contract Clause limits otherwise legitimate exercises of state legislative authority, and the existence of an important public interest is not always sufficient to overcome that limitation. "Undoubtedly, whatever is reserved of state power must be consistent with the fair intent of the constitutional limitation of that power." Moreover, the scope of the State's reserved power depends on the nature of the contractual relationship with which the challenged law conflicts.[266]

The Court freely acknowledged the state's broad power to regulate without concern for destruction of *private* contracts, since private arrangements could not have the effect of securing immunity from state regulation.[267] But even this broad power is not unrestricted—laws regulating existing private contracts "must serve a legitimate public purpose":[268]

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264. *Id.* at 19 n.16.

265. *Id.* at 21.

266. *Id.* at 21-22 (citations omitted).

267. *Id.* at 22 ("One 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.") (citing Hudson Water Co. v. McCarter, 209 U.S. 349, 357 (1908)).

268. *Id.* at 22 (citing Home Bldg. & Loan Ass'n v. Blaisdell, 290 U.S. 398, 444-45 (1934)).

A State could not "adopt as its policy the repudiation of debts or the destruction of contracts or the denial of means to enforce them." Legislation adjusting the rights and responsibilities of contracting parties must be upon reasonable conditions and of a character appropriate to the public purpose justifying its adoption. As is customary in reviewing economic and social regulation, however, courts properly defer to legislative judgment as to the necessity and reasonableness of a particular measure.[269]

Here was the third principle of *United States Trust:* While the states' power to regulate where private contracts are infringed or destroyed is broad, it is not without limits, and will be tested by the reasonableness of the legislation in the light of all the circumstances. The factors to be assessed, which "cannot be regarded as essential in every case,"[270] include (1) the existence of an emergency; and (2) the duration of any relief.[271]

Putting aside the private contract issue, Justice Blackmun turned to a state's impairment of its own contract, where "the reserved power doctrine has a different basis."[272] He first discussed the ability of a state to make a contract limiting its power to act in the future; for if the state lacked power ab initio to create an irrevocable undertaking, then the issue of the reasonableness of its subsequent impairment would never be reached.[273] "In short, the Contract Clause does not require a State to adhere to a contract that surrenders an essential attribute of its sovereignty."[274]

Historically the police power and the power of eminent domain were considered inalienable, while the state could commit itself with respect to future taxes or spending:[275]

Such formalistic distinctions perhaps cannot be dispositive, but they contain an important element of truth. Whatever the propriety of a State's binding itself to a future course of conduct in other contexts, the power to enter into effective financial contracts cannot be questioned. Any financial obligation could be regarded in theory as a relinquishment of the State's spending power, since money spent to repay debts is not available for other purposes. Similarly, the taxing power may have to be exercised if

269. *Id.* at 22-23 (citations and footnote omitted).

270. *Id.* at 22 n.19.

271. *Id.* The Court invited a comparison of W.B. Worthen Co. v. Thomas, 292 U.S. 426, 432-34 (1934), and Treigle v. Acme Homestead Ass'n, 297 U.S. 189, 195 (1936), with Home Bldg. & Loan Ass'n v. Blaisdell, 290 U.S. 398 (1934), Veix v. Sixth Ward Bldg. & Loan Ass'n, 310 U.S. 32, 39-40 (1940), and East New York Savings Bank v. Hahn, 326 U.S. 230 (1945).

272. 431 U.S. at 23.

273. *Id.* at 23.

274. *Id.* at 23.

275. *Id.* at 24. The tax conclusion is very doubtful, but no Supreme Court case has squarely held that the tax power is within the "inalienable" category. *Id.* at 24 n.21.

debts are to be repaid. Notwithstanding these effects, the Court has regularly held that the States are bound by their debt contracts.[276]

Turning back to the case in issue, the Court crossed the threshold, holding: "The instant case involves a financial obligation and thus as a threshold matter may not be said automatically to fall within the reserved powers that cannot be contracted away."[277]

But the Court continued, "Not every security provision . . . is necessarily financial,"[278] positing a revenue bond secured by a promise to operate the facility producing the revenues, with residual power in the state to close the facility "for health or safety reasons."[279] But with respect to the 1962 Covenant:

The security provision at issue here, however, is different: the States promised that revenues and reserves securing the bonds would not be depleted by the Port Authority's operation of deficit-producing passenger railroads beyond the level of "permitted deficits." Such a promise is purely financial and thus not necessarily a compromise of the State's reserved powers.[280]

Thus the Court reached the plateau of finding that the 1962 Covenant was valid when adopted. But here the contract clause inquiry *begins* rather than ends:

Of course, to say that the financial restrictions of the 1962 covenant were valid when adopted does not finally resolve this case. The Contract Clause is not an absolute bar to subsequent modification of a State's own financial obligations. 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

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276. *Id.* at 24 (footnote omitted). The Court also noted with approval the specific holdings in the post-Civil War depression cases that a state could not enable a subdivision to borrow and then limit its taxing power, thus frustrating repayment. Louisiana v. City of New Orleans, 215 U.S. 170 (1909); Wolff v. City of New Orleans, 103 U.S. 358 (1881); Von Hoffman v. City of Quincy, 71 U.S. (4 Wall.) 535 (1867). As discussed above in the text accompanying note 258, however, it did not adopt the per se rule suggested by those cases.

277. 431 U.S. at 24-25 (footnote omitted).

278. *Id.* at 25.

279. *Id.* The example was a confusing and unnecessary misstep by the Court. Better to conclude that the promise to continue operating the facility is a "financial" obligation, as it is viewed by municipal bond counsel and investors, and then to consider whether the state could superimpose the police power in a health or safety emergency. A promise of this type should clearly satisfy the Court's initial inquiry and fall within the irrevocable category; whether that promise may be modified if reasonable should be a subsequent inquiry.

280. *Id.* at 25.

wanted to spend the money for what it regarded as an important public purpose, the Contract Clause would provide no protection at all.[281]

The Court then began to structure its legal test, and agreed with counsel for United States Trust that *Worthen* did not control the case:

> The trial court's "total destruction" test is based on what we think is a misreading of *W.B. Worthen Co. v. Kavanaugh*, 295 U.S. 56 (1935). In the first place, the impairment held unconstitutional in *Kavanaugh* was one that affected the value of a security provision, and certainly not every bond would have been worthless. More importantly, Mr. Justice Cardozo needed only to state an "outermost limits" test in the Court's opinion, *id.*, at 60, because the impairment was so egregious. He expressly recognized that the actual line between permissible and impermissible impairments could well be drawn more narrowly. Thus the trial court was not correct when it drew the negative inference that any impairment less oppressive than the one in *Kavanaugh* was necessarily constitutional. The extent of impairment is certainly a relevant factor in determining its reasonableness. But we cannot sustain the repeal of the 1962 covenant simply because the bondholders' rights were not totally destroyed.[282]

The Court then considered *Faitoute Iron & Steel Co. v. City of Asbury Park*,[283] the one Supreme Court case in modern times that had upheld alteration of a municipal bond contract. *Faitoute*, however, was not controlling. There the bond alternatives enabled the city to cure a default, to discharge an obligation, and the market value of the bonds went up.[284] *United States Trust* involved "a much more serious impairment than occurred in *Faitoute*,"[285] and no one contended that the states acted to help bondholders or that the secondary market was enhanced by repeal.

Finally, the Court turned to the claimed defense of repeal: the argument that harm to bondholders was outweighed by the goals of mass transit, energy conservation, and environmental improvement sought to be benefited by repeal.[286] Justice Blackmun immediately declined to engage in the balancing so feared by Justice Black in *El Paso*:[287]

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281. *Id.* at 25-26 (footnotes omitted). In a footnote the Court referred to the stricter standard applied when the impairment is occasioned by a need for money. *Id.* at 26 n.25; *see* Perry v. United States, 294 U.S. 330, 350-51 (1935); Lynch v. United States, 292 U.S. 571, 580 (1934).

282. 431 U.S. at 26-27 (footnotes omitted). The Court even agreed with the main brief on appeal that since here an express promise had been cancelled rather than an implied promise as in *Worthen*, "the instant case may be regarded as a more serious abrogation of the bondholders' expectations than occurred in [*Worthen*]." *Id.* at 26 n.26.

283. 316 U.S. 502 (1942).

284. 431 U.S. at 27-28.

285. *Id.* at 28.

286. *Id.* at 28-29.

287. *Id.* at 29.

> Thus a State cannot refuse to meet its legitimate financial obligations simply because it would prefer to spend the money to promote the public good rather than the private welfare of its creditors. We can only sustain the repeal of the 1962 covenant if that impairment was both reasonable and necessary to serve the admittedly important purposes claimed by the State.[288]

This is the fourth principle of the case and the key to *United States Trust*: however reasonable the proposed modification of a state's own financial obligation, it will not be upheld unless it can be shown that such action was not only reasonable but necessary to serve important state purposes.

Where necessity is the test, the availability of other less intrusive alternatives becomes a critical area of inquiry. Thus Justice Blackmun considered the state's specific justification for repeal—the plan to raise bridge and tunnel tolls to discourage auto use and use the revenues to subsidize commuter rail service. Here repeal was neither necessary to achieve the plan nor reasonable in the circumstances. The necessity test was not satisfied because a less intrusive adjustment of the Covenant, short of total cancellation, would have been enough. Further, there were obvious alternatives to reach the goals of inhibiting auto use and improving railroads,[289] and the state is not "completely free to consider impairing the obligations of its own contracts on a par with other policy alternatives [nor] to impose a drastic impairment when an evident and more moderate course would serve its purposes equally well."[290]

Nor to the Court was repeal reasonable. Unlike *El Paso,* where the effect of a 19th century statute was unforeseen and unintended, both the need for mass transit and its deficit nature were well known for years before the Covenant was enacted; in fact, these problems were the reason for its enactment.[291] Changes between 1962 and the Covenant's repeal were "of degree and not of kind"[292] and thus repeal was not reasonable in light of the change in circumstances, which was

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288. *Id.*

289. *Id.* at 30.

290. *Id.* at 30-31. A somewhat disconcerting note in the Court's opinion suggests that one alternative might be to limit mass transit diversions to the "new" bridge and tunnel tolls, or to increase the "permitted deficit" formula, or to loosen the bondholder consent procedures. But this note was clearly only for the purpose of illustrating that the states had gone too far in their total cancellation of the Covenant, and the note concluded: "Of course, we express no opinion as to whether any of these lesser impairments would be constitutional." *Id.* at 30 n.28; *see* concurring statement of Burger, C.J., *id.* at 32-33.

291. *Id.* at 31-32.

292. *Id.* at 32.

the key element in *El Paso*: "We therefore hold that the Contract Clause of the United States Constitution prohibits the retroactive repeal of the 1962 covenant. The judgment of the Supreme Court of New Jersey is reversed."[293]

In his brief concurring statement the Chief Justice read the Court's opinion as requiring the state to demonstrate that impairment was essential to achieve an important state purpose and furthermore that the state "did not know and could not have known the impact of the contract on that state interest at the time that the contract was made."[294]

Justice Brennan, dissenting, first reviewed the undisputed effectiveness of the Covenant in limiting Port Authority mass transit involvement, and then reviewed the energy and environmental concerns that were put forth to justify repeal.[295] The dissent expressed puzzlement at the majority's formulation of the necessity test, concluding that the alternatives proposed were "simply . . . not responsive" to the Port District's environmental and traffic problems.[296] Nor was Justice Brennan satisfied with Justice Blackmun's view of reasonableness: "Nowhere are we told why a state policy, no matter how responsive to the general welfare of its citizens, can be reasonable only if it confronts issues that previously were absolutely unforeseen."[297] The dissent reviewed at some length the allegedly negligible injury to bondholders which resulted from repeal,[298] a point effectively refuted by the majority, which pointed out that if the Covenant in fact meant so little then surely the states could simply have condemned it and paid the negligible compensation required.[299] The fact that the states did not choose this route is almost conclusive evidence in itself of the Covenant's material importance to investors.

The dissent then reviewed the history of the contract clause, concluding in essence that the clause today should be viewed as a vestigial appendage to the Constitution and that courts should defer all but conclusively to a legislative determination of whether the clause is offended by retroactive civil legislation.[300] In short the dissent was willing to leave bond purchasers to fend for themselves in the mar-

293. *Id.*
294. *Id.* (Burger, C.J., concurring).
295. *Id.* at 33-41 (Brennan, J., dissenting).
296. *Id.* at 40 (Brennan, J., dissenting).
297. *Id.* (footnote omitted) (Brennan, J., dissenting).
298. *Id.* at 41-44 (Brennan, J., dissenting).
299. *Id.* at 29 n.27.
300. *Id.* at 44-62 (Brennan, J., dissenting).

ketplace without a judicial remedy. One must wonder how the bondholders could have had their voices heard in the present case, where the states acted without notice, without hearings, without debates, and with one governor freely admitting that the sole purpose of repeal was to prompt a court test of the Covenant's validity.[301]

VII. CONCLUSION

United States Trust was hailed by the municipal bond community as establishing almost conclusive constitutional protection for municipal bond covenants.[302] It is not quite that. Opponents, on the other hand, foretold that the decision would have a profound adverse effect on rail mass transit in the Port District.[303] This is hardly the case. What the Court said was that public bond contracts will be treated with due respect and will withstand attempts at abrogation prompted principally by contemporary political expediency.

In reaching this conclusion the Court established the guidelines for the modern application of the contract clause in a society infinitely more complex than the one which prompted the formulation of the clause. In summary, notwithstanding the literal language of the clause, there is no per se rule; there are no contracts which will forever be impervious to subsequent state legislation. Second, all contracts are, as other property, subject to the states' powers of eminent domain, a principle which raises enormously complex issues when applied to municipal bond covenants. Third, where state regulation impinges on private contracts the legislature will be given broad leeway, but the legislation nevertheless must be reasonable in light of all the circumstances, and relevant factors to be considered are the existence of an emergency and the scope of the relief. Finally, there are areas where the states are competent as sovereigns to enter into binding obligations, and financial covenants with state creditors are a classic example. But even here the promise may not be entirely durable; any change, however, will be tested by a joint standard of reasonableness plus necessity.

United States Trust presents at the same time a primer for enactment of an irrevocable financial obligation and a recipe for its subsequent modification. Neither process should be undertaken casu-

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301. *See* text accompanying note 98 *supra*.

302. *E.g.*, N.Y. Times, May 2, 1977, at 51, col. 3; Wall St. J., Apr. 29, 1977, at 12, col. 1-2; Am. Banker, Apr. 28, 1977, at 1, col. 1.

303. *E.g.*, Newark Star-Ledger, May 1, 1977, at 1, col. 3.

ally. The case was won (or lost) by the narrowest of margins, and it may well have been that a properly orchestrated modification of the 1962 Covenant would have withstood constitutional attack. But the process of adjusting prior bond covenants is an agonizing one at best. In *United States Trust* investors suffered paper and actual losses which may have totalled millions of dollars while the market fluctuated in the months following repeal. The State of New Jersey suffered in the minds of potential investors and was forced to pay increased interest costs when its credit rating was dropped by the principal rating agency, in part because of the repeal of the Covenant.[304] The State of New York suffered as did its agencies when many informed institutional investors simply crossed New York and New Jersey off their lists because of the repeal.[305] Experts viewed the repeal of the Covenant as a principal contributing factor to the financial collapse of the New York Urban Development Corporation[306] and the end of the moral obligation bond as an effective tool of municipal finance.[307] The Port Authority, in every sense a bystander in the conflict between the states and the agency's investors, saw its financing program stopped dead in the water for almost three years while the judicial process went on. In a sense the courts of New Jersey suffered, since bond lawyers are confident that repeal of the Covenant would never have been sustained by the New York Court of Appeals,[308] and prior to *United States Trust* the New Jersey judiciary had been viewed as the most steadfast advocates in the nation of the rights of municipal investors.[309]

In short, the damage done by the repeal of the 1962 Covenant far exceeded any possible benefit to the states from a few extra dollars for mass transit. If there is a practical lesson to be learned from *United States Trust* it is that political expediency can never justify in fact the cavalier repudiation of a sovereign's promises to its investors.

304. *See* Moody's Investors Service, Inc., Municipal Credit Report, State of New Jersey (June 23, 1975).

305. *See* notes 136-37 *supra* and accompanying text.

306. *See* N.Y. State Moreland Act Comm'n on the Urban Dev. Corp. & Other State Financing Agencies, Restoring Credit and Confidence 161 (Mar. 31, 1976).

307. *See* note 136 *supra*; Moody's Investors Service, Inc., Policy Statement (June 23, 1975).

308. *See, e.g.*, Flushing Nat'l Bank v. Municipal Assistance Corp., 40 N.Y.2d 731, 358 N.E.2d 848, 390 N.Y.S.2d 22 (1976); Patterson v. Carey, 41 N.Y.2d 714, 363 N.E.2d 1146, 395 N.Y.S.2d 411 (1977).

309. *See, e.g.*, New Jersey Sports & Exposition Auth. v. McCrane, 61 N.J. 1, 292 A.2d 545, *appeal dismissed sub nom.* Borough of East Rutherford v. New Jersey Sports & Exposition Auth., 409 U.S. 943 (1972); New Jersey Highway Auth. v. Sills, 109 N.J. Super. 424, 263 A.2d 498 (Ch. Div.), *supplemented*, 111 N.J. Super. 313, 268 A.2d 308 (Ch. Div. 1970), *aff'd per curiam*, 58 N.J. 432, 278 A.2d 489 (1971).

The legal lesson of *United States Trust* is just as clear. The financially independent public authority represents the modern format for accomplishing great public purpose projects while not increasing the general tax burden. Where its covenants and those of states and their subdivisions are constructed to ensure the financial well-being of the issuer, then those covenants will be sustained short of a demonstration that the covenant must yield because that course is not only reasonable but necessary to effectuate a legitimate state interest. This is, as it should be, a most difficult test. Hopefully, it is one that will rarely be applied.