1977

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Cover Page Footnote
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This article is available in Fordham Urban Law Journal: https://ir.lawnet.fordham.edu/ulj/vol6/iss1/1
ENHANCING THE SECURITY BEHIND MUNICIPAL OBLIGATIONS: FLUSHING AND U.S. TRUST LEAD THE WAY

Kenneth W. Bond*

I. Introduction

When bond counsel render their legal opinion approving the issuance and delivery of a municipal obligation, one of the opinions traditionally expressed is that the obligation is "valid and legally binding according to its terms." Significant, here, are the words "valid" and "binding."

The validity of a municipal obligation can usually be determined by straightforward observation. Bond counsel must be satisfied that (1) the issuer has statutory and sometimes constitutional authority to borrow and incur indebtedness, (2) the funds borrowed are to be used for a public purpose, and (3) the issuer has complied with the preconditions to issuing debt obligations and incurring indebtedness.

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1. Bond counsel are attorneys who specialize in the law of municipal finance. Their clients are municipalities, states and other public bodies which issue debt obligations. Their opinion that a municipal obligation is legal, valid and binding, and that the interest thereon is exempt from income taxation, is usually required by purchasers and underwriters at the time the obligations are delivered.


5. When an issuer of municipal obligations fails to comply with a precondition to incurring debt (e.g., failing to publish a notice of sale), and yet a recital of compliance with
The more subtle question in this area revolves around the meaning of the phrase "binding according to its terms." A municipal obligation is a form of contract, and as such, is subject to laws affecting creditors' rights. In recent years, contract terms have become susceptible to modification, a source of concern to bond counsel and investors alike.6

One of the terms which binds the issuer of a municipal obligation to pay principal and interest punctually is the pledge of the issuer's "faith and credit" (in the case of a general obligation),7 or the pledge of specific revenues derived from the project financed with bond proceeds (in the case of a revenue bond).8 Practitioners in the law of municipal finance do not consider these pledges of security to be absolute, and the case law in the area has generally confirmed their belief. For example, where the taxing power of a municipality was

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7. The pledge of "faith and credit" is essentially a pledge of the municipality's taxing power for the benefit of holders of general obligations. Indeed, in New York, a municipality may not issue its general obligations without pledging its "faith and credit". See Tierney v. Cohen, 268 N.Y. 464, 198 N.E. 225 (1935). See also N.Y. LOCAL FIN. LAW § 100 (McKinney 1968).

8. In the case of revenue bonds, specific revenues or assets of the enterprise receiving bond proceeds are pledged to support the payment of principal and interest. If the enterprise fails, the bondholder must stand in line with other general creditors in bankruptcy proceedings, unless he is secured by some additional revenues or assets. For example, the payment of revenue bonds of a political subdivision may be guaranteed by the pledge of the "faith and credit" of the state. See, e.g., DEL. CODE ANN. tit. 6, § 7003(b) (1974); see also 15 McQuillin MUN. CORP. § 4311 (3d ed. 1970).
fiscally exhausted, the U.S. Supreme Court has held that a municipality is permitted, under state law, to adjust its general obligation indebtedness to preserve its taxing power. Likewise, where the public interest was best served by modifying an agreement between the state and a purchaser of its real property, a modification, if reasonable and necessary, has been held not to violate the contract clause of the United States Constitution.

However, two recent cases, *Flushing National Bank v. Municipal Assistance Corp.*, and *United States Trust Co. of New York v. New Jersey* ("U.S. Trust"), suggest that the pledge of security to the holders of municipal obligations is something more than a mere promise to pay principal and interest assuming tax or enterprise revenues are presently available or could be raised. The holdings of these cases clearly point to a new judicial direction favoring strict construction of the terms binding the issuer to the obligation holders. The general result of these cases is to enhance substantially an obligation holder's creditor interest in municipal obligations against competing claims for public funds.

II. *Flushing* and *U.S. Trust*: A Brief Synopsis


In the *Flushing* case, the New York Court of Appeals held that the pledge of "faith and credit" in short-term notes of the City of New York (the "City") meant that the City was bound to pay the notes when due, regardless of a real or imagined financial emergency. The court declared that the New York City Emergency Moratorium Act violated the "faith and credit" provisions of the New York State Constitution. The Act had prevented the holders

13. 40 N.Y.2d at 735, 358 N.E.2d at 851, 390 N.Y.S.2d at 25.
15. Article VIII, section 2 of the New York Constitution requires that no municipality may contract indebtedness unless it shall have pledged its "faith and credit" for the payment of principal and interest, and further provides that if appropriations are insufficient to make such payments, a lien attaches on the "first revenues" of the municipality.

Plaintiffs, in their *Flushing* reply brief, contended that the City's 1975-1976 real estate tax revenues were about $3 billion, and thus there were enough funds available on the "first revenue" theory to redeem the $1 billion of Moratorium-tainted short-term notes. Reply Brief
of short-term notes who refused to exchange them for Municipal Assistance Corporation\textsuperscript{18} ("MAC") bonds to bring an action to enforce their payment for three years.\textsuperscript{17} The elimination of all remedies, and thus of all rights, rendered worthless the constitutional pledge of "faith and credit" made when the notes were issued.\textsuperscript{18}

The court's decision in the Flushing case is a considerable departure from prior case law, particularly from the U.S. Supreme Court case of Faitoute Iron & Steel Co. v. City of Asbury Park.\textsuperscript{19} Faitoute and its progeny\textsuperscript{20} had established the rule that "faith and credit" merely meant that a municipality was bound to exercise its good faith, or use its best efforts, to apply its credit—traditionally its power to levy and collect taxes—to pay principal and interest on its debt obligations. The pledge of "faith and credit" under the Faitoute rationale was not a guarantee that the City of Asbury Park would pay its indebtedness in times such as the Great Depression when resort to the taxing power would be futile.\textsuperscript{21} In Faitoute the Supreme Court approved a scheme which discharged existing in-
debtedness and substituted for it new indebtedness payable over a longer period of time in order to save "the resources of the municipality . . . the taxes which [could] alone . . . meet the outstanding claims."\textsuperscript{22}

The court of appeals in \textit{Flushing}, interpreting the strictures of the New York Constitution as mandatory and inviolate of legislative adjustment, made several determinations at variance with the conception of "faith and credit" espoused in \textit{Faitoute}.

First, the court adopted the plaintiff's interpretation of "faith and credit." It declared that the pledge is not merely a commitment of the municipality to use good faith in exercising its taxing power, but rather is a continuing commitment to make payment when due until the last principal maturity is redeemed.\textsuperscript{23}

Second, the court held that the source of repayment funds need not be only tax revenues, but may include all revenues which can be generated in good faith from the municipality's "general revenue powers."\textsuperscript{24} While the court's suggestion that a municipality's credit includes all its revenues and not merely its taxing power may be a novel interpretation of the "faith and credit" pledge, the authority for the court's determination is clearly derived from the "first revenues" language of Article VIII, section 2 of the New York Constitution.\textsuperscript{25} Defendants, foreseeing this possible interpretation, argued that application of all the City's revenues to satisfy the Moratorium-tainted short-term obligations would bring collapse upon the financially embarrassed City.\textsuperscript{26} However, the argument

\begin{itemize}
\item \textsuperscript{22} \textit{Id.} at 512. In the Supreme Court's analysis, under the State of New Jersey's bankruptcy power, the State could regulate its political subdivision's fiscal affairs with a plan of composition approved by a state bankruptcy court. \textit{Id.} at 508, \textit{citing} United States v. \textit{Bekins}, 304 U.S. 327 (1938).
\item \textsuperscript{23} 40 N.Y.2d at 735, 358 N.E.2d at 851, 390 N.Y.S.2d at 25 (1976). In an analysis contrary to the \textit{Faitoute} case, the court of appeals explained that a "constitutional prescription of a pledge of faith and credit is designed . . . to protect rights vulnerable in the event of difficult economic circumstances." \textit{Id.} at 736, 358 N.E.2d at 852, 390 N.Y.S.2d at 26. It felt that "the presence of the specific remedy against a defaulting municipality, beyond the generality of the faith and credit clause, is conclusive that the Constitution permits no escape for the municipality from performing its obligations. . . . The only practical significance of a pledge of faith and credit with respect to an indebtedness must be in relation to its payments here on earth and on its due day." \textit{Id.} at 738-39, 358 N.E.2d at 853-54, 390 N.Y.S.2d at 277-28.
\item \textsuperscript{24} \textit{Id.} at 738, 358 N.E.2d at 853, 390 N.Y.S.2d at 27.
\item \textsuperscript{25} See note 15 \textit{supra}.
\item \textsuperscript{26} Brief for Defendant Appellee, at 7, 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). The brief stated "if the
was proven groundless since subsequent attempts to devise a repayment plan for holders of the affected short-term obligations were successful.\textsuperscript{27} 

Third, the court concluded that the police power may not be used to override the New York State Constitution, even in an alleged financial emergency.\textsuperscript{28}

By its resort to the New York Constitution to define the application of the "faith and credit" pledge, the court of appeals avoided a determination of whether the Moratorium Act constituted an impairment of the City's obligation under the contract clause\textsuperscript{29} of the United States Constitution.\textsuperscript{30} The two lower courts in the \textit{Flushing} case had held there was no such impairment.\textsuperscript{31} The court also avoided a determination of what circumstances might constitute a "financial emergency" sufficient to justify exercise of the police power to modify the "faith and credit" pledge. Thus, while the \textit{Flushing} case breathes new power into the "faith and credit" pledge in a municipality's general obligations in New York, and presumably in other states whose constitutions may contain similar wording, the decision may be of little precedential value in other states where the "faith and credit" pledge is merely statutory.\textsuperscript{32} For those states,

\begin{itemize}
  \item \textbf{27.} The City devised a plan for repayment of the Moratorium-tainted notes by aggregating revenues from several sources. The plan was quickly approved by the EFCB. The Daily Bond Buyer of March 11, 1977 reported that the EFCB approved the City's plan to redeem approximately $983 million short-term notes from the following sources of revenues: (1) $410 million from the sale of housing project mortgages, (2) $50 million from the City's Education Construction Fund as a repayment of a loan from the City, (3) $90 million from a 5-year stretchout of MAC bonds held by the City pension funds, (4) $250 to $300 million from an exchange offer of MAC bonds, (5) $109 million from three sinking funds or debt reserve funds, and (6) $57 million from the City's cash flow due to advance receipt of certain state and federal aid. The Daily Bond Buyer, March 11, 1977 at 1, col. 1.
  \item \textbf{28.} 40 N.Y.2d at 740, 358 N.E.2d at 854, 390 N.Y.S.2d at 28.
  \item \textbf{29.} "No State shall . . . pass any . . . Law impairing the Obligations of Contracts. . . ." U.S. Const. art. I, § 10, cl. 1.
  \item \textbf{30.} The court of appeals stated: "Thus, the Moratorium Act, by depriving short-term noteholders of judicial remedies for at least three years, makes meaningless the verbal pledge of faith and credit. On this view the Federal questions need not be reached." 40 N.Y.2d at 732-33, 358 N.E.2d at 850, 390 N.Y.S.2d at 24.
  \item \textbf{31.} 84 Misc. 2d 976, 979, 379 N.Y.S.2d 978, 984 (Sup. Ct. N.Y. Cnty. 1975); 52 App. Div. 2d 84, 87, 382 N.Y.S.2d 764, 767 (1st Dep't. 1976).
\end{itemize}
the dissenting opinion in *Flushing*, which thoroughly discusses the issues the majority avoided, may provide the needed judicial guidance.\(^{33}\)

**B. U.S. Trust Co. of New York v. New Jersey**

In *U.S. Trust*, the United States Supreme Court addressed the questions of police power and financial emergency dealt with in *Flushing*. However, it also considered the major question avoided in *Flushing*: the impairment of contracts under the contract clause of the United States Constitution. The *U.S. Trust* case concerned revenue bonds whose only security and source of payment were receipts from operations of the facilities of the Port Authority of New York and New Jersey (the “Port Authority”), a political subdivision of each state.\(^{34}\) Although the Port Authority’s “faith and credit” was pledged as a term of its revenue bonds, the pledge was not that of a municipality with general taxing power as in *Flushing*, but rather that of an authority which only could pledge its specific revenues.

In 1974 the legislatures in New York and New Jersey repealed a 1962 covenant which had been a term securing certain of the Port Authority’s revenue bonds.\(^{35}\) The 1962 covenant forbade the Port Authority from issuing additional revenue bonds if deficits in its supposedly self-supporting rail service facilities exceeded permitted levels.\(^{36}\) The 1962 covenant had protected the security and the source of payment of the Port Authority’s existing revenue bonds by assuring that there would be sufficient cash reserves available to pay principal and interest as the bonds matured.\(^{37}\) By repealing the

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33. See text accompanying notes 80-89 infra.

34. The Port Authority was established in 1921 by a bi-state compact between New York and New Jersey to effectuate a “better co-ordination of the terminal, transportation and other facilities of commerce in, about and through the port of New York...” 1921 N.J. Laws ch. 151; 1921 N.Y. Laws, ch. 154. The compact received Congressional approval. 42 Stat. 174 (1921). Effective July 1, 1972, the Port Authority’s name was changed to the Port Authority of New York and New Jersey. 1972 N.J. Laws, ch. 69; 1972 N.Y. Laws, ch. 531.


36. *i.e.* 10 percent of the amount in the general reserve fund held for the payment of debt service on its revenue bonds, or 1 percent of the Port Authority’s aggregate bonded debt. 431 U.S. at 11. The purpose for this limitation on operating deficits was “to promote continued investor confidence in the Authority.” 134 N.J. Super. at 178, 338 A.2d at 864.

37. It should be pointed out that the 1962 covenant was entered into at the same time the Port Authority took over the passenger rail facilities of the deficit-ridden Hudson & Manhattan Railroad through its wholly-owned subsidiary, the Port Authority Trans-Hudson Corporation (“PATH”). Without the 1962 covenant, had additional revenue bonds been
1962 covenant and permitting the Port Authority to issue additional revenue bonds to finance the cost of constructing new passenger rail facilities, the New York and New Jersey legislatures partially divested existing bondholders of the protection conferred by the 1962 covenant.

Plaintiffs attacked the repeal of the 1962 covenant by alleging that it constituted an unlawful impairment of a term of the Port Authority’s obligation under the contract clause.38 The Port Authority defended the repeal, asserting that the contract clause does not prohibit a municipality from exercising its police power to modify its contracts if a public emergency exists and the action is required to protect the public interest.39 In such a case, the Port Authority argued, a modification of a term of a contract did not necessarily impair the bondholders’ rights or remedies under their contract, especially where the modification had only a slight economic impact on the total security behind payment of the revenue bonds.40

The United States Supreme Court, in overruling the decision of the New Jersey Supreme Court41 resolved important issues of constitutional and municipal law which will have a substantial impact on the security of municipal obligations in the future.

The Court first pointed out that none of the cases relied upon by the defendants to prove that there was no impairment of creditors’ rights dealt with situations where the state or municipality was one of the parties to the contract.42 Where a state enters into an agreement, the Court declared that the contract clause does not require

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38. 431 U.S. at 17.
39. Id. at 28-29. The Port Authority relied on the cases of Home Bldg. & Loan Ass’n v. Blaisdell, 290 U.S. 398 (1934), East New York Savings Bank v. Hahn, 326 U.S. 230 (1945), and City of El Paso v. Simmons, 379 U.S. 497 (1965). In the Blaisdell and Hahn cases, the financial difficulties of the Great Depression created a situation which the Supreme Court considered an “emergency.” It therefore permitted Minnesota and New York to exercise their reserved police power to protect home owners from defaulting on their mortgages by extending the time for repayment.
40. 431 U.S. at 41-44 (dissenting opinion).
42. 431 U.S. at 22-23.
adherence to an undertaking which surrenders essential attributes of its sovereignty, such as the police power and the power of eminent domain.\textsuperscript{43}

The Court next observed that the Port Authority had \textit{not} contracted with the bondholders pursuant to its police power.\textsuperscript{44} Rather, the contract had been made under its spending and borrowing powers, which, unlike some other governmental powers, could be entirely bargained away.\textsuperscript{45} Once the Port Authority had entered into a financial obligation, such as the terms securing payment of the revenue bonds, its spending and borrowing powers had been surrendered, and the monies in the trustee's general reserve fund set aside under the 1962 covenant could be used for payment of debt service and nothing else.\textsuperscript{46} The exercise of the New York and New Jersey legislatures' reserved police power to affect a financial agreement was simply inapplicable in this case. It could not be used to modify the terms of the Port Authority's obligations to the bondholders.\textsuperscript{47}

Despite the inefficacy of the police power, the Court proposed a new test. An impairment of a contract may be constitutional if it is both "reasonable and necessary to serve an important public purpose."\textsuperscript{48} However, the standard of reasonableness and necessity cannot be applied with complete deference to local legislative discretion.\textsuperscript{49} Where a state or municipality is a contracting party, the

\textsuperscript{43} Id. at 23-25.

\textsuperscript{44} The police power is not susceptible to exact definition. Generally, it is the power of government to regulate in the public interest. Specific actions authorized by the police power include: (1) regulation of highways, railroads, and motor vehicles, (2) regulation of buildings, housing, zoning, and urban development, (3) regulation of labor relations, (4) regulation of health and sanitation, (5) regulation of public markets, trade, and commerce, and (6) regulation of gambling and intoxicating beverages. See generally 6 MCQUILLEN MUN. CORP. ch. 24 (3d ed. 1970).

\textsuperscript{45} 431 U.S. at 24-25. It is the analysis of the power under which the state or political subdivision acts that is crucial to the Court's decision. Without considering the Port Authority's contract with its bondholders as a "purely financial" contract entered into under the taxing, spending, and borrowing powers, there is little in the facts of \textit{U.S. Trust} to distinguish it from the earlier case of \textit{City of El Paso v. Simmons}, 379 U.S. 497 (1965), and applying the holding therein.

\textsuperscript{46} 431 U.S. at 24-25. To reach this conclusion, the Court referred to early 19th century cases, discussed below, which considered attempted modifications of the municipal taxing and spending powers in light of the contract clause. See notes 72-77 infra.

\textsuperscript{47} See generally, 431 U.S. at 21-28.

\textsuperscript{48} Id. at 25.

\textsuperscript{49} The usual rule for impairment of contracts between private parties is that the court will only inquire whether the exercise of the police power is reasonable in light of all the
diminution of its financial obligation might well be in its provincial self-interest. Because repeal of the 1962 covenant was not essential to alleviate the alleged rail passenger emergency, the Court concluded that the repeal was not necessary. It likewise found that the repeal was not reasonable. Since the alleged emergency was foreseeable when the 1962 covenant was enacted, the change in conditions between 1962 and 1974 had not been of such magnitude as to make the repeal reasonable as one done “in light of changed circumstances.”

In sum, the Supreme Court established the rule in the *U.S. Trust* case that once a debt obligation is incurred under the spending and borrowing powers, the municipality may not impair or repudiate it in any way, unless it is absolutely reasonable and necessary to serve a legitimate and important public purpose such as the alleviation of a true emergency.

### III. *Flushing* and *U.S. Trust* Compared

#### A. The Police Power and the Impairment of Contracts

The *Flushing* case and the *U.S. Trust* case both illustrate new limitations on the exercise of a state’s reserved police power to contravene contracts established under other governmental powers. While the police power is generally thought to be vested perpetually in the state or municipality to protect its vital interests, the exercise of the power is now clearly limited by constitutional provisions which preserve the terms of existing contracts between a governmental unit and its debt obligation creditors.

While the contract clause had usually been applied in cases involving only private parties, it had long been suggested that the

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50. Thus, the *U.S. Trust* case observed more stringent standards in determining the reasonableness and necessity of legislative actions impairing a contract to which a state or municipality is a party. The authority for their reasoning is derived from the case of *Perry v. United States*, 294 U.S. 330 (1935), which involved U.S. government obligations. In that case, the Supreme Court stated: “There is a clear distinction between the power of the Congress to control or interdict the contracts of private parties when they interfere with the exercise of its constitutional authority, and the power of the Congress to alter or repudiate the substance of its own engagements when it has borrowed money. . . .” *Id.* at 350-51. (emphasis added).

51. 431 U.S. at 29-31.

52. *Id.* at 31-32.
clause also applied to contracts involving a state or municipality. In *U.S. Trust*, the Court was faced with the determination of whether an exercise of the reserved police power impaired a term of a debt obligation sufficiently to invoke the contract clause's prohibition.

As a general rule, the courts have attempted to harmonize the contract clause with the essential reserved powers of the states. The Supreme Court set out the basic test to review the exercise of the police power in *Home Building & Loan Association v. Blaisdell*: the legislation must be addressed to a legitimate end and the measures taken must be appropriate and reasonable.

In an older line of cases, a distinction was made between the impairment of rights and remedies under a contract. A remedy might be altered or modified without necessarily impairing the substantive contractual rights. The Supreme Court generally discarded the "right vs. remedy" reasoning in the 1930 Depression era decisions which sustained laws suspending mortgagees' rights as not violative of the contract clause. Both the Supreme Court in the *U.S. Trust* case and the court of appeals in the *Flushing* case rejected the "right vs. remedy" theory argued by the defendants on the grounds that the rights conveyed in a contract would be a mere naked right to litigate without a means to enforce the remedy.

The principal exception to the prohibition of the contract clause against the impairment of financial obligations was carved out in

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53. The authority for the proposition that the contract clause applies to contracts with a state or municipality can be traced to a citation in *Home Bldg. & Loan Ass'n. v. Blaisdell*, 290 U.S. at 435-36, to *Long Island Water Supply Co. v. Brooklyn*, 166 U.S. 685, 692 (1897).

54. See 290 U.S. at 443.

55. Id. at 438.


59. 40 N.Y.2d at 736, 358 N.E.2d at 852, 390 N.Y.S.2d at 26; 431 U.S. at 19-21, n.17. Indeed, in *City of El Paso v. Simmons*, 379 U.S. 497 (1965), the Supreme Court pointed out that the decisions dating from *Home Building & Loan Ass'n.* have not placed critical reliance on the distinction between obligation and remedy in analyzing the application of the contract clause. Id. at 506.
Home Building & Loan Association v. Blaisdell and East New York Savings Bank v. Hahn. These cases held that the police power may be invoked to modify the terms of a contract in a period of financial emergency where the state is acting to protect the vital interests of its people. Blaisdell, Hahn and their successors (the "Moratorium Cases") were cited to the courts in Flushing and U.S. Trust as precedent for validating the Moratorium Act and the repeal of the 1962 covenant. Although the majority in Flushing and U.S. Trust rejected the Moratorium Cases, they form the basis of the vigorous dissents in both decisions.

At first glance it is not difficult to understand why the lower courts in Flushing and U.S. Trust embraced the Moratorium Cases as precedential. The Moratorium Cases grew out of the period of the Great Depression. At that time, the laws of several states allowed suspension of mortgage foreclosures to give financially embarrassed mortgagors time to recoup their losses. In sanctioning the exercise of the police power to suspend the enforcement of mortgagees' rights, the courts approved such suspension when (1) it served a legitimate end, (2) it was temporary rather than permanent, and (3) it did not impair the substantial rights secured by the contract.

The Moratorium Cases found that the state's police power is never contracted away in a financial obligation between private parties. It remains an implied condition of every contract; and when certain events occur to trigger the exercise of the power, the terms of the contract can be modified without resulting in unconstitutional impairment. The only limitation on the exercise of the power is that it be reasonable.

The facts in Flushing and U.S. Trust did not neatly fit into the

60. 290 U.S. 398 (1934).
63. I.e. the protection of the public from widespread eviction. See 290 U.S. at 438, 444.
67. 431 U.S. at 22-23.
scenario from which the Moratorium Cases evolved. First, the contracting parties in both cases included a municipality or political subdivision of a state rather than a private party. Second, the powers under which these public bodies contracted with the bondholders were the spending, borrowing and taxing powers, casting doubt on the application of the exception carved out in the Moratorium Cases which permitted the exercise of the police power to impair contracts of private parties. Third, the event which triggered the exercise of the police power in the Moratorium Cases was the collapse of the United States' economy during the 1930s. The courts in the Moratorium Cases correctly characterized this event as a public emergency as dire as war, flood, and famine. But, as will be discussed below, the Flushing and U.S. Trust courts did not consider the events which led to the arguably reasonable and necessary exercise of the governmental power in those cases to amount to a public emergency.

Unfortunately, the court of appeals opinion did not emphasize the factual distinctions between Flushing and the Moratorium Cases. But these distinctions form the basis of the Supreme Court's opinion in U.S. Trust that the Moratorium cases were not controlling. The court of appeals could have arrived at its holding by addressing these distinctions under a contract clause analysis, thereby updating the guidelines enunciated in Faitoute on the interplay between the reserved police powers and the pledge of "faith and credit." It declined to do so, concluding that neither courts nor legislatures exercising their police powers can violate constitutional mandates of "faith and credit."68 However, the Flushing decision does put to rest many of the questions regarding the meaning of the peculiar language of Article VIII, section 2, the "faith and credit" provision of the New York Constitution. But further analysis of the contract clause as a prohibition of the impairment of rights of the holders of municipal debt obligations may be found in the U.S. Trust case and in the dissent in Flushing.

68. 40 N.Y.2d at 736-37, 358 N.E.2d at 852, 390 N.Y.S.2d at 26.
B. The Police Power versus the Spending, Borrowing and Taxing Powers

1. The U.S. Trust Opinion

In the U.S. Trust case the Supreme Court initially observed that the contracting party was a political subdivision of the States of New York and New Jersey. It then inquired into the specific powers employed by the Port Authority when it entered into the contract with its bondholders. By so doing, the focus of the Court's examination turned away from inquiring whether the police power could be exercised as an exception to the prohibition of the contract clause, to an inquiry of whether the police power could be exercised subsequent to the creation of contractual rights established under the spending, borrowing and taxing powers. By making the latter inquiry, the Supreme Court took judicial notice of a fact long assumed in the municipal credit market: debt obligations of states and municipalities are considerably different from unsecured obligations between private parties. While a private party may repudiate or modify its debt terms, state and municipal obligations are generally inalterable, absent creditor consent or bankruptcy of the governmental entity.

To find the legal relationship between the contract clause and the powers under which municipal obligations are issued, the Supreme Court delved into a number of early cases which had lain dormant in the reporters. These cases held that once legally authorized municipal obligations are outstanding, a legislature cannot impair the terms protecting creditors' rights to payment when due.

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69. The power to spend public revenues is usually statutory, and is often delegated by the state to its political subdivisions. The spending power includes power to make purchases, enter into contracts (other than debt obligations), and to pay annual debt service on municipal obligations. It is generally believed that the power to borrow implies the power to spend from annual appropriations, at least with respect to general obligations where "faith and credit" is pledged. 15 MCQUILLIN MUN. CORP. § 39.17 (3d ed. 1970).

70. The authority giving a state or municipality the power to borrow money is usually found in a state statute or constitution. See 15 MCQUILLIN MUN. CORP. § 43.20 (3d ed. 1970). The act of borrowing implies the assumption of an absolute obligation to pay principal and interest on the debt obligation. Thus, a lending of credit under the borrowing power is to be differentiated from a current budget appropriation under the spending power.

71. The power to levy, assess, and collect taxes (such as income, property, sales and ad valorem taxes) is authorized by state statutes and constitutions in order that governmental functions may be performed. 16 MCQUILLIN MUN. CORP. § 44.05 (3d ed. 1972).

72. See Scotland County Court v. United States, 140 U.S. 41, 46-47 (1891); Ralls County
These early decisions establish a fundamental rule of the law of municipal finance: the power to raise taxes or whatever revenues are pledged for the payment of principal or interest on debt obligations imposes a trust on the municipality to honor the terms of payment which cannot be impaired.\textsuperscript{73} Strict compliance with the contract terms is necessary,\textsuperscript{74} since the bondholders' contract would be worthless and would represent only abstract rights if the municipality were free to excuse itself.\textsuperscript{75} Thus, where the municipality exercises its spending, borrowing or taxing powers, it reserves no power to amend or modify its contractual obligations incurred thereunder.

What reservation of the police power is possible under these cases? The Supreme Court provided the answer in \textit{Murray v. Charleston},\textsuperscript{76} where it stated that a contract to pay principal and interest on bonds pledging the taxing power contains no reservation or restriction of the duty described. Indeed, the Court stated that a promise to pay with a reserved right "is an absurdity."\textsuperscript{77} Once the spending, borrowing and taxing power have been bargained away entirely, a law altering the terms of a contract is a law which impairs the contractual rights of the bondholders.

On the basis of these early decisions it was not difficult for the Supreme Court in \textit{U.S. Trust} to formulate a general rule that the reserved police power does not permit a modification of the terms securing payment under a contract entered into under the municipality's spending, borrowing, and taxing powers. A case allowing a slight impairment would only be precedent for a later case permitting greater impairment, until the security behind municipal obligations would be so eroded as to diminish substantially their financial value.\textsuperscript{78} Indeed, the court of appeals in the \textit{Flushing} case raised this point by stating that a law permitting a moratorium on the payment of the City's short-term notes for three years would only be authority for a moratorium of a longer duration until the bond-

\textsuperscript{73} See Von Hoffman v. City of Quincy, 71 U.S. 535, 555 (1866).
\textsuperscript{74} See \textit{Murray v. Charleston}, 96 U.S. 432 (1877).
\textsuperscript{75} 71 U.S. at 555.
\textsuperscript{76} 96 U.S. 432 (1877).
\textsuperscript{77} \textit{Id.} at 445.
\textsuperscript{78} 431 U.S. at 25-26.
holders’ rights to enforce their creditors’ remedies became worthless.\(^7\)

2. **The Flushing Dissent and Impairment of Contracts**

Having reviewed the opinion in the *U.S. Trust* case, it is instructive to consider the dissenting opinion of *Flushing* with respect to the impairment question. The crux of the dissenting opinion is that the “faith and credit” pledge contained in Article VIII, section 2, of the New York Constitution was not intended to immunize or insulate the entire contract from the valid exercise of the police power.\(^8\)

The dissent then reasoned that the majority opinion, carried to its logical conclusion, meant there could be no moratorium laws affecting contracts containing the “faith and credit” pledge.\(^9\) In large measure, the dissent in *Flushing* disregarded the distinctions between state and municipal powers in favor of an argument pitting the reserved police power against the New York Constitution. It argued that the Moratorium Cases, as expressions of “the Nation’s highest court” should be controlling.\(^9\)

The dissent emphasized that the holdings of the Moratorium Cases permitting the exercise of the police power to modify contracts in times of public emergency should apply equally to obligations between the City and the holders of the affected notes.\(^3\) It based its view on a dictum in the Supreme Court’s opinion in *Blaisdell*.\(^4\) But as discussed above, other Supreme Court cases which authorized contract impairment under the police power involved contracts between private parties.\(^5\) In light of the holding in the *U.S. Trust* case that the spending, borrowing and taxing powers are impervious to the exercise of the police power, the dictum in *Blaisdell* is clearly wrong when it suggests that municipal obligations may be impaired by the police power just as those between private parties.

80. Id. at 748, 358 N.E.2d at 860, 390 N.Y.S.2d at 34 (dissenting opinion).
81. Id. at 749, 358 N.E.2d at 860, 390 N.Y.S.2d at 35 (dissenting opinion).
82. Id. at 755, 358 N.E.2d at 864, 390 N.Y.S.2d at 38 (dissenting opinion).
83. Id. at 749-52, 358 N.E.2d at 860-62, 390 N.Y.S.2d at 35-37 (dissenting opinion).
84. The dictum from *Blaisdell* states that the reservation of essential attributes of sovereignty (e.g. the police power), applies to every contract. 290 U.S. at 435. This could include, by inference, those containing the “faith and credit” pledge.
85. See text accompanying notes 60-67 supra.
Nevertheless, relying on the premise that the police power may be permitted to impair the terms of a municipality’s debt obligations, the dissent argued further that the Moratorium Act should be sanctioned as constitutional because the New York Legislature found a financial emergency to exist in the City.\textsuperscript{85}

Finally, perhaps the most fatal flaw in the dissent’s argument is its incorrect view of the “faith and credit” pledge as a mere promise to pay given when municipal obligations are issued.\textsuperscript{87} As the \textit{U.S. Trust} case made clear, when debt obligations are issued under the spending, borrowing and taxing powers, the promise to pay secured by the “faith and credit” pledge (in the case of a general obligation bond) or the specific revenues pledge (in the case of a revenue bond) must continue unaltered throughout the period the debt obligation is outstanding. These pledges, therefore, express more than a mere undertaking to exercise taxing and revenue generating powers to pay debt service. Except for the rule announced in \textit{Faitoute},\textsuperscript{88} the exercise of the state’s police power cannot diminish the performance of the payment terms of the contract. The dissent’s conclusion that the legislature may exercise its reserved police power to impair the performance of payment of the contract is therefore against the weight of authority. When a financial obligation involves the pledge of revenues and taxes under the spending, borrowing and taxing powers, no reserved power remains to be exercised.\textsuperscript{89}

3. \textit{Faitoute v. Asbury Park} Distinguished

One cannot discuss the distinction between the various powers of a state or municipality in the context of \textit{U.S. Trust} and \textit{Flushing} without paying heed to the decision in \textit{Faitoute}.\textsuperscript{90} Indeed, the holding in \textit{Faitoute} was the source both of the Port Authority’s argument

\textsuperscript{85} 40 N.Y.2d at 754, 358 N.E.2d at 863, 390 N.Y.S.2d at 38 (dissenting opinion).
\textsuperscript{87} \textit{Id.} at 745-46, 358 N.E.2d at 858, 390 N.Y.S.2d at 32-33 (dissenting opinion).
\textsuperscript{88} \textit{Id.} at 746-47, 358 N.E.2d at 858-59, 390 N.Y.S.2d at 32-33 (dissenting opinion).
\textsuperscript{89} Of course, the performance of a municipality’s general obligations may be modified under a plan of adjustment under Chapter IX of the Bankruptcy Act, 11 U.S.C.A. §§ 401-418 (Cum. Supp. 1977), or possibly under a state bankruptcy proceeding. In \textit{Board of Educ. v. Yonkers Fed’n of Teachers}, 40 N.Y.2d 268, 276, 353 N.E.2d 569, 573, 386 N.Y.S.2d 657, 661 (1976), the court of appeals pointed out that “[i]n bankruptcy all obligations may suffer impairment or dissolution. . . .” In addition, if an enterprise whose revenues are pledged for the debt service on revenue bonds, fails or becomes bankrupt, there may be a default on the payment of interest and principal. See notes 6, 8 \textit{supra}.
\textsuperscript{90} See text accompanying notes 19-22 \textit{supra}.
that the 1962 covenant could be repealed and of MAC's assertion that the Moratorium Act was constitutional. After careful consideration, it would appear that Faitoute must simply stand as a unique case in municipal finance, the result of the existence of extraordinary circumstances.

When Faitoute was decided, there was no Federal Bankruptcy Act. Instead, the decision was made under a New Jersey act which allowed a municipality in financial distress to adjust its debts under state bankruptcy proceedings. The New Jersey statute permitting municipal bankruptcy was clearly an exercise of the state's reserved police power. However, this "bankruptcy power" exception to the contract clause recognized in Faitoute is distinguishable from Flushing and U.S. Trust in several important aspects.

The New Jersey statute allowed the refinancing of old debt only upon consent of holders representing "85 per centum . . . in amount of the indebtedness affected." In contrast, neither the Moratorium Act nor the repeal of the Port Authority's 1962 covenant were subject to the consent of affected obligation holders. Had such consent been required and attained, there would have been no impairment. By accepting the terms of any modification the holders of the affected debt obligations would have waived their objections and have been estopped from asserting a contract impairment.

91. See 431 U.S. at 27-28; 40 N.Y.2d at 752-53, 358 N.E.2d at 862-63, 390 N.Y.S.2d at 37 (dissenting opinion).


93. 1933 N.J. Laws, ch. 331.

94. This exercise is expressly recognized in the current version of Chapter IX of the Bankruptcy Act. Section 403 continues to provide that states may enact their own remedies to adjust municipal debt, 11 U.S.C.A. § 403 (Cum. Supp. 1977), to comply with the holding of United States v. Bekins, 304 U.S. 27 (1938), which required the Federal Bankruptcy Act to be "carefully drawn so as not to impinge upon the sovereignty of the State." Id. at 51.

95. 1933 N.J. Laws, ch. 331.

96. Where debt obligations are held in bearer form, locating the holders of the obligations to obtain consent is no easy task. This fact is recognized, for example, in Rule 9-7(c) of the Bankruptcy Rules to Chapter IX of the Bankruptcy Act. This rule permits supplemental claims of credit to be initiated after the filing of the bankruptcy petition, since all the holders of bearer obligations would not ordinarily be ascertainable when bankruptcy proceedings are commenced. 11 U.S.C.A. Rule 9-7(c) (Cum. Supp. 1977).

Faitoute acknowledged the existence of a bona fide public emergency in the financial condition of the City of Asbury Park, a fact which would permit the reasonable exercise of the state’s police power impairing contracts. However, in neither Flushing nor U.S. Trust did the respective courts equate the City’s financial embarrassment or the Port Authority’s need to raise revenues to finance passenger rail facilities with the economic emergencies experienced during the Great Depression, the period from which the Faitoute case and the Moratorium Cases arose.

Finally, and most important, the result of the bankruptcy proceedings in the Faitoute case was a discharge of an old obligation to pay debt service and the substitution of a new obligation with an identical security interest but with a longer period for redemption and a lower interest rate. In Faitoute the Supreme Court found no impairment of the bondholders’ rights and remedies since the new bonds had the same security as the old ones—the “faith and credit” pledge of Asbury Park’s taxing power. This is in contrast to the Moratorium, Flushing and U.S. Trust cases where the state’s action impaired the old obligation, but did not offer new obligations with the same security interest.

The discharge versus impairment distinction is crucial to understanding why the Faitoute case is not authority for granting legal sanction to the Moratorium Act or to the repeal of the 1962 covenant as valid exercises of the police power under the contract clause. Indeed, the Supreme Court notes the distinction between discharge and impairment in the U.S. Trust case. However, similar analysis is lacking in the dissenting opinion in Flushing and the Faitoute case is not even cited by the Flushing majority.

98. For a discussion of the meaning of “discharge,” see generally id. at §§ 1229-31.
99. 316 U.S. at 507.
100. Id. at 515-16.
102. 431 U.S. at 28.
103. However, the court in Flushing pointed out that “those responsible [for the City’s financial difficulties] have made an expedient selection of the temporary noteholders to bear an extraordinary burden.” 40 N.Y.2d at 736, 358 N.E.2d at 852, 390 N.Y.S.2d at 26. It may be reasonably inferred that had the Moratorium Act suspended payment of all the City’s debt obligations, the moratorium could have been viewed as a plan of debt adjustment such as that in the Faitoute case, and similar to the provisions of Chapter IX of the Bankruptcy Act. 11 U.S.C.A. §§ 401-418 (Cum. Supp. 1977). In that case, the legislative enactment of the Moratorium Act could have been held to have been a discharge of the City’s old debt obligations under a bankruptcy statute.
C. Factual Determinations: Public Emergency versus Financial Embarrassment

Throughout the litigation in *Flushing* and *U.S. Trust* there is a thinly-veiled controversy regarding characterization of the events which led to the enactment of the Moratorium Act and to the repeal of the 1962 covenant. The defendants in both cases considered the City's financial problems and the need for additional rail passenger facilities as public emergencies, justifying the exercise of the police power, on the basis of the precedents set in *Faitoute* and the Moratorium Cases. The courts viewed these facts with less alarm.

In the *Flushing* case, the court stated it must construe the New York Constitution strictly and literally, despite the usual rule that a legislative finding of emergency is entitled to great weight. The court only recognized the City's financial crisis to the extent of requiring the plaintiffs to wait a period of time for the city to marshal its revenues before the affected noteholders could be paid.

In *U.S. Trust*, the Supreme Court held that a state cannot refuse to meet its legitimate financial obligations simply because it would prefer to promote the public good rather than the private welfare of its creditors. It suggested that the Port Authority's financial problems were foreseeable at the time of the 1962 covenant, and that the alleged emergency was merely a shift in public policy which would not justify a modification which diverted revenues set aside for the payment of the affected revenue bonds. Furthermore, since the Port Authority could raise its tolls and charges, it had other means of effecting its public policy. Thus, the Supreme Court found the

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104. *See Matter of Tuthill, 163 N.Y. 133, 145, 57 N.E. 303, 307 (1900); Matter of Sherrill v. O'Brien, 188 N.Y. 185, 207, 81 N.E. 124, 131 (1907). The dissent makes much of this point, and even goes so far as to assert that since the Emergency Clause of the New York Constitution (Article III, section 25) was enacted after Article VIII, section 2, the latter enactment "must prevail as the latest expression of the constitutional will of the people." 40 N.Y.2d at 760, 358 N.E.2d at 867, 390 N.Y.S.2d at 42. The majority view was that "[e]mergencies and the police power, although they may modify their applications, do not suspend constitutional principles." *Id.* at 740, 358 N.E.2d at 855, 390 N.Y.S.2d at 29.

105. *Id.* at 29-31.

106. *Id.* at 30, n.28.
repeal of the 1962 covenant neither reasonable or necessary as an exercise justified by emergency conditions.

This judicial disinclination to give full credibility to the cry of "financial emergency" follows a line of cases which suggests that the financial embarassment of a municipality is not the type of public disaster (such as a depression, flood or famine) which permits the state to exercise its police power in contravention of constitutional rules to maintain public order, health and safety. It was, of course, an extraordinary type of financial emergency amounting to a public disaster—the Great Depression of the 1930's—which vindicated the police power in the Moratorium Cases and Faitoute. But neither the City nor the Port Authority were caught in a national economic depression. Indeed, it may be more accurate to say that the City suffered from financial embarassment due largely to its own fiscal mismanagement, while the Port Authority merely attempted to raise revenues for its capital projects without raising user charges on its own facilities or reducing its level of "permitted deficits" in order to issue additional bonds.

The Court's distinction between traditional public emergencies and mere financial embarassment is an important judicial development in protecting municipal obligations from diminution by the legislature's police power. A contrary development, allowing permissive exercise of the police power and abrogation of Constitutional mandates, would invite the development of a host of creative "financial emergencies" making a municipal obligation a highly speculative investment.


110. To be sure, the fiscal difficulties of the City are not unique. In recent years large urban centers have suffered from loss of population and industry resulting in a stagnant tax base, while at the same time the demands for services have increased. See generally, Advisory Comm'n on Intergovernmental Relations (ACIR), Financial Emergencies: The Intergovernmental Dimension (July 1973). However, as the Securities and Exchange Commission has recently reported, the fact that the City is now frozen out of the capital markets is a direct result of City officials having misled the investing public as to its fiscal condition during 1974 and 1975. See Staff Report, S.E.C., Transactions in Securities of the City of New York (Aug. 26, 1977).

111. 431 U.S. at 29.
IV. Full Faith and Credit Reconsidered

Having discussed the *Flushing* and the *U.S. Trust* cases in the context of contract impairment, there remains a lingering question of what the pledge of "faith and credit" means.

In New York, the *Flushing* case appears to stand for the proposition that the pledge of "faith and credit" is more than a mere promise and undertaking to pay principal and interest when due. It now appears to be a stronger security interest than the good faith promise to exercise the taxing power, as the *Faitoute* case suggested, because the pledge to pay when due creates a lien on all of the municipality's revenues to pay an installment of principal and interest at the time it becomes due.\(^{112}\)

But even these general statements redefining the pledge are perhaps saying too much. Only five months after the *Flushing* decision, the New York Court of Appeals decided *Quirk v. Municipal Assistance Corp.*\(^{113}\) The *Quirk* case holds that a legislative diversion of the City's sales tax and stock transfer tax to secure MAC bonds does not unconstitutionally impair the contract with the holders of the City's outstanding debt obligations. The court correctly distinguished the *Flushing* case by pointing out that the City never committed its sales and stock transfer tax revenues to debt obligation holders by pledging its "faith and credit." Such revenues, the court stated, are only available when the "first lien" of Article VIII, section 2 becomes operational. Although the court notes that the diversion of such revenues does not leave the City "stripped of all sources of revenues, other than the real estate tax. . . ."\(^{114}\) the *Quirk* case may be a dangerous precedent for permitting other legislatively-created diversions of a municipality's taxing and revenue generating power which seriously deplete its ability to produce

\(^{112}\) Indeed, an opinion of the New York State Comptroller underlines the "first revenues" rule in stating that where no appropriation is made for payment of obligations falling due in a fiscal year, Article VIII, section 2, requires that "first revenues thereafter received" be set aside to pay such obligations. 5 Op. State Comp. 149-50 (1949).


\(^{114}\) Id. at 647, 363 N.E.2d at 551, 394 N.Y.S.2d at 844. With regard to the fact that certain City revenues are diverted to support debt service on MAC bonds, the court said of the City's pledge of "faith and credit" on its obligations that "[t]he challenged statute does not, and could not, alter this obligation . . . Nowhere, however, . . . is there any requirement that collection of particular taxes be continued." Id. at 647, 363 N.E.2d at 551, 394 N.Y.S.2d at 844.
sufficient funds to pay principal and interest on outstanding debt obligations.

In jurisdictions which have a constitutional "faith and credit" pledge the Flushing case may be an important precedent to avert legislative diminution of such a pledge by exercise of the police power, under the general rule that the legislature cannot abridge constitutional principles. However, in other jurisdictions where the "faith and credit" pledge exists only by statute,115 Flushing's precedential value is questionable since the opinion avoids a discussion of whether that pledge is susceptible to impairment as an exception to the prohibition of the contract clause.

The U.S. Trust analysis of the contract clause may be helpful in preventing abridgement of the "faith and credit" pledge if subsequent cases follow the Supreme Court's distinction between those powers, such as the spending, borrowing and taxing powers, which can be entirely bargained away and the police power which is always reserved to the state.

In the meantime, the "faith and credit" pledge, under cases such as Sacramento Municipal Utility District v. Spink,116 State v. County of Citrus,117 and State v. City of Lakeland,118 will continue to stand for the proposition that only taxes and revenues specifically pledged for the payment of principal and interest on municipal obligations can be reached by debt obligation creditors in an ordinary creditor's action. The broader "first revenues" lien in New York on all revenues of a municipality to pay general obligations remains a peculiar constitutional rule of New York law, modified to an extent by the permitted diversions of certain taxes and revenues in Quirk.

V. Conclusion

Upon reflection, it may seem that the reasoning employed by the court of appeals in the Flushing case and the Supreme Court in the U.S. Trust Co. case is somewhat convoluted and is simply a pretext for arriving at the desired result. Indeed, the appellate division's opinion in the Flushing case convincingly portrayed the City on the
brink of financial collapse and the Moratorium Act as merely the final legislative step in a series of actions to shore up the City's operating cash for daily municipal service delivery. Similarly, the New Jersey Superior Court went into considerable detail to describe how the state legislatures of New York and New Jersey concluded that the Port Authority's revenues were more urgently needed for constructing mass transit passenger rail service in the City's metropolitan area.

If one accepts the "financial emergency" theory, then it follows that the Faitoute case is a clear precedent for the state to exercise its police powers to abrogate its own obligations in the name of protecting vital public interests. But such reasoning would have to ignore the constitutional pledge of "faith and credit" in Flushing, the impairment versus discharge distinction in U.S. Trust, and the line of cases which has established the immunity of the spending, borrowing and taxing powers to alteration by the police power because of the contract impairment clause of the United States Constitution.

While victories for defendants in Flushing and U.S. Trust would have diverted public monies to salutory purposes other than payments to creditors, such victories would certainly have been Pyrrhic. But for the Faitoute case, the special circumstances of which have been discussed above, no reported case has been found which plausibly suggests that the security behind municipal obligations may be diminished unilaterally to the detriment of obligation holder creditors. Contrary holdings in either Flushing or U.S. Trust would have established the undesirable rule that the holders of municipal obligations may be powerless to prevent impairment of payment of principal and interest on their investments as competing claims for use of municipal funds arose. Municipal obligations would have been transformed from the low risk investments they usually are,

121. It may be that Faitoute should now be relegated to the annotations under "bankruptcy" rather than those under "faith and credit." But had the Flushing and U.S. Trust courts wanted to give judicial sanction to the challenged statutes in these two cases, they could have followed the holding in Faitoute, as the courts below them had done.
into high risk investments appealing only to speculators in venture capital.\footnote{122}

Although the courts in \textit{Flushing} and \textit{U.S. Trust} applied a heavy hand to the independence of local governmental entities, they saved all municipalities from the temptation to tamper with creditors' rights in their debt obligations and thus from the possible self-destruction of their credit markets.\footnote{123} The temptation to tamper with creditor's rights is not a mere academic notion.\footnote{124} Severe budgetary restraints are now imposed on local governments as revenues strain to keep up with the mounting increase in municipal expenditures.\footnote{125} Report reports of the Advisory Commission on Intergovernmental Relations\footnote{126} indicate, for example, that in the past twenty

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\item \footnote{122. There is some evidence which substantiates this assertion. In April, 1976, the City of Newburgh, N.Y. sold its general obligation bonds at a coupon interest rate of 7.50 percent. In May, 1977, the City of Jamestown, N.Y. sold its general obligation bonds at a coupon rate of 5.10 percent. Both cities are comparably rated by one of the nationally recognized rating agencies, are of similar population, and are older urban areas surrounded by more prosperous, expanding suburbs. Yet the timing of the sale of bonds had a tremendous effect on the interest rate. In April, 1976, the \textit{Flushing} case was still in litigation in the lower courts and the municipal bond market was highly wary of New York municipal obligations. By May, 1977, \textit{Flushing} had been decided by the New York Court of Appeals, and the bond market had regained considerable confidence in New York obligations.  
\item \footnote{123. According to an article which appeared in the November 11, 1977 edition of the Wall Street Journal, Moody's Investors Service, one of the nationally recognized agencies which rate the credit-worthiness of municipal obligations, gave the City's forthcoming issue of $200 million in short-term notes a rating of MIG-4, its lowest rating. Wall St. J., Nov. 11, 1977, at 25, cols. 2-3. This caused the underwriters to cancel the sale. Among the several reasons given by Moody's to justify the low rating was the damage caused "by the residual effect of the city debt moratorium passed by the State Legislature in 1975." N.Y. Times, Nov. 11, 1977, at 1, col. 6.  
\item \footnote{124. The growth in municipal debt financing over the past decade has been impressive. For example, according to the August 4, 1977 edition of the Daily Bond Buyer, in 1968 total long-term general obligations issued by all states and municipalities in the United States exceeded $16 billion in aggregate principal amount. In 1976 the total was nearly $34 billion, or more than a 100 percent increase. Similarly, the 1968 total long-term revenue obligations issued by all states in the United States was nearly $7 billion in aggregate principal amount. In 1976 the total was nearly $17 billion, or almost a 150 percent increase. The Daily Bond Buyer, August 4, 1977, at 12, cols. 1-5. Thus, state and municipal debt financing is an increasingly important segment of total capital formation in the United States.  
\item \footnote{125. For a good comparison of trends in expenditures and revenues for selected municipalities in the State of New York from 1971 to 1975, see Bond, \textit{Municipal Bankruptcy Under the 1976 Amendments to Chapter IX of the Bankruptcy Act}, 5 Fordham Urb. L.J. 1,2,3,5 (1976).  
\item \footnote{126. The Advisory Commission on Governmental Relations (ACIR) is a commission established in 1959 to monitor the operation of federal, state and local governments. Its

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years interest payments on debt obligations have been rising faster than the rate of increase in revenues.127 Furthermore, employment in the state-local government sector over the past twenty years has grown faster than in either the Federal government or the private sector.128 From 1957 to 1974 average annual earnings of employees in local government increased faster than in the private sector and almost as fast as in the Federal government sector.129 And while local government reliance on State and Federal aid has increased substantially over the past twenty years,130 the expenditure by state and local governments of their own funds—much of which are proceeds of debt obligations—has expanded as a percentage of GNP.131

Thus, state and local governments must be viewed as a big business facing fiscal problems which require sound management techniques and budgetary planning. The holdings of the Flushing and U.S. Trust cases have established a preference for creditors' rights which should sustain the confidence of the investment community in the credit-worthiness of the fiscally prudent municipality.132 The statistics compiled on state and local financial matters are among the most reliable in determining recent trends in these areas.

127. Between 1954 and 1974, interest on debt obligations of State government increased from 1.6 to 3.2 percent of their own source revenues. For the same period, the increase for local government was from 3.9 to 6.3 percent. ACIR, SIGNIFICANT FEATURES OF FISCAL FEDERALISM, 1976 EDITION 4, 66-67 (June 1976).

128. Between 1955 and 1973, employment at the state-local level increased by 119.5 percent, compared to 17.1 percent at the Federal level, and 35.8 percent in the private sector for the same period. ACIR TRENDS IN FISCAL FEDERALISM, 1954-1974 2-3, 32-33 (Feb. 1975).

129. Between 1955 and 1973, average annual earnings in the state-local government sector increased from $3,562 to $9,448, or 165.2 percent, compared to from $3,882 to $8,900, or 129.3 percent in the private sector, and from $4,589 to $12,984, or 182.9 percent in the Federal government sector. Id. at 3, 34-35.

130. Federal and state aid to local governments have increased from $5.9 billion in 1954 to $68.8 billion in 1976, and represents an increase from 30 percent to 46 percent of all total local general revenue. ACIR, SIGNIFICANT FEATURES OF FISCAL FEDERALISM, 1976 EDITION at 3-4, 52-58.

131. Due largely to increase in the tax burden, State and local government revenues have risen from 4.9 percent of the GNP in 1945 to 12.4 percent in 1976. ACIR, SIGNIFICANT FEATURES OF FISCAL FEDERALISM, 1976-1977 EDITION 1,6 (March 1977).

132. The determination of "fiscal prudence" of a state or municipality is now the subject of disclosure of detailed material economic and financial information about the state or municipality produced in an "official statement" (a document similar to a prospectus in private corporate financing). The document is circulated to potential interested bidders in a public sale and usually prepared as a closing document in connection with a private or negotiated sale. Indeed, the "era of disclosure" in the municipal finance industry was brought about largely by the fiscal difficulties of the City which culminated in the Moratorium Act
state of the law of municipal finance now prohibits diminution of the security behind municipal obligations in order to satisfy competing claims for public monies or to alleviate a financial crisis.

and the Flushing case. No federal regulations now exist which govern what information is required for full disclosure, although many states have regulations prescribing minimum disclosure requirements. In addition the Municipal Finance Officers Association in December, 1976 published “Disclosure Guidelines for Offerings of Securities by State and Local Governments” which suggests voluntary disclosure guidelines.