Loosening the Grips of the Contract Claws: How a More Balanced Approach Can Help States Address Their Budget Shortfalls

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INTRODUCTION

In recent years, as states have struggled to find solutions for the budget shortfalls and revenue shortages brought about by the Great Recession, the compensation of public employees has become a contentious subject. A number of politicians have reasoned that public employee compensation has contributed to the current fiscal crisis and have encouraged legislators to cut public employee pay and benefits, modify collective bargaining agreements, privatize certain public services, and even eliminate collective bargaining rights altogether. Several examples of recent condemnation have raised important questions about the appropriate level of state and local government compensation.

"We have a new privileged class in America. We used to think of government workers as underpaid public servants. Now they are better paid than the people who pay their salaries . . . . Who serves whom here? Is the public sector — as some of us have always thought — there to serve the rest of society? Or is it the other way around?"2

-Governor Mitch Daniels, Indiana

There are “two classes of people in New Jersey[…] Public employees who receive rich benefits, and those who pay for them.”3

-Governor Chris Christie, New Jersey

1 J.D., St. John's University School of Law, 2012; B.A., University of Virginia, 2007
“Look, I understand that teachers are the brains of the operation, O.K.? But my hours are cut, and my taxes are killing me. They have got to take it in the ear, too.”

-Michael Tini, Card Dealer, Atlantic City, New Jersey

Regardless of the degree to which public employees are to blame for states’ dire fiscal circumstances, the frustration of Gov. Daniels and Gov. Christie is understandable. Indiana and New Jersey, like the vast majority of other states in the country, are currently in a financial crisis amidst the most serious and sustained economic downturn since the Great Depression. The economic slowdown has caused the steepest decline in tax receipts on record. While tax revenues have decreased, the need for critical state-funded services has not. As a result, even after making very deep spending cuts over the last two years, at least forty-six states struggled to close shortfalls when adopting budgets for fiscal year 2011.

For states that face large budget gaps, the consequences are severe. Budget difficulties have led over forty-six states to reduce services to their residents, including some of their most vulnerable families and individuals. Thirty-one states, including New York, have restricted eligibility to health insurance programs or access to health care services. Even more states have implemented cuts to K-12 education and public


9 Johnson, supra note 8; K-12 EDUCATION AND OTHER CHILDHOOD EDUCATION PROGRAMS, GLOBAL COLLEGE SEARCH ASSOCIATES, LLC [hereinafter GLOBAL COLLEGE SEARCH ASSOCIATES],
colleges and universities, while increasing the price of college tuition due to insufficient state funding. Finally, states have made reductions in a variety of other programs, including those for poor families and other vulnerable populations. Such spending cuts are additionally problematic during a recession because they reduce overall demand and can make the downturn deeper.

In New York State, one group that has not experienced the effects of these budget cuts is the State's unionized workforce, which is one of the largest categories of expenditures for government operations. Out of an operating budget of $79.2 billion, New York State spends nearly $11 billion on wages for its work force of 220,000. Moreover, the cost of providing medical insurance for these workers is expected to surge from $1.8 billion to $2.5 billion over the next three years. By 2015, state pension costs, which are set by law in Albany, will exceed $8 billion a year, compared with $2.6 billion last year, according to a state projection.

Governor Paterson’s Executive Budget Proposal for fiscal year 2011 attempted to address the projected $8.5 billion shortfall by providing for savings of $250 million from money spent on its state workforce by renegotiating some of the terms of its collective bargaining agreements.


10 Johnson, supra note 8; Global College Search Associates, supra note 9. In its FY2011 budget New York cut funding for public universities by 10 percent relative to the previous academic year, cut aid to community colleges by 11 percent and cut grants awarded by a financial aid program that serves students from low and moderate income families. The state’s university system previously increased resident undergraduate tuition by 14 percent beginning with the spring 2009 semester.

11 New York, for example, has implemented cuts to localities, leading to local concerns about reductions in funding for policing, child care assistance, meals for the elderly, hospice care, services for veterans and seniors, and other services. See Johnson, supra note 8.

12 Id. The companies and organizations that would have received such government payments have less money to spend on salaries and supplies, and individuals who would have derived benefits now have less money for consumption. This reduces demand from the economy. Id.


14 When the State enters into a collective bargaining agreement with its unionized workforce, certain terms and conditions of the agreements are enacted into law. The most recent agreements were negotiated in 2007, and were predicated upon optimistic forecasts regarding the State’s and nation’s fiscal health. See Editorial, State Workers and N.Y.’s Fiscal Crisis, N.Y. TIMES, Mar. 5, 2011, at WK9.

15 See Michael Barbaro, Cuomo on a Collision Course With Unions, N.Y. TIMES, Nov. 3, 2010, at P10; see also Editorial, supra note 14.


17 See Barbaro, supra note 15. In addition, New York State has promised more than $200 billion worth of health benefits to its retirees, but has set aside almost nothing to pay for them. Id.

18 See Defendants’ Memorandum of Law in Opposition to Motion for Preliminary Injunction at
Governor Paterson attempted to achieve those savings by negotiating with the collective bargaining representatives of public employees. These efforts were unsuccessful, and the representatives declined to agree to any reductions in expenditures for current State employees.19

A. How New York State’s Collective Bargaining Agreements Work

New York State is party to collective bargaining agreements with a number of public employee organizations20 pursuant to Article 14 of the New York Civil Service Law, also known as the Taylor Law. "[T]o promote harmonious and cooperative relationships between government and its employees and to protect the public by assuring, at all times, the orderly and uninterrupted operations and functions of government," the Taylor Law describes the rights of employee organizations as well as the rules that govern their employment relationship with the State..21 In addition, the Taylor Law grants state employees the right to be represented by unions,22 prohibits strikes by public employees,23 requires public employers to negotiate and enter into agreements with public employee organizations regarding terms and conditions of employment,24 establishes impasse procedures for the resolution of CBA disputes,25 and establishes a state agency to administer the law—the Public Employment Relations Board (PERB).26

11-12, Donohue v. Paterson, No. 1:10-CV-00544 (N.D.N.Y. May 19, 2010) [hereinafter Defendants’ Memorandum of Law] The specific process for achieving such savings was to allow unions representing the State workforce to negotiate personnel savings on the basis of mutual agreement so that the State could close its revenue shortfall. Predictably, no such agreement occurred. id.; see also Press Release, Division of the Budget, State of New York, Governor Paterson’s 2010-11 Executive Budget Proposes Significant Spending Reductions, Key Long-Term Reforms To Eliminate $7.4 Billion Budget Cap (Jan. 19, 2010), available at http://www.budget.ny.gov/pubs/press/2010/pressRelease10_eBudget01.html.

19 See Defendants’ Memorandum of Law, supra note 18, at 7; see also Division of the Budget, supra note 18.

20 These public employee unions include the Civil Service Employees Association, the Public Employees Federation, the N.Y.S. Correctional Officers and Police Benevolent Association, among others. See GOVERNOR’S OFFICE OF EMPLOYEE RELATIONS, NEW YORK STATE, STATE-UNION CONTRACTS (2012), http://www.goer.state.ny.us/Labor_Relations/Contracts/index.cfm; see also OFFICE OF COLLECTIVE BARGAINING, WHO WE ARE, http://www.ocb-nyc.org/ (last visited Apr. 12, 2012).

21 N.Y. CIV. SERV. LAW § 200 (Consol. 2011).
22 N.Y. CIV. SERV. LAW § 203 (Consol. 2011).
23 N.Y. CIV. SERV. LAW § 210 (Consol. 2011).
24 N.Y. CIV. SERV. LAW § 204-a (Consol. 2011).
26 N.Y. CIV. SERV. LAW § 213 (Consol. 2011). The PERB was established as an independent agency, statutorily separated from the Civil Service Department. To perform the functions mandated by the Taylor Law, it is organized with three program units, each responsible for administering the collective negotiations dispute resolution processes, resolving representation and improper practice matters, and representing the PERB in court actions. See PUBLIC EMPLOYEE RELATIONS BOARD, NEW
An examination of a number of provisions in the State's contract with the Public Employees Federation, a union that represents attorneys, accountants, social workers, and nurses, reveals that the State has vested a number of rights to its employees. These provisions include a four percent wage increase, salary schedule and job rate parity, overtime work and pay, paid leave, the right to be laid off only on the basis of seniority, and a thirty-day minimum notice requirement before altering the worker's workweek or workday. Terms also restrict the State's ability to modify or impair these contracts by giving State employees the right to be free from unilateral attempts to modify the CBA, prohibiting abridging the duration of the CBA, and providing the right to be free from furlough type layoffs. Moreover, the Triborough Amendment to the Taylor Law prohibits public employers from altering any provision of an expired labor agreement until a new labor agreement is reached. This amendment requires automatic pay increases where a salary step schedule or longevity schedule exists, even if the labor agreement has expired.

The New York State Legislature finally passed the budget for fiscal year 2011 on August 2, 2010, 125 days after it was due. The budget did not provide for any reductions to the salary or benefits of New York's unionized workers, partially because of the contractual provisions codified by the Taylor Law and the Triborough Amendments. Instead, the budget raised taxes by nearly $4 billion, cut school aid by over $1.5 billion, and raised another $1 billion through uniform, across-the-board cuts to programs such as Medicare.
B. New York State's Budget Crisis and Donohue v. Paterson

Six months before the passage of the August 2, 2010 legislation, the State had no budget in place. This necessitated the "appropriation of funds to authorize essential expenditures such as payroll, unemployment insurance, pharmaceutical coverage, and veterans' benefits." Determined to achieve the $250 million in savings that Governor Paterson was unable to negotiate with the public employees' unions, the State Legislature passed an emergency appropriations bill that enacted unpaid furloughs, a wage freeze, and a benefits freeze on its unionized state employees. These appropriation bills, also known as "extender bills," temporarily funded the operation of the State in the absence of an official budget. These extender bills suspended payment of a four percent wage increase, suspended reimbursement paid to employees for professional development and training programs, and imposed a one-day unpaid furlough, forcing the majority of State employees to take an unpaid day off during the week of May 10th.

C. Contract Clause Analysis

By way of the Contract Clause, which provides that "[n]o state shall . . . pass any . . . Law impairing the [o]bligation of [c]ontracts," various civil service organizations moved for a preliminary injunction to enjoin the State from submitting, enacting, and implementing these "extender bills." While the language of the Contract Clause appears absolute on its face, its reach is limited by the State's sovereign power to protect the health, safety, and welfare of its citizens. The extent to which the Clause limits State power is determined by a three-part test articulated by the Supreme Court in United States Trust v. New Jersey, which questions "(1) whether the contractual impairment is, in fact, substantial; if so, (2) whether the law serves a significant public purpose, such as remedying a general social or economic problem; and, if such public purpose is demonstrated, (3)

35 See Defendants' Memorandum of Law, supra note 18, at 12.
36 See id. at 5. The majority of furloughs were to last for only one day, and the wage freeze applied only to management and confidential level employees. The benefits freeze was intended to be temporary.
37 See id. at 4; see also Fighting for Our Future, 29.5 PUBLIC EMPLOYEE ADVOCATE: THE NATIONAL PUBLICATION OF AFT PUBLIC EMPLOYEES 1, 3 (2010).
38 Defendants' Memorandum of Law, supra note 18.
whether the means chosen to accomplish this purpose are reasonable and necessary.”

Applying the test set forth in *U.S. Trust*, the district court in *Donohue v. Paterson* granted the public employees unions’ preliminary injunction and held that that the proposed unpaid furloughs, wage freezes, and benefit freezes violated the Contract Clause. First, the court found that these measures constituted a substantial contractual impairment, reasoning that in an employment contract, the promise to pay a certain sum of money is the “most important element [ ] of a contract,” and “the central provision upon which it can be said [the employees] reasonably rely.” Thus, despite the State’s contention that the withholding of salary increases was temporary and therefore not substantial, the court found that the plaintiffs satisfied the first prong of the Contracts Clause inquiry. Addressing the second prong of the test, the court found that the emergency appropriations bill served the significant public purpose of addressing the State’s fiscal crisis. While the court noted that the public purpose inquiry was not “immediately resolved by reference to the State’s budgetary problems,” the court found that the State’s pressing need to meet its obligations constituted a legitimate government interest.

Even if a state establishes that its legislation addresses a legitimate public purpose, to withstand challenge under the Contract Clause, legislation that substantially impairs contractual rights must employ means that are “reasonable and necessary” to meet the stated legitimate public purpose of the legislation. Because the State of New York was a party to the contracts underlying the Plaintiffs’ challenge, the court subjected the State to “less deference scrutiny.” To be reasonable and necessary under this type of scrutiny, it must be shown that the State “did not (1) ‘consider impairing . . . the contracts on par with other policy alternatives’ or (2) ‘impose a drastic impairment when an evident and more moderate course

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41 Sanitation and Recycling Indus., Inc. v. City of N.Y., 107 F.3d 985, 993 (2d Cir. 1997) (citing U.S. Trust Co. v. New Jersey, 431 U.S. 1, 22–23 (1977)).
43 See Donohue, 715 F. Supp. 2d at 319.
44 See id. at 320–21.
45 Id. at 320.
46 See id. at 321.
47 See U.S. Trust Co. v. New Jersey, 431 U.S. 1, 25 (1977); see also Ass’n of Surrogates & Supreme Court Reporters v. New York, 940 F.2d 766, 774 (2d Cir. 1991) ("The contract clause, if it is to mean anything, must prohibit New York from dishonoring its existing contractual obligations when other policy alternatives are available.").
would serve its purpose equally well,’ nor (3) act unreasonably ‘in light of the surrounding circumstances.’”49 The extender bills, in the court’s view, did “not present a close case,” because the State could not direct the court to legislative consideration of more moderate policy alternatives, even though neither the plaintiffs nor the court could identify an alternative means for the State to address its budget gap.50

Finally, because the weekly extender bills were not “budgetary legislation in the normal course,” the court found that the State acted unreasonably.51 Here, the bills did not permit deliberation beyond approval or rejection in its entirety, because a failure to enact the bill for the subsequent week was in effect a vote for government shutdown.52 As a result, the judge issued a preliminary injunction to enjoin the State from enacting the extender bills, finding that the State could not show the requisite level of consideration and tailoring to prove that the provisions of the bill were reasonable and necessary.53

The conclusion that Governor Paterson’s proposed extender bill was not “reasonable and necessary” is an understandable application of U.S. Trust. Under U.S. Trust, when a state attempts to modify a contract that it is a party to, it is virtually impossible for a state’s contractual impairment to be found reasonable and necessary under “less deference scrutiny.” This is because a court need only hypothesize an alternative means of achieving all, or merely some, of the State’s objectives, even if those means severely impair the rights of taxpayers. This analysis imposes severe substantive restraints on a state’s ability to free itself from a contractual provision that may be inconsistent with the broader interests of its citizens. Considering the massive budget shortfalls that states face in recessions and the harsh consequences that can result from alternative budget balancing measures, this Comment argues that modification of Contract Clause jurisprudence is necessary for states to exercise their critical police power.

This Comment begins in Part I by reviewing modern Contracts Clause jurisprudence and examining how courts have applied it to public contracts. Part II then contrasts this approach with the more deferential standard advocated by the Framers and the first two hundred years of Supreme Court jurisprudence. In Part III, this Comment explains the confusion

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49 Id. (quoting Buffalo Teachers Fed’n v. Tobe, 464 F.3d 362, 371 (2d Cir. 2006) (citing United States Trust Co., 431 U.S. at 30–31)).
50 See Donohue, 715 F. Supp. 2d at 323.
51 Id. at 323.
52 See id.
53 See id. at 325.
created by the "reasonable and necessary" doctrine and argues why a more deferential approach is required. Part IV of this Comment proposes a solution that will bridge the gap between the deferential framework of the first two centuries of the Contract Clause and the modern test arising out of U.S. Trust. This solution strikes an appropriate balance between the social costs associated with the deprivation of public contracts and the negative consequences that result from a state being forced to enact harsh measures to close its budget gaps. Finally, Part V of this Comment addresses arguments against applying a more deferential Contracts Clause standard to public contracts.

I. THE MODERN APPLICATION OF THE CONTRACTS CLAUSE TO PUBLIC CONTRACTS

A. Blaisdell and Asbury Park: Laying a Foundation for the Exercise of a State's Police Power

The seminal case in modern Contracts Clause jurisprudence, Home Building and Loan Association v. Blaisdell stands for the proposition that states can modify contracts when they are acting within the scope of their emergency police powers.54 In this case, after the onset of the Great Depression, the Minnesota legislature passed a law that postponed the foreclosure of mortgages and extended periods of redemption.55 Home lenders challenged the statute as an impairment of their contract under the Contract Clause. However, the Blaisdell Court concluded that the statute was an appropriate extension of the State's police power to protect the vital interests of the community.56 While an emergency does not create state power, the Court reasoned that an emergency "may furnish the occasion for the exercise of power."57 Such an exercise of power, the Court noted, must be balanced with the importance of protecting contracts against impairment, which is inherently vital to the peace and stability of society.58

Given that the legislation in Blaisdell addressed an economic emergency and the period of redemption was to be extended only temporarily, the Supreme Court concluded that the Minnesota statute did not violate the

55 See id. at 415. The Act, which declared that an emergency existed, was to remain in effect only during the continuance of the emergency and for no longer than two years. Id.
56 See id. at 434.
57 Id. at 426. The Court in Blaisdell concluded, therefore, that the reservation of the central attributes of sovereign power are read into contracts. See id. at 435.
58 See id. at 443–44.
Contracts Clause. Thus, *Blaisdell* established that some flexibility would be allowed in Contracts Clause jurisprudence, laying the foundation for future decisions, which allowed states to modify contracts to protect the welfare of its citizens. This standard was reinforced by the Supreme Court thirty years later in *Faitoute Iron and Steel Co. v. Asbury Park*, where the Court stated that a state’s powers are more expansive when the contracting parties are corporations created for “public purposes, by legislative acts, and where the subject matter of the contract is one which affects the safety and welfare of the public.”

**B. Applying the Contract Clause to the Impairment of Contracts to Which a State Is a Party**

In recent years, courts have implemented a more restrictive view of the Contract Clause, giving less deference to legislators when a state is a party to the contract. In *United States Trust Company v. New Jersey*, the Supreme Court considered a challenge to a New Jersey statute that limited the ability of the Port Authority of New York and New Jersey to subsidize rail passenger transportation from revenues and reserves. In this case, the Court stated that “a State is not completely free to consider impairing the obligations of its own contracts on a par with other policy alternatives” and noted that a state “cannot refuse to meet its legitimate financial obligations” simply because it would rather spend the money on the public good rather than on the welfare of its creditors. Any substantial impairment of a contract, the Court stated, must be “reasonable and balanced against the competing interest as well as the public good.”

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59 See id. at 447.
61 *Faitoute Iron & Steel Co. v. Asbury Park*, 316 U.S. 502, 515 n.2 (1942) (quoting Chicago B. & Q. R. Co. v. Nebraska, 170 U.S. 57, 72 (1898)). *Faitoute* involved the New Jersey Municipal Finance Act, which provided that a bankrupt local government could be placed in receivership by a state agency. *Id.* at 503. A plan for the composition of creditors’ claims was required to be approved by the agency, the municipality, and 85 percent in amount of the creditors. *Id.* at 504. The plan would be binding on nonconsenting creditors after a state court conducted a hearing and found that the municipality could not otherwise pay off its creditors and that the plan was in the best interest of all creditors. *Id.* at 504 n.1.
62 See U. S. Trust Co v. New Jersey, 431 U.S. 1, 1 (1977). The Port Authority was established by a compact between New York and New Jersey to coordinate the transportation infrastructure, including the bridges, seaports, tunnels, and airports, within the Port of New York and New Jersey. *Id.* at 4. While the compact was between the two states and was approved by Congress, the Port Authority was conceived as a financially independent entity with funds primarily derived from private investors. *Id.*
63 *Id.* at 30–31.
64 *Id.* at 29.
necessary” to address the state’s important purposes.65

Because New Jersey sought to impair contracts to which it was a party, the Court introduced a test called “less deference scrutiny” to determine whether New Jersey’s contractual impairment was “reasonable and necessary.” For legislation to be found reasonable and necessary under this standard, the state must show that it did not (1) consider impairing the contract(s) on par with other policy alternatives, (2) impose a drastic impairment when an evident and more moderate course would serve its purpose equally well, or (3) act unreasonably in light of the surrounding circumstances.66 The Court found that New Jersey’s impairment was not “necessary” for two reasons. First, it reasoned that a less drastic modification could have permitted the contemplated plan without removing the covenant’s limitations on the use of Port Authority revenues and reserves to subsidize commuter railroads.67 Second, the court reasoned that New Jersey could have adopted alternative means of achieving its goals by implementing taxes on gasoline or parking.68

C. New York State Cases Applying the Contract Clause to Collective Bargaining Agreements

In In re Subway-Surface Supervisors Association v. New York City Transit Authority, the New York Court of Appeals upheld a state statute barring the payment of a five percent wage increase for New York City Transit Authority workers due to a financial emergency.69 At that time, New York City was undergoing an historic fiscal crisis after years of incurring substantial deficits.70 The court held that the statute was constitutional even though the wage increases were mandated pursuant to a collective bargaining agreement.71 Employing a broader and more flexible view of the Contracts Clause than the Supreme Court in U.S. Trust, the Court of Appeals stated that the State may validly exercise its police power to serve an important public purpose if it does so in a manner that is not

65 Id.
66 See id. at 30–31.
68 See id. at 30.
70 See id. at 387.
71 See id. Under the collective bargaining agreement entered into by the parties, the New York City Transit Authority employees were to be given a five percent general wage increase. Id. The suspensions of the salary increases were to continue for one year or until the Emergency Financial Control Board met its financial plan. Id.
"arbitrary or oppressive." The court considered the wage freeze to be a "limited intrusion" because it "neither terminat[ed]... existing employment nor depriv[ed]... payment for services that had been rendered in the past." Thus, the court found the statute to be a "necessary and reasonable address to a concededly important public purpose."

In a more recent application of the *U.S. Trust* test to public contracts, the Second Circuit in *Buffalo Teachers Federation v. Tobe* upheld a New York State statute that froze teachers' wages. In the spring of 2004, the Buffalo Fiscal Authority faced a $50 million budget gap and estimated that its budget gap for the next four years would exceed $250 million. This led the Fiscal Authority to implement a wage freeze that prohibited the unionized city employees from receiving a two percent wage increase. The Second Circuit applied the *U.S. Trust* three-pronged test to examine whether the contractual impairment was substantial, whether it addressed a legitimate public purpose, and if so, whether the means that served this purpose were reasonable and necessary. First, the court found the two percent wage freeze to be a substantial impairment. The court also determined that the New York Legislature had a legitimate public purpose in implementing the wage freeze because the City of Buffalo faced a severe fiscal crisis. Thus, the relevant inquiry was whether the wage freeze was "reasonable and necessary."

Here, the court applied "less deference scrutiny" because the State was a party to the contract. The court noted that the review board did not treat the wage freezes on par with other policy alternatives because the wage freezes were only intended to be a last resort measure. Addressing the second prong of this inquiry, the Second Circuit noted that the Authority imposed the wage freeze only after other measures had been tried or

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72 Id. at 388.
73 See id. at 390.
74 Id. at 391.
75 *Buffalo Teachers Fed'n v. Tobe*, 464 F.3d 362, 370 (2d Cir. 2006) (The State Legislature established the Buffalo Fiscal Stability Authority to oversee the City of Buffalo's finances. *Id.* The Buffalo Fiscal Stability Authority Act stated that the city was in a state of fiscal crisis and that the welfare of its residents was being threatened. *Id.* The purpose of this Act was to achieve fiscal stability for Buffalo and its schools by 2007-2008. *Id.*
76 Id. at 366.
77 Id. at 367.
78 Id. at 368.
79 See id.
80 See id.
81 See *Buffalo Teachers*, 464 F.3d at 371.
82 See id.
considered. Finally, the Second Circuit noted that this wage freeze was temporary and did not affect past salary due for work already performed. Thus, the court found that the impairment was not "drastic."

In analyzing whether an evident and more moderate course would have served the City's purpose equally well, the court rejected the union's argument that taxes could have been raised or other services could have been burdened or eliminated; stating that "[i]t cannot be the case . . . that a legislature's only response to a fiscal emergency is to raise taxes." The court found "no need to second-guess the wisdom of picking the wage freeze over other policy alternatives," preferring the City's methods of closing its budget gap over the "Draconian" remedies of further layoffs, or the elimination of essential services.

II. THE HISTORICAL APPLICATION OF THE CONTRACT CLAUSE TO PUBLIC CONTRACTS

A. Did the Founders Intend for the Contract Clause to Apply to Public Agreements?

While modern courts have understood the Contract Clause to require "less deference scrutiny" when a state attempts to modify a contract to which it is a party, many scholars have argued that the Constitution's Framers perceived the Contract Clause to be applicable only to private agreements. Indeed, the ability for representatives to respond to the needs of their constituents is one of the "fundamental premises of our popular democracy." For a political system that relies on elections to hold politicians accountable and to "clean out the rascals," the effectiveness of this system is compromised when these same "rascals" can perpetuate their policies indefinitely by simply creating binding contracts.

In line with this idea, the Framers of the Constitution understood the
Contract Clause to be used as a safeguard for economic transactions entered into by private parties, rather than as a protection for obligations of which the State is a party.\textsuperscript{90} A review of the history of the Constitutional Convention reveals that the Contract Clause was not intended to apply to anything other than purely private contracts.\textsuperscript{91} Many founders stated that the Clause referred "merely to contracts between individuals."\textsuperscript{92} Indeed, only two anti-federalists supported a reading of the Clause that encompassed public contracts. However, their "interpretations were denied by members of the Convention, and the denials were not challenged."\textsuperscript{93}

\textbf{B. Contract Clause Jurisprudence Before U.S. Trust}

While Contract Clause cases decided before the Supreme Court's \textit{U.S. Trust} decision involved corporate charters rather than public undertakings, these decisions established the principle that Contract Clause challenges were to be resolved by "according unusual deference to the lawmaking authority of state and local governments."\textsuperscript{94} The Supreme Court's holding in the case of \textit{Atlantic Coast Line Railroad Company v. Goldsboro} is emblematic of this deference to states' sovereign authority.\textsuperscript{95} In this case, North Carolina contracted with a railway company to operate rail lines in the State.\textsuperscript{96} Pursuant to the charter, the railroad acquired in fee land for use as rights-of-way and similar transportation activities.\textsuperscript{97} While the Court recognized that the charter was a binding contract, the Court upheld a State ordinance that circumscribed the railroad's activities on its own land, holding that the Contract Clause does not have the effect of overriding the State's power to "establish all regulations that are reasonably necessary to secure the health, safety, good order, comfort, or general welfare of the

\textsuperscript{90} See JONATHAN ELLIOT, THE DEBATES IN THE SEVERAL STATE CONVENTIONS, Vol. IV, 334 (2d ed. 1836); see also WRIGHT, supra note 87, at 15.

\textsuperscript{91} See U.S. Trust Co., 431 U.S. at 45 (Brennan, J., dissenting); see also WRIGHT, supra note 87, at 15.

\textsuperscript{92} ELLIOT, supra note 90, at 191.

\textsuperscript{93} WRIGHT, supra note 87, at 16.

\textsuperscript{94} U.S. Trust, 431 U.S. at 46 (Brennan, J., dissenting).

\textsuperscript{95} See id. at 49; see, e.g., Fertilizing Co. v. Hyde Park, 97 U.S. 659, 670 (1878). In this case, the Illinois General Assembly granted a corporate charter to a fertilizer company to run for fifty years. \textit{Id.} at 663. The corporation thereafter invested in a factory on land it owned within the area designated by the charter. \textit{Id.} at 664. Five years later, the village authorities of Hyde Park passed an ordinance that prohibited the transportation within the village and forbade the operation of the factory, essentially rendering the company's charter valueless. \textit{Id.} at 665. The Supreme Court, nevertheless, rejected the contention that the new ordinance offended the Contract Clause. \textit{Id.} at 670.


\textsuperscript{97} \textit{Id} at 551.
community.”

In early 20th century cases such as *Blaisdell*, *Faitoute*, and *Goldsboro*, as long as a state’s actions were not “unreasonable and arbitrary”99 the Supreme Court deferred to the regulatory power of states. However, the Court in *U.S. Trust* characterized this historical view of the Contract Clause as “provid[ing] no protection at all.”100 It reasoned that deference to a legislature’s assessment of necessity would be inappropriate because the legislature would virtually always prefer to reduce its financial obligations and spend that extra money on what it regards as a more important public purpose.101 The Court reconciled its requirement that legislation be “reasonable and necessary” to meet its stated public purpose with prior precedent by distinguishing between the exercise of state power that is “purely financial”102 and the exercise of state power in the areas of health, environmental protection, and transportation.103 The Court then reasoned that when a state has a financial obligation, it acts on the level of an ordinary person entering into a contract rather than in its capacity as sovereign entity.104

While one cannot disregard the importance of states fulfilling the contracts into which they enter, the Supreme Court had previously determined the distinction between financial motives and health and safety concerns as illusory.105 As a practical matter, the Court recognized in *Blaisdell* that a state’s interest in financial decisions is just as legitimate as its interest in regulating health and transportation.106 As an analytical matter, the Contract Clause prohibits a state from making policy decisions “motivated by a simple desire to escape its financial obligations”107 just as it prevents a state from recklessly pursuing policies involving health and safety.108 Thus, rather than automatically according less deference to states that infringe upon the rights of its public employees, the proper inquiry

98 *Id.* at 558; see *Faitoute Iron and Steel Co.* v. *Asbury Park*, 316 U.S. 502, 508 (1942).
99 *New Orleans Pub. Serv.* v. *New Orleans*, 281 U.S. 682, 685 (1930) In applying this standard, Justice Butler explained that a state would have wide discretion in determining what precautions taken in the public interest were actually appropriate under the circumstances. *Id.*
101 *See id.* at 29.
102 *See id.* at 25.
103 *See id.* at 21.
104 *See id.* at 24.
105 *See id.* at 43 (Brennan, J., dissenting); *see also Home Bldg. and Loan Ass’n v. Blaisdell*, 290 U.S. 398, 435–36 (1934).
106 *Blaisdell*, 290 U.S. at 435.
107 *U.S. Trust*, 431 U.S. at 52 (Brennan, J., dissenting).
108 *See id.* at 42.
should more closely follow previous Contracts Clause jurisprudence by asking whether, in times of fiscal emergencies, the state’s choice of policy is not “retroactive, reckless or excessive.”

III. PROBLEMS WITH A “REASONABLE AND NECESSARY” STANDARD OF REVIEW

Many problems have arisen from the U.S. Trust Court’s three-pronged “less deference scrutiny” test. Namely, the inquiry makes it nearly impossible for states to respond to economic crises by modifying burdensome contracts. In the case of Donohue v. Paterson, the State of New York, unable to address its $8.5 billion budget shortfall by modifying the contracts of its unionized workers, was forced to raise taxes by nearly $4 billion, reduce Medicare services by $1 billion, and reduce education costs by another $1.5 billion. Such measures hardly resemble the “evident and more moderate course” required by the third prong of the U.S. Trust test.109

The “reasonable and necessary” standard has also been difficult for judges to apply. This is in part because the words “reasonable” and “necessary” have long had very different meanings. Reasonableness has long been considered the most relaxed form of judicial inquiry,110 while necessity has been known as the strictest form of review.111 The result is an odd hybrid combining the two extremes of judicial analysis.112 Courts have faced confusion wielding this test, as evidenced by decisions that have applied very different levels of deference to cases with similar factual circumstances. In Carlstrom v. Washington, for example, the State declared an economic emergency and enacted legislation that deferred a five percent salary increase for teachers at community colleges.113 The Washington Supreme Court invalidated this legislation, reasoning that “the State was fully aware of its financial problems . . . prior to signing the Agreement.”114 However, in Subway-Surface Supervisor’s Association v.

109 See id. at 31.
110 See Dandridge v. Williams, 397 U.S. 471, 485 (1970) (“If the classification has some ‘reasonable basis,’ it does not offend the Constitution . . . .”); see also Lindsley v. Natural Carbonic Gas Co., 220 U.S. 61, 78 (1911).
114 Id. at 5.
New York City Transit Authority, the New York Court of Appeals took a more flexible view of the Contracts Clause and held that the withholding of a five percent general wage increase was a valid exercise of the State’s police power.115 In recent New York cases, the Second Circuit in Buffalo Teachers found “no need to second-guess the wisdom” of the City of Buffalo’s proposed wage freeze over harsh alternatives,116 while the Donohue court held the State of New York to an exacting standard by invalidating its extender bills.117

Part of this confusion can be attributed to the new meanings given to the word “necessary” by the majority in U.S. Trust. Rather than inquiring whether “the government can achieve the purposes of the regulation equally effectively by one or more narrower regulations,”118 the courts in U.S. Trust and in Donohue found that a state’s impairment of a contract was not “necessary” simply by hypothesizing alternatives that were more burdensome to taxpayers. The phrase “equally effective,” a component of the third prong of the U.S. Trust test, should be applied literally. A regulation should not be invalidated because of an alternative that is “nearly as effective.”119 Moreover, a regulation that is less restrictive for one group of people, but more restrictive for others, should not be considered a more moderate alternative.120

The new meaning of “reasonableness”121 also leads to confusion. Courts no longer defer to the “‘reasonable judgments’ of the duly authorized decision-makers.”122 Instead, they ask whether the changed circumstances took the legislature by surprise, or whether the proposed contractual impairment was “budgetary legislation in the normal course.” Such a high standard is extremely difficult for states to meet. While the economic crisis must be unforeseeable, a state’s emergency response must be measured and

119 See Struve, supra note 117, at 1463; see also United States Trust Co. v. New Jersey, 431 U.S. 1, 31 (1977).
121 See U.S. Trust., 431 U.S. at 54 n.17 (Brennan, J., dissenting) (describing how the meaning of reasonableness, which long signified the most relaxed regime of judicial review, is considered “new” because it has now been fused with necessity, which has played a key role in the most demanding level of constitutional review).
122 Id. at 60 (citing Knebel v. Hein, 429 U.S. 288, 297 (1977)).
demonstrate a high level of consideration and tailoring to withstand Contract Clause inquiry. This fails to appreciate the challenges states face in economic crises. This standard also presupposes that, given the opportunity, states would blindly repudiate their financial obligations whenever it would be beneficial for them to do so.123

IV. THE PROPOSAL: AN APPROPRIATE MIDDLE GROUND THAT PRESERVES STATES’ POLICE POWERS

This Comment proposes a solution that bridges the gap between the deferential framework of the first two centuries of Contract Clause jurisprudence and the strict and confusing test arising out of U.S. Trust. This solution preserves the first prong of U.S. Trust by asking whether the contractual impairment is substantial, and then adds additional inquiries to the second and third parts of the test. Under this new test, a state can modify a public employee contract in a fiscal emergency, so long as the impairment does not have retroactive, reckless, or excessive effects. This approach strikes an appropriate balance between the costs of impairing contracts with the costs of increased taxation and reductions in important services.

A. Revising the Second Prong of the U.S. Trust inquiry: Establishing a Difference Between “Compelling” and “Legitimate” Public Purposes

Rather than asking only whether a state can establish a legitimate public purpose, this new test will also ask whether a state can demonstrate a “compelling” public purpose. A state that can establish a compelling public purpose will then be subjected to a lesser level of scrutiny, and a court will uphold its legislation, provided that it is not “retroactive, reckless or excessive.” Legislation that addresses a public purpose that is merely “legitimate,” however, will be subjected to the “reasonable and necessary” standard set forth by U.S. Trust.

Under this proposed solution, whether a public purpose is “compelling”

123 See id. at 61. Justice Brennan explains that the ability of states to enter into one-sided contracts would provide little incentive for anyone to enter into a contract with a state. See id. A state’s ability to obtain credit, however, is dependent on its ability to use its lawmaking powers with restraint. As Justice Brennan concluded in his dissenting opinion, few jurisdictions would “use their authority ‘so foolishly as to kill a goose that lays golden eggs for them.”’ Id. (quoting Erie R.R. v. Bd. of Pub. Util. Comm’rs, 254, U.S. 394, 410 (1921)). Thus, a more deferential standard should be applied so that states can respond to fiscal crises, as the financial welfare of public employees and similarly situated parties is being policed by both the bond marketplace and by political processes. See also Evan C. Zoldan, The Permanent Seat of Government: An Unintended Consequence of Heightened Scrutiny Under the Contract Clause, 14 N.Y.U. J. LEGIS. & PUB. POL’Y 163, 183–84 (2011).
will depend on four factors: (1) whether the emergency that the legislation addresses is "severe;" (2) whether the emergency is of an immediate nature; (3) whether the emergency was foreseeable when the state entered into the contract; and (4) whether reckless state government behavior contributed to its fiscal emergency. Applying these criteria, the fiscal emergency New York State faced in Donohue v. Paterson would constitute a compelling public purpose. While it is difficult to precisely define "severity," an $8.5 billion deficit that constitutes nearly 20 percent of a state’s operating budget would pass the test. Similarly, this emergency would be considered "immediate" because New York State must have funds available to function, which it would not if the emergency was not addressed. Finally, because the State’s collective bargaining agreements were negotiated before the Great Recession and were predicated on optimistic forecasts as to the State’s overall financial health, the State would also have passed this test’s foreseeability inquiry.

The fourth factor is premised on the notion that a state should not be able to impair its contracts if it has acted recklessly in creating the financial emergency. While what constitutes recklessness is difficult to quantify, current New York Governor Andrew Cuomo’s attempt to repeal the millionaire’s tax would affect the State’s ability to impair its union contracts. Similarly, under this proposed test, Wisconsin Governor Scott Walker’s ability to take away the collective bargaining rights of its union employees would have been compromised by his corporate tax cut bill. Because New York’s millionaire’s tax remained in effect at the time of Governor Paterson’s proposed extender bills, the State would have passed this inquiry.

124 See Defendants’ Memorandum of Law, supra note 18, at 11–12. (Discussing how the State was in danger of running out of money.).
125 See id. at 8.
B. “Reckless and Excessive” vs. “Necessary and Reasonable”

Even if it can establish a compelling public purpose, a state must demonstrate that its impairment is not "reckless or excessive." In this test, a court will look at three factors to ensure that the impaired party receives adequate protection: (1) whether the impairment is prospective, rather than retroactive; (2) whether the government can achieve the purposes of the contractual impairment equally effectively by more narrower measures; and (3) whether the challenged legislation cuts "recklessly and excessively" into the value of the creditors' financial interests. While the state would have the burden of showing that it could not achieve the purposes of the challenged regulation equally effectively by one or more narrower regulations, this standard of review would not allow a court to strike down a contractual impairment by simply hypothesizing other means of achieving the state's objectives that may either be implausible or overly burdensome to taxpayers. Under this framework, New York State's furloughs, wage freezes, and benefit freezes would have passed constitutional muster. Even if the government would have achieved $250 million in savings from its public employee budget, it raised taxes by $4 billion, reduced Medicare services by $1.5 billion, and reduced school funding by $1 billion to close its $8.5 billion shortfall. The State could not have demonstrated a more moderate alternative with such drastic measures already in place.

Finally, the cost saving measures of the emergency appropriations bills would not be considered "reckless and excessive" under this proposed framework. To determine whether the contractual impairment would be considered reckless and excessive, courts would look to the length and the severity of the contractual deprivation, as Justice Cardozo's did in *W.B. Worthen Company v. Kavanaugh*. In *Kavanaugh*, the Supreme Court struck down an impairment in which creditors were "without an effective remedy" for at least six and one-half years, during which time the government's obligation to pay principal or interest was suspended. Here, because the unionized state workers' injuries were temporary in nature and did not reach the level of the impairment described in *Kavanaugh*, Governor Paterson's proposed emergency appropriation bills

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128 In *Donohue*, New York's proposed furloughs and wage freezes would pass the first prong of this test as they did not apply to work already performed, making the cuts prospective.

129 *W.B Worthen Co. v. Kavanaugh*, 295 U.S. 56, 62 (1935). In this case, Arkansas enacted a statute that diminished the remedies available to creditors under their bonds as a relief measure to financially depressed local governments. *Id.* at 61.

130 *Id.*
would pass constitutional scrutiny under this new test.

V. ADDRESSING ARGUMENTS AGAINST A MORE DEFERENTIAL FRAMEWORK

Some commentators have argued that the potential for abuse of police power would be greatly increased under a more deferential judicial standard.\(^{131}\) The argument is that, given the power to alter its own contract unilaterally, a state would not act with any more restraint than an individual wishing to escape an onerous contract.\(^{132}\) However, this ignores states' incentives to exercise self-restraint and discipline in order to maintain credibility in the credit market and among voters.

Another argument against applying a more deferential standard to the impairment of public contracts is that it would lead to higher costs to the public in the long run. Commentators have argued that by allowing legislatures to avoid their contractual obligations, public confidence in these institutions would be shaken, leading to higher interest rates for municipal borrowing or decreasing investment in municipal bonds.\(^{133}\) This Comment addresses these concerns by proposing a solution that would strike down contractual impairments that are retroactive, excessive, or reckless in nature.

This proposed solution gives states a way to respond to fiscal emergencies while still leaving public sector employees with competitive salaries and benefits. But can public employees afford to “take a haircut?”

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National Annual Wages by Occupation, 2009 - 
State and Local Government vs. Private Sector\textsuperscript{134}

<table>
<thead>
<tr>
<th>Occupation</th>
<th>State &amp; Local</th>
<th>Private Sector</th>
<th>Percent Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>Physicians</td>
<td>$107,445</td>
<td>$188,147</td>
<td>-42.9%</td>
</tr>
<tr>
<td>Lawyers</td>
<td>$82,164</td>
<td>$127,712</td>
<td>-35.7%</td>
</tr>
<tr>
<td>Computer Programmers</td>
<td>$63,963</td>
<td>$73,543</td>
<td>-13.0%</td>
</tr>
<tr>
<td>Accountants</td>
<td>$53,860</td>
<td>$63,266</td>
<td>-13.6%</td>
</tr>
<tr>
<td>Janitors &amp; Cleaners</td>
<td>$28,251</td>
<td>$24,421</td>
<td>17.0%</td>
</tr>
<tr>
<td>Security Guards</td>
<td>$31,351</td>
<td>$23,927</td>
<td>31.0%</td>
</tr>
<tr>
<td>Maintenance Workers</td>
<td>$30,889</td>
<td>$22,911</td>
<td>34.8%</td>
</tr>
<tr>
<td>Mechanics</td>
<td>$46,221</td>
<td>$42,588</td>
<td>8.6%</td>
</tr>
<tr>
<td>Police Officers</td>
<td>$75,400</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>Firefighters</td>
<td>$69,620</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>Teachers</td>
<td>$63,111</td>
<td>N/A</td>
<td>N/A</td>
</tr>
</tbody>
</table>

The data in this study suggests "that the mostly highly paid jobs in the private sector, usually held by workers with high levels of education and experience, are often not paid as well in the public sector."\textsuperscript{135} Conversely, occupations that typically require lower levels of education or experience are compensated comparatively well in the public sector.\textsuperscript{136} While there are no private sector equivalent jobs for policemen and firefighters, their earnings approximate the average private sector worker with a college degree.\textsuperscript{137}

It would be unreasonable to assert that public employees and their unions are to blame for the states' fiscal crises, or that closing states' budget shortfalls requires taking away the ability of unions to collectively bargain. But given these economic times, taxpayers cannot afford to continue to provide pensions and benefits for public workers that nearly no one in the private sector enjoys. A Contract Clause standard that allows states to


\textsuperscript{135} See id.

\textsuperscript{136} See id.

\textsuperscript{137} See id. at 13.
make reasonable contractual modifications in times of fiscal emergencies will help prevent taxpayers from bearing all of the consequences of closing budget shortfalls in the form of tax increases and reductions to essential services.