The Constitutional Limitations upon Federal Regulation of Municipal Issuers

Robert J. Brady

Follow this and additional works at: https://scholarship.law.stjohns.edu/lawreview

Recommended Citation

Available at: https://scholarship.law.stjohns.edu/lawreview/vol51/iss3/3
NOTES AND COMMENTS

THE CONSTITUTIONAL LIMITATIONS UPON FEDERAL REGULATION OF MUNICIPAL ISSUERS

INTRODUCTION

In recent times the municipal securities industry has become the object of increased public concern and federal scrutiny. The municipal securities or bonds are debt obligations issued by state and local government entities to finance governmental operations. They can be divided generally into four categories: (1) general obligation bonds, secured by the full faith and credit of the issuing authority to the extent of its taxing power; (2) revenue bonds, secured by revenues generated by the project financed; (3) special obligation bonds, secured usually by special taxation; and (4) industrial development bonds, secured by rent charged to the private industrial lessee of the project financed by the issue. See Note, Municipal Bonds and the Federal Securities Laws: The Results of Forty Years of Indirect Regulation, 28 VAND. L. REV. 561, 563-64 (1975) [hereinafter cited as Municipal Bonds]. Interest income to the holder of municipal securities is generally exempted from the federal income tax. I.R.C. § 103(a)(1). There are, however, certain exceptions to this exemption; notably, interest on most classes of industrial development bonds is taxable. I.R.C. § 103(c). Until 1975, municipal securities were also exempt from most provisions of the Securities Act of 1933, 15 U.S.C. § 77c(a)(2) (1970), and the Securities Exchange Act of 1934, 15 U.S.C. § 78c(a)(12) (1970), as amended, (Supp. V 1975). The scope of the tax and regulatory exemptions are substantially similar. Indeed, when a reevaluation of the policy considerations underlying the municipal tax exception resulted in the enactment of limitations upon the industrial development bond exemption, Revenue Expenditure Control Act of 1968, Pub. L. No. 90-364, § 107(a), 82 Stat. 266 (codified at I.R.C. § 103(c)), the same limitations were imposed upon the exemption from the securities acts. Employment Security Amendments of 1970, Pub. L. No. 91-373, § 401, 84 Stat. 718 (codified at 15 U.S.C. §§ 77c(a)(2), 78c(a)(12) (1970)).

The policy of exempting municipal securities from federal taxation and regulation rests upon interests of federalism. The exemptions were indicative of a congressional intent to avoid the constitutional controversy which would result from imposition of federal controls over municipal obligations. H.R. REP. No. 85, 73d Cong., 1st Sess. 14 (1933). Arguably, federal taxation of municipal bond interest or regulation of municipal bonds would impair state power to borrow, "and would thus constitute an impermissible or at least undesirable federal interference with an important power of the states." Note, The Limited Tax-Exempt Status of Interest on Industrial Development Bonds Under Subsection 103(c) of the Internal Revenue Code, 85 HARV. L. REV. 1649, 1652 (1972) (footnote omitted) [hereinafter cited as Industrial Development Bonds]. It is uncertain, however, whether such federal imposition actually is an impermissible transgression of intergovernmental immunity as well as an affront to intergovernmental comity. See Industrial Development Bonds, supra, at 1653 n.25; see also Tribe, Intergovernmental Immunities in Litigation, Taxation, and Regulation: Separation of Powers Issues in Controversies About Federalism, 89 HARV. L. REV. 682 (1976) [hereinafter cited as Tribe].

1 Municipal securities or bonds are debt obligations issued by state and local government entities to finance governmental operations. They can be divided generally into four categories: (1) general obligation bonds, secured by the full faith and credit of the issuing authority to the extent of its taxing power; (2) revenue bonds, secured by revenues generated by the project financed; (3) special obligation bonds, secured usually by special taxation; and (4) industrial development bonds, secured by rent charged to the private industrial lessee of the project financed by the issue. See Note, Municipal Bonds and the Federal Securities Laws: The Results of Forty Years of Indirect Regulation, 28 VAND. L. REV. 561, 563-64 (1975) [hereinafter cited as Municipal Bonds].

2 For a discussion of the current concern for the municipal securities industry, see Casey & Smith, A New Look at Municipal Bonds Disclosure Responsibilities in the Municipal Bond Market, 50 ST. JOHN'S L. REV. 639, 640 (1976) [hereinafter cited as Casey & Smith].
spiraling cost of local governmental services has forced the states and their subdivisions to borrow increasing amounts of capital. At the same time, considerable doubt regarding the capacity of public borrowers to honor their obligations has arisen among investors. The New York City fiscal crisis in particular has stimulated federal interest in and investigation of the municipal bond market. This interest led to the enactment in 1975 of legislation intended to remedy what was arguably the major defect in the field — the exemption of municipal bond brokers and dealers from SEC registration requirements. Congress remains concerned, however, with the state of investor confidence in the municipal bond market, and has directed its attention toward the possibility of imposing a degree of responsibility upon public issuers. Toward this end, several proposals which would provide federal regulation of municipal issuers are

---

2 In 1955, the short term debt owed by American cities equaled 8.6% of their general revenues; by 1972, the proportion had increased to 19.1% of general revenue. Although short term borrowing is at best a temporary solution to a municipality’s fiscal problems, R. Pettin-Gill & J. Uppal, Can Cities Survive? 145-47 (1974), city officials occasionally may lose sight of the essential bankruptcy of fiscal policy founded on deficit financing. Indeed, the use of “bookkeeping gimmicks” may delay realization of the unfortunate result for some time. When New York City’s financial crisis was recognized, the city comptroller decried the city’s accounting system and practices, contending that they promoted fiscal irresponsibility by enabling the city to spend without generating revenue. It was estimated that this irresponsibility would cost New York more than $5.5 billion over a 15-year period to erase the resulting deficit. Note, Federal Regulation of Municipal Securities, 60 Minn. L. Rev. 567, 589 (1976) [hereinafter cited as Federal Regulation].

4 See Federal Regulation, supra note 3, at 587. The general investor distrust of all municipal securities which was engendered by New York City’s difficulties is estimated to have increased debt servicing costs to states and municipalities by $3 billion per year. N.Y. Times, Oct. 19, 1975, at 48, col. 5. Loss of investor confidence has contributed to a growing demand for greater municipal disclosure. See Casey & Smith, supra note 2, at 643-45.


7 See note 8 infra. In a report accompanying the 1975 amendments to the securities laws, the Senate Committee on Banking, Housing and Urban Affairs explicitly noted the existing exception of municipal issuers from all but the general antifraud provisions of the federal securities laws, see note 1 supra, and reaffirmed the exemption for issuers and employees of such issuers who act pursuant to their official duties. S. Rep. No. 75, 94th Cong., 1st Sess. 44, 95, reprinted in [1975] U.S. Code Cong. & Ad. News 179, 221-22, 272. The Committee observed that it was “not aware of any abuses which would justify . . . a radical incursion on states’ prerogatives.” Id. at 44, reprinted in [1975] U.S. Code Cong. & Ad. News 222. There does exist, however, substantial sentiment for legislation mandating greater issuer responsibility, either in the form of disclosure requirements or subjection to full regulation under the acts. See Casey & Smith, supra note 2, at 655-65.
under consideration. In addition, the Securities and Exchange Commission has begun to utilize powers long dormant in the municipal sector by employing its authority under section 20(a) of the Securities Act of 1933 and section 21(a) of the Securities Exchange Act of 1934 to investigate possible violations of the securities laws.

Public concern with municipal securities has focused primarily upon the propriety and appropriate extent of federal regulation of municipal issuers. Recently, however, because of the realization that concern for the vitality of the federal system may affect the extent to which state and local governments, as issuers of securities, may validly be subjected to federal control similar to that presently exercised over private issuers, increased attention has been directed

---

8 Two bills were before the Senate in 1976. The first, introduced by Senator Eagleton late in 1975, would strike the general exemption for municipal securities embodied in § 3(a)(2) of the Securities Act of 1933, 15 U.S.C. § 77c(a)(2) (1970). S. 2574, 94th Cong., 1st Sess. (1975). The second, the Municipal Securities Full Disclosure Act of 1976, proposed by Senator Williams, would amend the 1934 Act by adding a § 13A requiring municipal issuers to disclose certain material information in the form of annual reports and distribution statements. S. 2969, 94th Cong., 2d Sess. (1976). The Williams bill, which had also been introduced in the House of Representatives, H.R. 15205, 94th Cong., 2d Sess. (1976), is considered by many to be better suited to the peculiarities of the municipal bond industry; consequently, it has received greater support. See Casey & Smith, supra note 2, at 662-65. Senator Eagleton's bill was criticized as an unnecessary and unwarranted extension of SEC regulatory authority. Several commentators noted that it fails to provide adequately for the distinctions between the municipal securities industry and the corporate securities industry for which the regulations were developed. See, e.g., id. at 662 & n.82; Federal Regulation, supra note 3, at 591 n.158.

9 15 U.S.C. § 77t(a) (1970). Section 20 also authorizes the SEC to seek injunctions, transmit evidence to the Attorney General for possible prosecution, and apply for writs of mandamus to compel compliance with the Act. Id. § 77t(b), (c).

10 Id. § 78u(a) (Supp. V 1975).

11 On January 5, 1976, the SEC instituted an investigation of transactions in New York City securities "to determine whether any violations of those Acts have occurred or are occurring." Commission Press Release, Jan. 8, 1976. The Commission announced the institution of the private investigation to minimize the deleterious impact which the information would have upon the securities markets. A stated "major reason" for the investigation was the SEC's "desire to restore investor confidence in the municipal bond markets." Id.

12 See, e.g., Chazen, More Regulation of Municipals, Greater Disclosure on the Horizon, 176 N.Y.L.J. 112, Dec. 13, 1976, at 35, col. 1; Federal Regulation, supra note 3; Note, Disclosure by Issuers of Municipal Securities: An Analysis of Recent Proposals and a Suggested Approach, 29 VAND. L. REV. 1017 (1976). See also Hearings on S. 2574 & S. 2969 Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs, 94th Cong., 2d Sess. 155-58 (1976) (remarks of R. Carver, representing National League of Cities). In analyzing the effect of S. 2969 upon municipalities, SEC Chairman Hills approached the issue in terms familiar to students of the balancing test employed in determining the availability of intergovernmental tax immunity, asking whether disclosure requirements would constitute an "undue burden" on the governmental units. Id. at 21. See also Industrial Development Bonds, supra note 1.
to the constitutional issues presented by federal regulation of municipal issuers. It has been suggested that governments which finance their activities by issuing securities stand in a position fundamentally different from that of private issuers in that they enjoy an immunity from private suits emanating from the eleventh amendment, and, perhaps, a tenth amendment immunity from federal infringement of state sovereignty.

Eleventh amendment immunity from suit has long had an impact on state liability for causes of action based upon federal law. The existence of a tenth amendment immunity was uncertain, however, until the Supreme Court's decision in *National League of Cities v. Usery*, in which the Court recognized an affirmative tenth amendment limitation upon the power of the federal government to regulate certain state activities which affect interstate commerce. Applying this limitation, the Court invalidated an attempted extension of wage and hour provisions of the Fair Labor Standards Act (FLSA) to cover most public sector employees. In its opinion the Court, in extremely broad terms, discussed the effect of federalism restraints upon Congress' power under the commerce clause, thereby casting doubt upon the extent to which Congress may compel state compliance with laws promulgated pursuant to the commerce power.

This Note will examine the *National League* decision and will attempt to analyze its impact on the question of governmental regulation of municipal issuers. The tenth amendment rationale suggested by *National League* will then be applied both to proposed federal legislation calling for the implementation of increased regulation of municipal issuers and to the current regulatory scheme in an attempt to determine whether any or all of these measures are constitutionally permissible. Finally, this Note will examine the effect of the states' eleventh amendment immunity from suit upon private actions brought under the federal securities laws. In this context, questions arise concerning the implied private right of action under rule 10b-5 and the current insistence on the part of the Supreme Court, that congressional efforts to abrogate eleventh amendment immunity be expressly stated by Congress and unequivocally accepted by a state.

---

The Commerce Power and the Tenth Amendment

For more than 40 years municipal securities have been exempted from all but the antifraud provisions of the federal securities acts. To a great extent, this exemption reflects a legislative sensitivity to the nature of the American federal system. The question has remained unsettled, however, as to whether there exists an affirmative limitation upon congressional authority to regulate state activities under the commerce clause, or whether the limitation is merely a matter of policy, the result of a determination by Congress that certain functions are more appropriately reserved to the states: a determination made by a body which, composed of representatives of the several states, has weighed the states' interest as sovereign entities against the federal interest in the regulation of interstate commerce. It is only recently that the Supreme Court has addressed itself to the apparent conflict between Congress' "plenary" authority to regulate aspects of commerce and the doctrine of intergovernmental immunity.

In 1968 the Supreme Court, in Maryland v. Wirtz, considered

---


17 The Securities Act of 1933 provides exemptions from its provisions for "Unites States, Territorial, and State obligations, or obligations of any political subdivision of these governmental units." H.R. Rep. No. 85, 73d Cong., 1st Sess. 14 (1933), reprinted in 2 LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934, Item 18 (1973). The term political subdivision, as defined by the statute, generally corresponds to those local obligations which are exempted from federal taxation, for "[b]y such a delineation, any constitutional difficulties that might arise with reference to the inclusion of State and municipal obligations are avoided." Id. The original exemption for securities of public instrumentalities was limited to those "exercising an essential governmental function." Deletion of this limitation the following year, Securities Act of 1933, ch. 38, § 3(a)(2), 48 Stat. 76 (1933), as amended Securities Exchange Act of 1934, ch. 404, § 202(a), 48 Stat. 906 (1934) (current version at 15 U.S.C. § 77c(a)(2) (1970)), indicates a congressional intent to apply the exemption liberally, apparently in the interests of comity. See Landis, The Legislative History of the Securities Act of 1933, 28 GEO. WASH. L. REV. 29, 39 (1959) (municipal bond exemption was added "for obvious political reasons"). Municipal securities were accorded an exemption from regulation under the 1934 Act only after Congress was persuaded that subjection to the disclosure provisions would unduly burden municipal issuers. See Municipal Bonds, supra note 1, at 582-86. Thus, the municipal exemption from the substantive provisions of the Acts was based both upon solicitude for the possible constitutional ramifications of such regulation, and upon practical considerations of comity and "polities."


a constitutional challenge to legislation extending the wage and hour provisions of the FLSA to employees of state and local government hospitals, institutions, and schools.\textsuperscript{20} The \textit{Wirtz} Court ruled that despite the substantial interference in state functions caused by the amendments, they were a valid exercise of Congress’ power to regulate interstate commerce. Minimizing the direct effect of the law upon “sovereign state functions,” Justice Harlan, author of the majority opinion, noted that Congress was not dictating to the states the manner in which they were to perform such functions; rather, it was merely requiring that public employers who engage in activities affecting commerce be subject to the strictures of the federal labor standards.\textsuperscript{21} In determining whether this minimal interference with state sovereignty was constitutionally permissible, the Court had only to determine whether the labor conditions sought to be regulated affected interstate commerce.\textsuperscript{22} The Court debunked the notion that Congress’ commerce clause power might be subordinate to state sovereignty interests in the performance of governmental functions, deeming that argument “simply . . . not tenable.”\textsuperscript{23} Thus, according to Justice Harlan, the federal government’s power to regulate commerce is plenary, and countervailing interests, be they private or state, proprietary or governmental, cannot inhibit the exercise of that power.\textsuperscript{24}

\textsuperscript{21} 392 U.S. at 193-94.
\textsuperscript{22} Id. at 194-95.
\textsuperscript{23} Id. at 195.
\textsuperscript{24} Id. The distinction rejected by the \textit{Wirtz} Court as a basis for determining the constitutional “weight” to be accorded a state interest — whether that interest is governmental or proprietary — is the standard which was developed by the Court to deal with state activity in functions traditionally engaged in by private business. In South Carolina v. United States, 199 U.S. 437 (1905), the Court found it reasonable to hold that, while the [national government] may do nothing by taxation in any form to prevent the full discharge by the [state] of its governmental functions, yet, whenever a state engages in a business which is of a private nature, that business is not withdrawn from the taxing power of the nation. \textit{Id.} at 463. \textit{Accord}, Allen v. Regents of the Univ. Sys., 304 U.S. 439 (1938). The governmental-proprietary distinction was deemed “untenable” in New York v. United States, 326 U.S. 572 (1946), where the Court upheld the federal government’s taxation of New York State’s sale of mineral water, despite the state’s contention that it was engaged in the disposition of its resources, a “traditional and essential governmental function.” \textit{Id.} at 574. Justice Frankfurter, in an opinion joined in by Justice Rutledge, reasoned that a nondiscriminatory tax upon revenue “not uniquely capable of being earned only by a State” passed constitutional muster since it did not amount to the taxation of a state as a state. \textit{Id.} at 582. He considered the governmental-proprietary test to be “too shifting a basis for determining constitutional power and too entangled in expediency to serve as a dependable legal criterion. The essential nature of the problem cannot be hidden by an attempt to separate manifestations of indivisible governmental powers.” \textit{Id.} at 580. Chief Justice Stone, in a separate concurring opinion
Reaction to Wirtz was largely unfavorable. Several commentators objected to the Supreme Court's sweeping dismissal of state claims of sovereignty and contended that such claims should be accorded greater weight. Indeed, the Court itself subsequently limited the scope and effect of the Wirtz rationale, and finally ex-

joined in by three of the eight members of the Court, refused to go as far as did Justice Frankfurter in applying the nondiscrimination standard. Suggesting that some nondiscriminatory taxes would impair a state's sovereign statutes, and agreeing that the governmental-proprietary distinction was inappropriate for the determination of tax immunity, the Chief Justice maintained that "when and because the subject of taxation is State property or a State activity . . . we consider whether such a non-discriminatory tax unduly interferes with the performance of the State's functions of government. If it does, then the fact that the tax is non-discriminatory does not save it." Id. at 588 (emphasis added).

See 18 Buffalo L. Rev. 330, 336-37 (1969). Many case notes, analyzing the decision of the Wirtz 3-judge district court, suggested that the Supreme Court should adopt the viewpoint that there is something less than a plenary power to regulate state functions under the commerce clause. See, e.g., 56 Geo. L.J. 392, 399 (1967); 81 Harv. L. Rev. 1572, 1575 (1968); 66 Mich. L. Rev. 750, 761-71 (1968).

See Fry v. United States, 421 U.S. 542 (1975), where the Court upheld the applicability to state employees of the Economic Stabilization Act of 1970, Pub. L. No. 91-379, tit. II, 84 Stat. 799 (expired 1974), which authorized the President to place a ceiling upon wages and salaries. Writing for the Court, Justice Marshall observed that since the statute under consideration was a temporary, emergency measure intended to combat a national economic crisis, "[t]he federal regulation in this case is even less intrusive" than that in Wirtz. Moreover, exemption of public sector employees would have "drastically impaired" the federal emergency efforts. 421 U.S. at 548. The Justice also noted that

[w]hile the Tenth Amendment has been characterized as a "truism," stating merely that "all is retained which has not been surrendered," . . . it is not without significance. The Amendment expressly declares the constitutional policy that Congress may not exercise power in a fashion that impairs the States' integrity or their ability to function effectively in a federal system.

Id. at 547 n.7 (citation omitted). The Fry rationale suggested that the Court would reconsider tenth amendment restrictions upon federal regulatory power if confronted with a more intrusive statutory scheme. See The Supreme Court, 1974 Term, 89 Harv. L. Rev. 47, 50 (1975).

Justice Rehnquist dissented in Fry, arguing that the Wirtz Court had misplaced its reliance upon United States v. California, 297 U.S. 175 (1936), for support of the proposition that the federal government's plenary power to regulate commerce has the same effect against states as against individuals. 421 U.S. at 552 (Rehnquist, J., dissenting). The California Court had declined to apply to legislation enacted under the commerce clause the "state instrumentalities" immunity doctrine then prevalent in the area of intergovernmental tax immunity. Although the standard for determining tax liability was subsequently modified, Justice Rehnquist indicated that most members of the Court maintained a belief that, in the realm of federal taxation, principles of federalism reserved for the states a status distinct from that applied to individuals. Id. at 556; see New York v. United States, 326 U.S. 572 (1946). He questioned "why a State's immunity from the plenary authority to tax . . . should have been thought . . . to be any higher on the scale of constitutional values than is a State's claim to be free from the imposition of Congress' plenary authority under the Commerce Clause." 421 U.S. at 553-54. Justice Rehnquist suggested that state activities "sufficiently closely allied with traditional state functions" should be beyond the purview of the commerce power. Id. at 558.

The Wirtz Court expressly reserved for future consideration the apparent conflict between state immunity from suit under the eleventh amendment and the remedies provided
pressly overruled it in *National League of Cities v. Usery.*

**National League: New Viability For the Tenth Amendment**

*National League* involved a challenge to the provisions of the Fair Labor Standards Amendments of 1974 which further extended federal wage and hour standards to cover all public agencies, thereby completely eliminating the exemption previously afforded the states and their political subdivisions. Contending that this direct federal regulation of the states as public employers, while admittedly within the scope of congressional authority under the commerce clause, transgressed an affirmative tenth amendment limitation on the commerce power, the *National League* appellants in the FLSA, 29 U.S.C. §§ 216(b), (c), 217 (1970), which involve a direct action against the employer for the unpaid compensation and liquidated damages, suits by the Secretary of Labor for such compensation, and actions for injunctive relief by the Secretary, 392 U.S. at 199. In Employees of Dep't of Pub. Health & Welfare v. Department of Pub. Health & Welfare, 411 U.S. 279 (1973), the Court held that although state health employees were covered under the FLSA, the eleventh amendment barred them from bringing actions for recovery under 29 U.S.C. § 216(b) (1970). While it was within the power of Congress to bring "the States to heel, in the sense of lifting their immunity from suit in a federal court," the Court would not find, in the absence of a clear expression of purpose, that Congress had conditioned the operation of facilities regulable under the commerce power upon state forfeiture of its eleventh amendment immunity. 411 U.S. at 283, 285, distinguishing *Parden v. Terminal Ry.*, 377 U.S. 184 (1964). Justice Douglas emphasized that these employees were not being left without a remedy; suits for recovery, or for an injunction and equitable restitution, could be brought by the Secretary of Labor, and as suits by the United States against a state they would not be barred. 411 U.S. at 285-86. *But see* Note, *Section 216 Fair Labor Standards Act — A Right Without a Remedy*, 43 TEMPLE L.Q. 269, 276-77 (1970).

426 U.S. at 833 (1976).


Employer was redefined in 29 U.S.C. § 203(d) (Supp. V 1975) to include "a public agency." "Public agency" is defined so as to include "the government of a State or political subdivision thereof; any agency of . . . a State, or political subdivision of a State; or any interstate governmental agency." *Id.* § 203(x). The provision further specifies:

The employees of an enterprise which is a public agency shall for purposes of this subsection be deemed to be employees engaged in commerce, or in the production of goods for commerce, or employees handling, selling, or otherwise working on goods or materials that have been moved in or produced for commerce.

*Id.* § 203(a)(5).

Still exempt under the general terms of the FLSA are executive, administrative, and professional personnel, *id.* § 213(a)(1) (1970), while the amendments by their own terms exempt elected officials, their appointees, and advisors. *Id.* § 203(e)(2)(C) (Supp. V 1975).

426 U.S. at 837. Justice Rehnquist characterized the states' complaint as an appeal to "the established constitutional doctrine of intergovernmental immunity consistently recognized in a long series of our cases." *Id.* In considering the nature of this doctrine, the Court did not indicate whether the tenth amendment is the constitutional embodiment of the doctrine or merely an expression of the restraints inherent in the federal system. Justice Rehnquist, dissenting in *Fry v. United States*, 421 U.S. 542 (1975), had stated:
persuaded the Supreme Court "that the ‘far-reaching implications’ of Wirtz, should be overruled." Recognizing that the Constitution reserves for the states an essential role in the federal system, Justice Rehnquist, writing for the majority, reaffirmed the Court’s intention to preserve for the states their integrity within that system. Characterizing the power to determine wages and hours of employees performing governmental functions as an "undoubted attribute of state sovereignty," Justice Rehnquist appeared to frame the question dispositive of the constitutional issue as "whether these determinations are ‘functions essential to separate and independent existence,’ so that Congress may not abrogate the States’ ... authority to make them." 

Justice Rehnquist noted that compliance with the statutory provisions would increase substantially the cost of the affected governmental operations and in some instances necessitate curtailment of some important activities, such as a local affirmative action program for police trainees. Yet it was not the increased cost of gov-

[It is not the Tenth Amendment by its terms that prohibits [such] congressional action . . . . Both [the tenth and eleventh amendments] are simply examples of the understanding of those who drafted and ratified the Constitution that the States were sovereign in many respects, and that although their legislative authority could be superseded by Congress in many areas where Congress was competent to act, Congress was nonetheless not free to deal with a State as if it were just another individual or business enterprise subject to regulation.]

Id. at 557 (Rehnquist, J., dissenting).

2 426 U.S. at 840. Justice Douglas, dissenting in Maryland v. Wirtz, 392 U.S. 183 (1968), had admonished the Court that federal regulation which acted to "overwhelm state fiscal policy," id. at 203 (Douglas, J., dissenting), could "devour the essentials of state sovereignty." Id. at 205. Adopting the analysis suggested by the dissenting opinion in the court below, Justice Douglas examined the pervasive impact of this form of regulation: Congress was forcing the states to either (1) increase taxes, (2) curtail the extent and quality of hospital and educational services, (3) reduce services in other activities, or (4) avoid undertaking new activities necessitated by developing social responsibilities. Id. at 202-03, citing Maryland v. Wirtz, 269 F. Supp. 826, 853 (D. Md. 1967) (Northrup, J., dissenting) (3-judge court), aff'd, 392 U.S. 183 (1968).

3 426 U.S. at 842. In illustrating the Supreme Court's continuing adherence to the belief that there are federalism limits upon otherwise plenary congressional powers, Justice Rehnquist noted that even in Wirtz, the Court had offered the assurance that it had "ample power to prevent . . . ‘the utter destruction of the State as a sovereign political entity.’" Id., quoting 392 U.S. 183, 196 (1968). Justice Brennan, dissenting in National League, insisted that, in context, the quotation found the "ample power" to prevent this destruction, not in an affirmative constitutional limitation, but in the Court's duty of limiting congressional enactments to exercises of duly delegated power. 426 U.S. at 860 n.3 (Brennan, J., dissenting).


5 426 U.S. at 846-47. The Court pointed to the "significant impact" which the alleged cost of compliance would have upon state performance of governmental functions. For example, California estimated the increased budgetary expense occasioned by the FLSA amendments would be between $8 million and $16 million. Id. at 846.
ernmental functions to which the Court objected, but rather federal displacement of state policy decisions regarding the delivery of governmental services. Regardless of the ultimate economic impact on the states, the critical factor was the substitution of congressional choices for those of the states in structuring a traditional state governmental function. When Congress acts to control those traditional state "functions . . . which governments are created to provide," it impermissibly impinges upon an essential aspect of the state's separate and independent existence. Thus, the Court held that federal legislation which directly displaces state structuring of operations in areas of "traditional governmental functions" is not within the purview of the commerce power.

---

34 The majority did not believe that "particularized assessments of actual impact are crucial to resolution of the issue presented." Id. at 851. Rather, the Court emphasized that the federal government was circumscribing the states' exercise of discretion, as states:

The only "discretion" left to them under the Act is either to attempt to increase their revenue to meet the additional financial burden imposed upon them by paying congressionally prescribed wages to their existing complement of employees, or to reduce that complement to a number which can be paid the federal minimum wage without increasing revenue.

Id. at 848. The Court also noted that such discretion was further circumscribed in some states by constitutional provisions forbidding deficit financing or the levy of taxes beyond certain rates. Id. at n.15. This impairment of state discretion contravened the constitutional limit identified by the Court despite the social benefit which would accrue as a result of federal regulation.

35 426 U.S. at 849-50. Justice Rehnquist, in outlining the projected impact of the overtime provisions, stressed three effects. First, because of the financial burden of mandatory overtime disbursements, state and local governments would be forced to restructure work periods in areas, such as police and fire protection, where it had been commonly accepted practice to schedule working hours very flexibly. Second, there would be unavoidable overtime expenses which would present a hardship in any governmental activity "where the demand for a number of employees to perform important jobs for extended periods on short notice can be both unpredictable and critical." Finally, courts would be put to deciding whether individuals such as volunteer firemen were "volunteers" or "employees," a circumstance establishing that "provisions such as these contemplate a significant reduction of traditional volunteer assistance which has been in the past drawn on to complement the operation of many local governmental functions." Id. at 850-51. It should be noted, however, that the FLSA did make provision for the particular overtime difficulties inherent in the areas of fire protection and law enforcement. 29 U.S.C. § 207(k) (Supp. V 1975).

36 426 U.S. at 851. The Court identified as typical of these traditional, essential governmental functions "fire prevention, police protection, sanitation, public health, and parks and recreation." The majority carefully noted, however, that this was not an exhaustive list of the activities "well within the area of traditional operations" performed by local governments in their discharge of public administration and public services responsibility. Id. at 851 n.16 & accompanying text.

37 Id. at 852. In so holding, the Court expressly overruled Wirtz, finding its reasoning to be based upon dictum from United States v. California, 297 U.S. 175 (1936), which was tersely characterized as "simply wrong." The offending passage had stated:

[W]e look to the activities in which the states have traditionally engaged as mark-
Justices Marshall and White joined in an acrimonious dissent authored by Justice Brennan, who decried the majority’s “patent usurpation of the role reserved for the political process by their purported discovery in the Constitution of a restraint derived from sovereignty of the States on Congress’ exercise of the commerce power.” Justice Brennan maintained that although the existence of such a restraint had been pressed in the early days of our constitutional jurisprudence, it had been decisively rejected in favor of the principle that Congress’ duly delegated commerce power is plenary, restrained only by political processes and those limitations “prescribed in the constitution.”

Id. at 185, quoted in National League of Cities v. Usery, 426 U.S. 833, 854 (1976) (emphasis added). For an exposition of Justice Rehnquist’s position that this dictum in California was erroneous, see Fry v. United States, 421 U.S. 542, 549 (1975) (Rehnquist, J., dissenting).

Although it overruled Wirtz, the National League Court simply distinguished Fry. Justice Rehnquist observed that the statute involved in that case was a response to what amounted to a national economic emergency which could only be forestalled by collective national action. The action authorized in Fry interfered with state freedom for a very limited time, and did not restructure state operations, but merely “froze” the wage scales then in effect. Finally, and significantly, pressures on state budgets were decreased rather than increased by the statute. These facts served to validate the statute in Fry, for according to the National League Court, “[t]he limits imposed upon the commerce power when Congress seeks to apply it to the States are not so inflexible as to preclude temporary enactments tailored to combat a national emergency.” 426 U.S. at 853.

426 U.S. at 858 (Brennan, J., dissenting).

4 Id. at 857-58 (citation omitted). Justice Brennan stated that the Court was repudiating a principle of judicial interpretation enunciated by Chief Justice Marshall:

[T]he power over commerce . . . is vested in Congress as absolutely as it would be in a single government, having in its constitution the same restrictions on the exercise of the power as are found in the constitution of the United States. The wisdom and the discretion of Congress, their identity with the people, and the influence which their constituents possess at elections, are . . . the sole restraints on which they have relied, to secure them from its abuse. They are the restraints on which the people must often rely solely, in all representative governments.

Id. at 857, quoting Gibbons v. Ogden, 22 U.S. (9 Wheat.) 1, 197 (1824) (citation omitted) (emphasis added by Brennan, J.).

The recognition by the Supreme Court of limitations “prescribed in the constitution” extends, Justice Brennan asserted, only to express restraints. 426 U.S. at 858, citing Leary v. United States, 395 U.S. 6 (1969) (fifth amendment); United States v. Jackson, 390 U.S. 570 (1968) (sixth amendment); Mabee v. White Plains Publishing Co., 327 U.S. 178 (1946) (first amendment). He disputed the majority’s characterization of the tenth amendment as “an express declaration of limitation,” finding its meaning clear: Congress may not exercise powers not constitutionally delegated. Legislation within the ambit of the commerce power thus does not run afoul of the tenth amendment. As Justice Brennan observed, “[e]ven the author of [the majority] opinion stated in Fry that the Tenth Amendment does not ‘by its terms’ restrict Congress’ power to regulate commerce.” 426 U.S. at 861 n.4 (Brennan, J., dissenting), citing Fry v. United States, 421 U.S. 542, 557 (Rehnqust, J., dissenting).
dissent contended that judicial review of legislation enacted pursuant to the commerce clause is in all instances limited to determining whether that legislation is a regulation of interstate commerce. Justice Brennan insisted that the Court's alleged power to preserve state sovereignty from "utter destruction" is no more than the power to invalidate enactments not within the authority of the commerce clause. By participating in regulable commerce, the dissent asserted, a state subjects itself and its employment relations to congressional regulation; the degree to which such regulation is applicable to state activities is a question to be resolved by a federal policy judgment made within a political system structured to provide the states with substantial input in the decision.

Although Justice Brennan was perhaps rightly troubled by the sweeping language found in the majority opinion, his characterization of the decision as "mischievous" appears to be inappropriate. Despite the dissent's claim that the majority disregarded 150 years of precedent in finding a limitation upon the commerce power, Justice Rehnquist's position is not without authority. Although in recent decades the Supreme Court embraced a nationalist view of the Constitution, the National League decision is not without a theoretical underpinning; it is reminiscent of the nineteenth century doctrine of dual federalism. Moreover, the Court has given notice

---

42 Justice Brennan declared: "This Court is simply not at liberty to erect a mirror of its own conception of a desirable governmental structure. . . . Under the Constitution the judiciary has no role to play beyond finding that Congress has not made an unreasonable legislative judgment respecting what is 'commerce.'" 426 U.S. at 875-76 (Brennan, J., dissenting). Justice Stevens, who dissented separately, sympathized with the majority's concern for the wisdom of the legislation in issue, but regarded the matter as a policy question suitable for political, not judicial determination. Id. at 881 (Stevens, J., dissenting).

43 See note 33 supra.

44 426 U.S. at 860 n.3 (Brennan, J., dissenting).

45 Justices Brennan and Stevens both believed that the states possess sufficient political power to protect their interests. Id. at 876-77 (Brennan, J., dissenting); id. at 881 (Stevens, J., dissenting). Justice Brennan also referred to the vast financial assistance provided the states by the federal government as an indication of the political power of the states; to Justice Brennan, this demonstrated ability to obtain federal money left little doubt that state sovereignty, within the federal political system, was secure. Id. at 878 (Brennan, J., dissenting).

46 Id. at 880. Justice Brennan also detected "an ominous portent of disruption of our constitutional structure implicit" in the holding. Id.

47 Id. at 857.

48 Two competing theories of national power vied for acceptance during the nineteenth century. Under the nationalist theory espoused by Hamilton, the federal government, although admittedly one of enumerated powers, was, within the scope of those powers, a sovereign government "under no constitutional compulsion . . . to take account of the coexistence of the states or to concern itself to preserve any particular relationship of power between itself and the states." E. CORWIN, THE TWILIGHT OF THE SUPREME COURT 47 (1934). The other
in recent years that it intends to be more solicitous of state interests in the future. Indeed, the Court's readiness to invalidate congressional legislation affecting state autonomy may indicate a determination by the Court that the political safeguards contemplated in the Constitution under the federal system have ceased to function effectively. The National League dissent declared that "[j]udicial restraint in this area merely recognizes that the political branches of our Government are structured to protect the interests of the States, . . . [which] are fully able to protect their own interests in the premises." Where, however, the political structure has been altered so that it is no longer responsive to state interests, judicial scrutiny would appear to be an appropriate means of redressing the imbalance.

The judicial inclination to accord greater respect to state interests can be seen in several areas. The states have enjoyed some degree of immunity from federal taxation throughout the years, even if only insulation from taxes so burdensome as to threaten governmental destruction. See Tribe, supra note 1, at 712 (tax invalid if it undermines "state government's very survival"). But see New York v. United States, 326 U.S. 572, 584 (1946) (Stone, C.J., concurring) (undue interference standard applied). In Oregon v. Mitchell, 400 U.S. 112 (1970), noted in The Supreme Court, 1970 Term, 85 Harv. L. Rev. 38, 152 (1971), the Supreme Court struck down a legislative attempt to dictate minimum voting age in state elections. Recently, three federal appellate courts invalidated federal administrative efforts under the Clean Air Act Amendments of 1972 to compel state enforcement of federal regulations aimed at achieving approved ambient air quality standards. Interpreting Wirtz in light of Fry, these courts construed arguably ambiguous statutory provisions and legislative history to leave the EPA Administrator without statutory authority to compel state enforcement of the Act, thereby avoiding an adjudication of the constitutional issue. See District of Columbia v. Train, 521 F.2d 971, 989-94 (D.C. Cir. 1975), cert. granted, 96 S. Ct. 2224 (1976) (No. 76-1055); Maryland v. EPA, 530 F.2d 215, 224-28 (4th Cir. 1975), cert. granted, 96 S. Ct. 2224 (1976) (No. 76-980); Brown v. EPA, 521 F.2d 827, 837-42 (9th Cir. 1975), cert. granted, 96 S. Ct. 2224 (1976) (No. 75-909). But see Pennsylvania v. EPA, 500 F.2d 246, 257, 259-63 (3d Cir. 1974) (compulsion is statutorily authorized and constitutionally valid under Wirtz).

Evidence of the need for an adjustment in traditional federalism concepts may be found in the area of water pollution legislation. It is illustrated by the failure of the states to achieve adequate input in the Water Pollution Control Act Amendments of 1972, Pub. L. No. 92-500, 86 Stat. 816 (codified at 33 U.S.C. §§ 1251-1376 (Supp. V 1975)). The amendments have been criticized as enacting "uniform national legislation rather than a flexible federal
Justice Brennan clearly presents a plausible objection to the National League Court's conclusion that there exists a federalism limitation upon the commerce power. Asserting that the states constitute sovereign entities only to the extent that they have not delegated their sovereign powers to the national government, he maintained that the most notable of the powers delegated was the authority to regulate interstate commerce. Since the federal government possesses whatever degree of power the state would have retained were it not for the delegation, it is no invasion of sovereignty for Congress to exercise the delegated power to its fullest. Thus, the reasoning of the dissent leads to the conclusion that no otherwise valid congressional exercise of the commerce power will impair the integrity of the states. The majority, on the other hand, recognized a limitation on the commerce power inherent in the tenth amendment and declared that transgression of that limitation invalidates the exercise of the power, even though the exercise itself would otherwise be valid under the commerce clause. Justice Rehnquist emphasized that a primary objective implicit in the Constitution is the continued vitality of the federal system, a system which contemplates preservation of the integrity of each state as the feature distinguishing it from a unitary national entity with administrative subdivisions. Toward this end, the majority noted, the Court has

---

law." H. Lieber, Federalism and Clean Waters 193 (1975). State and local representation, in theory an effective political safeguard of state interests, received expression in the form of "pork barrel" benefits, while substantive provisions reflected a strong federal presence, serving to enhance the stature of Congressmen as national legislators. Id. State efforts to lobby directly for favorable legislation were hampered by disunity. Id. at 194. Indeed, the effect of the legislation creates doubts as to the propriety of a purely political limitation upon the commerce power:

The thrust of the new legislation is clearly in the direction of a federal takeover and away from the . . . intergovernmental power sharing which . . . has been confirmed for past environmental policies. This loss of partnership seems to be part of a general trend towards centralization in policy formulation and implementation that was noted in the 1960's. This Act and its implementation moves the federal role beyond dominance and closer to preemption of water pollution policy.

Id. at 201.

See 426 U.S. at 864 n.6 (Brennan, J., dissenting). In South Carolina v. United States, 199 U.S. 437 (1905), the Court observed that "two propositions in our constitutional jurisprudence are no longer debatable. One is that the national government is one of enumerated powers; and the other, that a power enumerated and delegated by the Constitution to Congress is comprehensive and complete, without other limitations than those found in the Constitution itself." Id. at 448. For a discussion of the plenary nature of the federal commerce power in relation to state activities, see note 59 and accompanying text infra.

See, e.g., Brown v. EPA, 521 F.2d 827 (9th Cir. 1975), cert. granted, 96 S. Ct. 2224 (1976) (No. 75-909), where the Ninth Circuit rejected the EPA's contention that its statutory authority was sufficient to compel state adoption and enforcement of federal environmental policy. The pre-National League panel rejected this interpretation because of its constitutional implications:
moved over the years to strike down numerous enactments which were thought to assert too firm a control over a state's political and judicial processes.\textsuperscript{55}

While it cannot seriously be contested but that, through dint of circumstance, the United States today requires a constitutional theory permitting the federal government broad discretion in the exercise of its sovereign powers,\textsuperscript{56} it remains questionable whether this discretion should include a plenary power to regulate every state activity bearing a rational relationship to interstate commerce. The existence of a plenary power under the commerce clause was propounded before the full extent of the commerce power was recognized.\textsuperscript{57} As Justice Rehnquist noted in his dissenting opinion in \textit{Fry v. United States},\textsuperscript{58} the presumptions underlying the conclusion that the commerce power admits of no distinctions between individuals and states were rather rashly made, and thus are analyt-

\begin{footnotesize}
\textsuperscript{55}To make \textit{governance} indistinguishable from \textit{commerce} for the purposes of the Commerce Power cannot be equated to the "unintrusive" regulation of economic activities of the states upheld by the Supreme Court in \textit{Maryland v. Wirtz} and \textit{Fry v. United States}. A Commerce Power so expanded would reduce the states to puppets of a ventriloquist Congress. We will not attribute to Congress any such intent unless it is expressed unequivocally. 521 F.2d at 839 (emphasis in original). The court stressed that its concern was "to preserve and protect a strong government of the United States and viable governments of the states." \textit{Id. at} 840.

In 1974, a similar objection was voiced to proposed federal legislation which would have mandated state "no-fault" insurance. One commentator recommended a careful study of this scheme of federal coercion so as to ensure that it did not "impair the essence of federalism by intruding on state autonomy in a manner not contemplated by the Constitution." Dorsen, \textit{The National No-Fault Motor Vehicle Insurance Act: A Problem in Federalism}, 49 N.Y.U.L. Rev. 45, 47 (1974).

\textsuperscript{56}See, e.g., \textit{Oregon v. Mitchell}, 400 U.S. 112 (1970) (invalidation of statute enfranchising 18-year-olds in state elections); Coyle v. Smith, 221 U.S. 559 (1911) (Congress is without power to condition statehood upon location of capital). In \textit{Lane County v. Oregon}, 74 U.S. (7 Wall.) 71 (1868), the Court construed a federal statute making United States notes legal tender for debts as having no application to payment of state tax levies. Faced with an Oregon statute requiring payment of taxes in gold and silver coin, Chief Justice Chase observed that it was not clear whether Congress had the power to interfere with this exercise of the state taxing power. Through a strict construction of the federal statute, however, the Court found that it was reasonable to conclude that no such interference was intended and that Congress had never sought to require that federal notes be legal tender for state tax payments. \textit{Id. at} 77-78.

\textsuperscript{57}See generally W. \textit{Anderson}, \textit{Intergovernmental Relations in Review} 16-33 (1960).

\textsuperscript{58}The principle of a plenary commerce power was expounded early in the course of American constitutional history. See \textit{Gibbons v. Ogden}, 22 U.S. (9 Wheat.) 1, 196-97 (1824). It was not until well into the twentieth century, however, that Congress was freed "from the anachronistic and doctrinally unsound constructions of the Commerce Clause which had previously been used to deny . . . to Congress authority to regulate economic affairs." \textit{Fry v. United States}, 421 U.S. 542, 551 (1975) (Rehnquist, J., dissenting).

\textsuperscript{59}421 U.S. 543, 549 (Rehnquist, J., dissenting).
\end{footnotesize}
ically suspect: the Court had accustomed itself to refuting the contention that federal regulation of private commercial enterprises infringed upon state prerogatives, and it did not take cognizance of the fundamentally different nature of the contention that regulation of state enterprises involves issues of federalism. National League represents an effort to reassess the relationship between the commerce power and state prerogatives within the federal system.

ANALYSIS OF National League

The restrictions which the Court has chosen to place upon legislation which affects a state's integrity is left unsettled by National League because of the broad and imprecise language utilized in the majority opinion. Justice Rehnquist stated without explanation that determination of wages and hours is an “undoubted attribute of state sovereignty.” He then summarily concluded that this determination is a function essential to the separate and independent existence of the state, and hence immune from regulation. This conclusion was reached because the Court believed that federal interference would displace state policy regarding “integral operations in areas of traditional governmental functions.”

It is suggested that the National League opinion could be interpreted as espousing either of two differing theories of tenth amendment immunity: that an affirmative constitutional limitation precludes direct congressional regulation of activities which are deemed traditional and integral state functions; or that a state is immune from regulation of an activity, be it traditional or not, when the ultimate impact of such regulation is the displacement of state policies with respect to traditional state functions.

\[\text{Id. at 551. Justice Rehnquist dismissed as inappropriate any reliance upon the Court's refusal, in United States v. California, 297 U.S. 175, 183 (1936), to distinguish between state governmental and proprietary activities in a commerce power context. Justice Rehnquist pointed out in Fry that California was decided at a time when the commerce clause was undergoing a process of reevaluation from a limited construction which under a state sovereignty theory had even impeded federal regulation of private industry. 421 U.S. at 551 (Rehnquist, J., dissenting); see E. CORWIN, THE TWILIGHT OF THE SUPREME COURT 19-20 (1934). Under these circumstances, the Justice found it understandable that the California Court was so quick to reject the state's 'sovereign capacity' claim, for '[t]he claim of 'states' rights' had so frequently been involved in the past as a form of ius tertii, not by a State but by a business enterprise seeking to avoid congressional regulation, that the different tenor of the claim made by the State of California may not have impressed the Court.' 421 U.S. at 551 (Rehnquist, J., dissenting).} \]

\[\text{426 U.S. at 845.} \]

\[\text{Id. at 852.} \]

\[\text{Although the Court devoted much attention to the economic effect of the federal} \]
The Traditional Governmental Function Requirement and Intimations of a Balancing Approach

The *National League* holding was narrowly drawn: the challenged amendments were invalid to the extent that they "operate to directly displace the States' freedom to structure integral operations in areas of traditional governmental functions." Thus, the first obstacle which faces any governmental unit attempting to extend the Court's holding beyond the field of labor relations is the possibility that the Court might limit the protected area of state activities to those functions which can be characterized as traditional or integral. If the Court is unwilling to extend protection to state activities which it regards as nontraditional or nonintegral,

a state challenge to federal regulation of municipal securities would fail were the financing function not to be regarded as a traditional or integral governmental function. Such a limitation upon tenth amendment immunity, however, would be difficult to apply. Efforts to distinguish between traditional and nontraditional, or integral and nonintegral functions, for purposes of placing a limit upon the scope of state immunity from taxation or suit, have failed to establish any reliable criteria for characterizing a particular function as either integral or nonintegral.

The proprietary-governmental distinction, which reflects the notion that functions which are governmental in nature, as opposed to state activities which are merely proprietary, should not be subjected to undue interference by another governmental authority, has long been recognized as unsatisfactory.

---

legislation, *id.* at 846-47, it disclaimed reliance upon the cost of compliance in reaching its holding. *Id.* at 851. Justice Brennan, in dissent, agreed with the majority that actual impact should not be determinative of the constitutional issue, since financial impact upon the states is a policy decision which has long been reserved to the political process. *Id.* at 874 n.12 (Brennan, J., dissenting), citing *Oklahoma v. Guy F. Atkinson Co.*, 313 U.S. 508, 527 (1941) (effectiveness of flood control efforts is a policy question for Congress). Justice Brennan feared, however, that the Court would henceforth feel free to invalidate legislation of even insignificant added cost, a portent which he considered "ominous." *426 U.S.* at 875 (Brennan, J., dissenting).

*3* *Id.* at 852 (Rehnquist, J.).

*4* See note 62 and accompanying text supra.


*6* The difficulties with the integral/nonintegral characterization were recognized by Justice Rehnquist in his dissent in *Fry v. United States*, 421 U.S. 542, 558 (1975). Although employing this criterion in the area of intergovernmental tax immunity, the Supreme Court in *United States v. California*, 297 U.S. 175 (1936) declined to utilize the governmental-proprietary test to scrutinize legislation enacted pursuant to the commerce power. The Court distinguished the intergovernmental tax immunity as one "implied from the nature of our
Analysis of the Court’s rationale is further complicated by Justice Rehnquist’s consideration of the actual impact on the state of the federal regulations. Although the Court noted that the extent of the impact was not determinative in National League, one could infer from the opinion that impact might be dispositive under other circumstances. In instances where a national regulatory scheme so substantially disrupts the performance of nontraditional state activities as to abrogate the state’s decisionmaking capacity with respect to traditional functions, resolution of a constitutional challenge by analysis of the regulation’s ultimate impact would appear to be a justifiable application of an immunity which purports to prevent impairment of “the States’ ‘ability to function effectively within a federal system.’” It should be noted, however, that although such an inference may be drawn from a careful reading of Justice Rehnquist’s opinion, the specific holding of the Court extended immunity only to “integral operations in areas of traditional governmental functions” which had suffered direct displacement.

The validity of this distinction soon came under criticism. In Case v. Bowles, 327 U.S. 92 (1946), the Court, in an opinion written by Justice Black, rejected an essential state function standard as a guide to the limits of congressional authority in the exercise of the war power. In so doing the Court noted that “[t]he use of the same criterion in measuring the Constitutional power of Congress to tax has proved to be unworkable.” Id. at 101, citing New York v. United States, 326 U.S. 572 (1946).

Justice Rehnquist nevertheless contended in Fry that activities “sufficiently closely allied with traditional state functions” should be beyond substantive federal regulation under the commerce power. Admitting that gray areas presented by this approach would require case by case elucidation, 421 U.S. at 557 (Rehnquist, J., dissenting), he observed that California had rejected all distinctions between types of state activities, but that a line will have to be drawn somewhere. It is conceivable that the traditional distinction between “governmental” and “proprietary” activities might in some form prove useful in such line drawing. The distinction suggested in New York v. United States, 326 U.S. 572 (1946), between activities traditionally undertaken by the State and other activities, might also be of service.

Id. at n.2.
47 See 426 U.S. at 846-51.
48 Such a situation arguably may exist regarding the municipal financing function. See text accompanying notes 81-82 infra.
49 426 U.S. at 852, quoting Fry v. United States, 421 U.S. 542, 547 (1975). For an exposition of such an application, see Note, The Clean Air Act Amendments of 1970: A Threat to Federalism?, 76 Colum. L. Rev. 990 (1976). Justice Rehnquist detailed the anticipated increased fiscal burden upon states and municipalities occasioned by the FLSA legislation, and also noted examples of “forced relinquishment of important governmental activities.” 426 U.S. at 846-47. It was because the legislation directly displaced state wage and hour policy in the area of traditional operations, however, that Congress acted impermissibly “even if appellants may have overestimated the effect which the Act will have upon their current levels and patterns of governmental activity.” Id. at 851.
50 426 U.S. at 852.
The National League Court spoke in absolute terms of an affirmative limitation upon the federal commerce power, suggesting that traditional state functions should be regarded as paramount to federal legislation. Nowhere did Justice Rehnquist intimate that it is appropriate to balance federal interests in a regulatory scheme against state interests in the maintenance of integral functions. Yet Justice Blackmun's pivotal concurrence in Justice Rehnquist's opinion rested upon such an understanding. It was Justice Blackmun's belief that although the National League Court claimed that Fry v. United States, wherein the Court upheld the application of federal wage ceilings to the states, was distinguishable as an acquiescence to temporary emergency measures, it was nonetheless in essence a recognition of the need to balance interests. Thus, Justice Blackmun stated that the National League decision did not, for example, "outlaw federal power in areas such as environmental protection, where the federal interest is demonstrably greater and where state facility compliance with imposed federal standards would be essential." Although it would require an extremely imaginative reading of Justice Rehnquist's opinion to find within it any intention to balance federal and state interests, it appears that, at least for the foreseeable future, the Court will invalidate federal legislation only after the competing interests have been weighed, and the state interest deemed superior.

Extending National League: Regulation of Municipal Issuers

The National League rationale suggests at least two possible approaches for disposing of a tenth amendment challenge to federal regulation of municipal issuers. By narrowly construing the decision, the Court could regard as determinative the characterization of deficit financing as traditional or nontraditional. Alternatively, under a broader construction the Court could conclude that the state's deficit financing activity is a function protected from federal interference under the commerce clause simply by finding that the ultimate impact of such regulation is the substantial impairment of state policymaking in the area of traditional functions.

Should the Court limit immunity to traditional or integral functions, a challenge to federal regulation of municipal issuers would fail if the deficit financing function was not deemed tradi-

---

71 Id. at 853, citing Fry v. United States, 421 U.S. 547 (1975); see note 26 infra.
72 426 U.S. at 856 (Blackmun, J., concurring).
tional in nature. If the broader standard were to be utilized, a dis-
ruptive economic impact upon traditional policymaking functions
would apparently be sufficient to justify immunity. This approach
would virtually assure a finding that municipal issuers enjoy the
protection of the tenth amendment. In either case, application of a
balancing test would prevent an overbroad assertion of state sov-
erignty where significant federal interests require a regulatory
scheme national in scope.73 If the federal regulations were found to

---

73 The federal courts which have considered National League have construed its holding
narrowly, thereby belying Justice Brennan's contention that it strikes "a catastrophic judicial
body blow at Congress' power under the Commerce Clause." 426 U.S. at 880 (Brennan, J.,
dissenting). The opinions are hardly uniform, however, illustrating the vagueness of the
Supreme Court's pronouncement and the difficulties facing courts which endeavor to apply
the National League rationale. To the extent that the legislation under attack is predicated
upon the commerce power, these cases may be taken as fair statements of the manner in
which courts will construe National League.

One area of recent controversy regarding federal-state relations involves actions under
the Equal Pay Act, 29 U.S.C. § 206(d) (1970). This provision, prohibiting discrimination in
pay on the basis of sex, was one of the labor standards extended to the states by the enact-
ments deemed invalid under National League. See note 30 supra. In Usery v. Dallas Indepen-
dent School Dist., [1976] 2 LAB. L. REP. (Wages & Hours) (CCH) (79 Lab. Cas.) ¶ 33,437
(N.D. Tex. Oct. 19, 1976), a district court denied the school district's motion, based on
National League, to dismiss a Department of Labor action seeking to enforce the statute. The
court noted that the Supreme Court's decision did not directly affect the challenged provi-
sion, id. at 47,552-53; nor did it "vanquish this legislation by virtue of its bold language and
irresistible sweep." Id. at 47,554. Rather, the court contended that the National League
rationale "should be applied very conservatively in overturning social and economic policies
of the Congress." Id. After viewing the applicable authority, Judge Hill was satisfied that the
affirmative limitation upon the commerce power would be restricted to those situations in
which three criteria are met: First, the affected function must be "integral"; second, interfer-
ence with the function must substantially disrupt state operations; and third, state interests
must be balanced against federal policies. Id. at 47,554-55.

In regard to the first factor, the integral nature of the function, the district court was
troubled by the Supreme Court's imprecise characterizations of "the protected areas of state
sovereignty." Reciting the formulations suggested in Justice Rehnquist's opinion—"functions
essential to separate and independent existence," activities of "States qua States," and
"integral government functions"—Judge Hill appeared less than enamored with the Court's
efforts to elucidate which sovereign interests it intends to protect. He noted that the National
League opinion did not detail the attributes of an "integral government function," and that
the Court seemed less concerned with the degree to which an activity could be deemed
essential than with the extent to which it could be considered traditional: "The federal
government cannot apparently dictate minimum wages for the city policemen or the janitor
at a livestock show under county sponsorship." Id. at 47,554. Despite the vagueness of these
formulations, the district court concluded that the protected areas must involve internal,
administrative, management, and housekeeping functions, thereby excluding any state pro-
prietary interest and other activities "involving a significant interface with the public do-
main," such as the sale of commodities to the public. Id. at 47,555.

In regard to the second characteristic suggested as indicative of an activity within the
ambit of National League, the Dallas court reasoned that Justice Rehnquist's recital of costly
budget displacements and economic coercion indicated that legislation is offensive when it
imposes “a drastic and disruptive cost of doing business on the state.” Id. Judge Hill believed it self-evident that no disruptive impact resulted from the requirement that states not discriminate against their employees according to sex. In what amounted to a suggestion that the states eat cake if they have no bread, he noted that “if the States find prohibitive the costs of increasing women’s wages to a standard level to be paid both sexes, the Supreme Court has now given its benediction to the States’ reducing men’s wages to any convenient substandard level to be paid both sexes.” Id. Unfortunately, this rather intriguing solution contravenes the Equal Pay Act’s express provision “that an employer who is paying a wage rate differential in violation of this subsection shall not, in order to comply with the provisions of this subsection, reduce the wage rate of any employee.” 29 U.S.C. § 206(d)(1) (1970).

Finally, the Dallas court viewed the ultimate limitation upon the principle of National League to be the balancing of federal and state interests. Noting the Supreme Court’s effort to distinguish its holding from that in Fry v. United States, 421 U.S. 542 (1975), Judge Hill expressed the opinion that the cases were reconcilable only “on the basis of an ad hoc balancing.” [1976] 2 LAB. L. REP. (Wages & Hours) (CCH) (79 Lab. Cas.) ¶ 33,437, at 47,555. Apparently deeming it unnecessary to illuminate the precise nature of this balancing process, he simply concluded “that the policies of social justice underlying the legislation outweigh the State interest in exploiting employees because of their sex.” Id. at 47,555 n.6.


One federal district court has also upheld application of the Age Discrimination in Employment Act, 29 U.S.C. §§ 621-34 (1970 & Supp. V 1975), to state employees. In Usery v. Salt Lake City Bd. of Educ., 421 F. Supp. 718 (D. Utah 1976), the court determined that the age discrimination prohibition embodied in 29 U.S.C. § 623(a) (1970) was properly extended to states and their subdivisions by 29 U.S.C. § 630(b) (Supp. V 1975). The court construed National League in light of Justice Blackmun’s concurring opinion and the Fry case to require the balancing of federal and state interests where integral state functions are affected. The court identified the federal interest supporting age discrimination legislation as the concern for preventing arbitrary age discrimination in employment. When balanced against the state’s “nominal interest” in arbitrary employment selection the national interest was clearly superior. 421 F. Supp. at 720. As an alternative rationale supporting the constitutionality of the enactment, the court pointed to the absence of a direct displacement of state freedom to structure “integral operations”; rather, the effect of the legislation was negative and indirect, with little impact upon the municipal employment structure. Id.

For an interpretation of National League in a nonlabor context, see Friends of the Earth v. Carey, Civ. No. 75-7497 (2d Cir. Jan. 18, 1977) (dictum) (impact of federal environmental
infringe upon protected state activities, the federal interest in a degree of control over the municipal bond market would then have to be weighed against the state interest in the policymaking autonomy afforded it by deficit financing unfettered by federal interference. A balancing approach would appear to afford state interests in state activities the same degree of protection they theoretically should enjoy within the federal political process. Indeed, a number of lower federal court decisions subsequent to National League have opted for a balancing approach.

---

74 See Wechsler, The Political Safeguards of Federalism: The Role of the States in the Composition and Selection of the National Government, 54 Colum. L. Rev. 543, 558-60 (1954).

75 See, e.g., Usery v. Dallas Independent School Dist., [1976] 2 Lab. L. Rep. (Wages & Hours) (CCH) (79 Lab. Cas.) ¶ 33,437 (N.D. Tex. Oct. 19, 1976); Usery v. Salt Lake City Bd. of Educ., 421 F. Supp. 718 (D. Utah 1976). Several other courts have disposed of tenth amendment challenges without reaching the question of a balancing process, see note 73 supra, and in at least one case a district court expressed its opinion in terms which appear to deny the applicability of a balancing test to federalism limitations upon the commerce power. Christensen v. Iowa, 417 F. Supp. 423 (N.D. Iowa 1976). It was that court's opinion that there are "attributes of sovereignty" which Congress may not impair when acting pursuant to the commerce clause. Id. at 425.

Interestingly, however, the federal courts appear reluctant to construe the National League decision in a manner inimical to other federal legislation. See note 73 supra. Broader interpretation may be forthcoming from state courts. For instance, in Staten Island Rapid Transit Operating Auth. v. IBEW Local 922, 177 N.Y.L.J. 42, Mar. 3, 1977, at 12, col. 4 (Sup. Ct. Kings County), the New York State Supreme Court, Kings County, cited National League as a reaffirmance of "the untrammeled right of States to protect their sovereignty and economic integrity to make fundamental employment decisions in regard to the performance of vital public services." Id. at 13, col. 1. The court utilized National League to buttress its conclusion that the Railway Labor Act, 45 U.S.C. §§ 151-60 (1970), does not preempt the state's power to prohibit public employees from striking under the Taylor Law, N.Y. Civ. Serv. Law § 210 (McKinney 1973). Justice Jones ruled that "[u]nder the Taylor Law, and the common law, the City of New York has the plenary right and responsibility to protect its economy from being disrupted to the point of disaster by a strike of its public employees." 177 N.Y.L.J. 42, Mar. 3, 1977, at 12, col. 5.

Although the court may have reached the correct result in upholding the state statute, it is submitted that use of the National League rationale to avert preemption by federal legislation is unwarranted and inadvisable. Although Justice Brennan accused the National League majority of "signaling abandonment of the heretofore unchallenged principle" of federal supremacy, 426 U.S. at 875, the majority in no way suggested that state legislation will control when it conflicts with a valid federal statute. Before considering the issue of federal preemption, a court must determine whether a statute regulating a state activity transgresses the limitation enunciated in National League. If a statute is adjudged valid under this standard, the court should then address the issue of preemption. The supremacy clause, U.S. Const. art. VI, cl. 2, must be viewed independently of congressional authority under the commerce clause. It is a constitutional provision which takes force only when Congress enacts valid legislation, and when confronted with a duly-enacted regulation "a State cannot disregard the limitations which the Federal Constitution has applied to her power." Ex parte Virginia, 100 U.S. 313 (1880), quoted in Fitzpatrick v. Bitzer, 427 U.S. 445, 454-55 (1976). The Fitzpatrick decision indicates that the Court did not intend a sweeping
Should the Court elect to proceed upon the narrow application of tenth amendment immunity, a challenge to the validity of municipal issuer regulation could pose serious definitional problems, for the question of whether deficit financing is a traditional or integral function is firmly rooted in what Justice Rehnquist has termed a "gray area." Assuming, arguendo, that these terms are simply a means to identify objectively those state activities believed to merit protection, then an analysis of the municipal financing function, or any other state activity, under the National League rationale will amount to an application of the governmental-proprietary test. As noted previously, this differentiation has not been well received. Although a seemingly simple method of determining whether a state activity is a traditional governmental responsibility involving the kind of function "which governments are created to provide," it has proved troublesome to apply. If not considered governmental, then an activity is deemed proprietary: one which is ordinarily engaged in by private industry. Although some activities are readily

restricting of the balance of federal and state power. In National League, the Court had declined to state "whether different results might obtain if Congress seeks to affect integral operations of state governments by exercising authority granted it under sections of the Constitution such as the Spending Power . . ., or § 5 of the Fourteenth Amendment." 426 U.S. at 852 n.17. Shortly after its decision in National League, the Court in Fitzpatrick apparently resolved the question with respect to the fourteenth amendment. In Fitzpatrick, the State of Connecticut defended a class action brought by male employees alleging a violation of Title VII of the Civil Rights Act of 1964, 42 U.S.C. § 2000e-2(a) (1970), by interposing as a bar to retroactive monetary relief the eleventh amendment immunity elucidated in Edelman v. Jordan, 415 U.S. 651 (1974). The Supreme Court reversed the denial of such relief by both the circuit and district courts, finding that because Congress had expressly authorized private actions against states in Title VII, "[o]ur analysis begins where Edelman ended." 427 U.S. at 452. Intimating that a stricter standard for constructive waiver would be applied when Congress acted pursuant to its authority under the commerce clause, id. at 452-53, the Court determined that eleventh amendment immunity is limited by the fourteenth amendment, because § 5 constitutes express authority to enforce the prohibitions directed against the states in the other sections of the amendment. The Court believed "that Congress may, in determining what is ‘appropriate legislation’ for the purpose of enforcing the provisions of the Fourteenth Amendment, provide for private suits against States or state officials which are constitutionally impermissible in other contexts." Id. at 456, citing Edelman v. Jordan, 415 U.S. 651 (1974).

---

77 State claims of immunity from federal interference normally are premised upon the theoretical inviolability of the state when it acts as a state. See, e.g., New York v. United States, 326 U.S. 572 (1946) (state contended that bottling and sale of mineral water was a "traditional and essential governmental function"); United States v. California, 297 U.S. 175 (1936) (state contended that its not-for-profit railroad constituted a public function performed in its sovereign capacity).
classified, difficulties arise when a state engages in an activity which possesses both commercial and governmental characteristics. A court presented with such a situation must undertake the often delicate and frustrating task of categorizing the activity as either governmental or proprietary.\textsuperscript{80}

Issuance of securities as a mode of finance is an excellent example of a state activity which presents a troublesome categorization problem. Since it is an activity engaged in by governments and private corporations alike, it is neither solely governmental nor solely proprietary in nature. It is not a traditional governmental activity in the sense of a function which governments are created to provide, for financing is not in itself either a service-providing or law-administering function;\textsuperscript{81} yet it is necessary to the existence of other state activities, some of which are clearly governmental and others clearly proprietary in nature. Thus, it may be argued that the borrowing function is governmental to the extent that it has traditionally been essential to the operation of the state in its sovereign capacity. The validity of such a characterization may be questioned, however, when the activities supported by financing are deemed proprietary.\textsuperscript{82}

If a narrow approach to the governmental-proprietary distinction were employed, the inquiry would be limited to an initial assessment of whether the financing activity could be considered per se a traditional or integral government function, that is, whether the activity itself supports the conclusion that it is clearly a function to be exercised by a state government, and hence deserving of protection from federal encroachment. It is submitted that this analysis would perforce require a determination that the borrowing function is proprietary in nature and therefore subject to full federal regulation under the commerce power. On the other hand, an approach emphasizing the nature of the state activities ultimately financed by the issuance of securities would apparently require a case by case determination based upon the purpose of the particular issue. In this context, the fact that revenue from a bond issue would often

---

\textsuperscript{80} For a discussion of the pitfalls lurking behind this doctrine, see Doty & Petersen, The Federal Securities Laws and Transactions in Municipal Securities, 71 Nw. U.L. Rev. 283, 362-63 (1976).


\textsuperscript{82} For instance, when tax free industrial development bonds were used increasingly for the development of private industry, Congress removed from the worst-offending categories of such bonds their exemption from federal bond interest taxation and securities regulation. See I.R.C. § 103(c); 15 U.S.C. §§ 77c(a)(2), 78c(a)(12) (1970). See generally Industrial Development Bonds, supra note 1.
be expected to support both governmental and proprietary activities would seemingly complicate this analytical approach beyond logical resolution. The governmental-proprietary test thus appears as ill suited to determining the appropriate limits of tenth amendment immunity as it has proved to be with respect to eleventh amendment immunity from private suit in federal court. The uncertainty engendered in the latter area by use of a governmental-proprietary test has prompted the suggestion that it be discarded as the basis for analysis of eleventh amendment immunity in the municipal securities field unless "the entire borrowing function can be viewed as a governmental activity." Similar policy considerations would appear to dictate the same conclusion in the tenth amendment context as well. If the courts choose to analyze the financing activity via a governmental-proprietary test, they should eschew case by case inquiry into the activity ultimately financed and characterize the borrowing function per se as governmental in nature. The judiciary could then utilize a balancing approach to determine the propriety of the particular challenged federal regulatory scheme.

Unfortunately, per se characterization of financing as a governmental activity in fact avoids rather than fulfills the test. The necessity of assuming what the governmental-proprietary test purports to establish demonstrates its inadequacy as a measure of the constitutional permissibility of federal regulation of municipal issuers.

**AN ALTERNATIVE TO THE National League Analysis**

Perhaps the strongest argument against application of the governmental-proprietary test is its failure to take into consideration another concern of the National League Court: whether the determinations regulated were "'functions essential to a separate
and independent existence.' Whether a particular activity is traditionally governmental in nature may well be no measure of whether it is essential to a state's continued autonomous existence. The serious harm caused by the wage and hour legislation involved National League was removal from the states of "decisions upon which their systems for performance of these [police, fire, sanitation, recreation] functions must rest." So too, where nontraditional state activities are so disrupted as effectively to remove from the states their decisionmaking capacity regarding essential functions, state autonomy would appear to be as seriously affected as when traditional functions are usurped. It would be illogical to preclude a finding of unconstitutionality simply because the federal legislation impinged upon a function not deemed to be traditional. The same is true of situations in which state autonomy is indirectly impaired as well. Whether a particular state function which the federal government seeks to regulate is deemed governmental or proprietary, integral or nonintegral, traditional or untraditional, should not alone determine whether the federal government is invading an area of heightened state concern. The only consistent method of limiting the federal commerce power in order to preserve state autonomy is to assess the regulation's ultimate impact upon state policymaking initiatives. Where regulation, either directly or indirectly through prohibitive cost increases, substantially limits the state's available policy options in the exercise of its vital functions, state autonomy has been impaired. As a result, the regulation must be justified as the effectuation of a paramount federal interest if it is to withstand a tenth amendment challenge.

426 U.S. at 845.

Id. at 851.

87 It has been suggested that National League should be construed to give the federal judiciary a stake in the protection of state "autonomy interests." Note, Municipal Bankruptcy, the Tenth Amendment and the New Federalism, 89 Harv. L. Rev. 1871, 1886 (1976). That student commentator suggests that where commerce clause legislation so burdens the state as to threaten its capacity to make and enforce laws and provide critical public services, a court must examine the legislation to determine if it comports with the federal system, striking down those provisions which fail to accommodate conflicting state interests to the fullest practicable extent. This would involve the application of a "less intrusive means" standard. Id. at 1890. For criticism of the less intrusive means standard, see notes 88-91 & accompanying text infra.

Before the "accommodation" of state and federal interests occurs, the commentator proposes a two-step "process" examination to assure, first, that legislation is tailored to give full voice to state interests, and second, that the legislation meets a "clear statement" rule: absent a clear statement of congressional intent, courts should not interpret a regulation so as to implicate these autonomy interests. Id. at 1888-90. It is submitted that the clear statement standard is inapplicable in a tenth amendment context. See Tribe, supra note 1, at 688-
Adoption of an approach which endeavors to safeguard state autonomy by assessing the ultimate impact of a regulation upon essential services and administrative functions might place a tighter rein upon federal authority under the commerce power, but more importantly, it would assure the states that careful consideration will be given to their interests whenever federal regulatory legislation is contemplated. The appropriate intensity of scrutiny is a matter of dispute. Although varying degrees of "less intrusive means" analysis have been proposed, those courts which have attempted to apply the National League rationale have either ignored the balancing approach or balanced the interests involved without careful examination of the availability of less drastic means for substantially achieving the goals of the regulation. It may be unrealistic to expect a federal court to inquire very closely into the balancing process; indeed, it is uncertain whether such a delicate weighing of the competing interests is either contemplated by Justice Blackmun or included in the policy considerations underlying the application of tenth amendment immunity. The interests of the states traditionally have been represented and safeguarded in Congress by representatives and senators who weigh the national interest in federal legislation against the interests of their home state. Thus, as long as courts require that the federal interests in a particular legislative measure be substantial as compared to the

99. Although the clear statement approach has been employed in cases under the eleventh amendment, see Edelman v. Jordan, 415 U.S. 651, 672 (1974) (congressional authorization to sue states was wholly absent); Employees of Dep't of Pub. Health & Welfare v. Department of Pub. Health & Welfare, 411 U.S. 279, 285 (1973) (absent clear language, Court would not infer abrogation of immunity), Professor Tribe contends that eleventh amendment immunity can be viewed as being conferred against the federal judiciary alone, with no effect upon Congress' power to subject states to suit in federal court. Tribe, supra note 1, at 694. The Court's insistence that Congress clearly state its intention to abrogate state immunity may thus be regarded as an exercise of judicial restraint — a demand for explicit authorization before a federal court will assume jurisdiction of a suit against a state. Where the tenth amendment regulatory immunity is involved, however, it operates directly against congressional authority under U.S. Const. art. I, and a clear statement requirement will not cure any constitutional defect.


8 See, e.g., Usery v. Dallas Independent School Dist., [1976] 2 LAB. L. REP. (Wages & Hours) (CCH) (78 Lab. Cas.) ¶ 33,437 (N.D. Tex. Oct. 19, 1976), wherein the court summarily stated that "the policies of social justice underlying the legislation outweigh the State interest in exploiting employees because of their sex." Id., at 47,555 n.6.

8 See Wechsler, The Political Safeguards of Federalism: The Role of the States in the Composition and Selection of the National Government, 54 COLUM. L. REV. 543 (1954).
state interests in the regulated area, it would seem that the judici-ary is discharging its responsibility for safeguarding the federal system.

The framework thus proposed for analysis of challenges to federal regulation of state activities is, like that suggested by National League, two-pronged. In an attempt to avoid the difficulties inherent in the governmental-proprietary test while still preserving a healthy regard for state autonomy, it is submitted that the threshold determination should involve a test of impairment of essential services and administrative functions to determine whether a particular federal regulatory scheme should be subject to judicial scrutiny under the tenth amendment. In the event that the requisite impairment is found, the court should then proceed to weigh the federal interests in the legislation against the state interests which it will affect to ensure that Congress gave due consideration to the latter. If so, then the challenged legislation must be sustained as a valid exercise of national authority under the commerce clause.

THE TENTH AMENDMENT AND FEDERAL REGULATION OF MUNICIPAL SECURITIES

SEC Injunctive Actions Under the Antifraud Provisions

As was previously stated, the antifraud provisions of the 1933 and 1934 Acts are the only federal securities regulations which apply to municipal issuers. Recently, SEC efforts to invoke its long dormant power to investigate possible violations of the antifraud provisions by municipal issuers spurred a tenth amendment challenge by New York City under the National League doctrine. Under the proffered analysis, the first question to resolve would be whether SEC investigation and regulation of municipal issuers threatens to interfere with the municipality's service-providing function. If so, then impairment of state autonomy should be sufficient to induce judicial scrutiny of the competing federal and state interests via application of a balancing test.

Although a municipality's ability to provide essential services may be impaired by an SEC investigation of issuer misconduct, investigation is neither affirmative nor negative regulation. Investigation involves no imposition of affirmative duties or prohibitions upon the municipality, which continues to operate independent of

---

92 See note 17 and accompanying text supra.

federal input. Of course, the very fact that a federal regulatory agency has initiated a formal inquiry into possible misconduct by an issuer may have an adverse effect upon the marketability of that issuer's securities, thus creating some hardship in the sale of notes and bonds. Adverse publicity, however, is a factor external to state autonomy. In the absence of some attempt to regulate municipal issuers, states subject to such investigation may be regarded as harmed but not injured.

An SEC injunctive action, on the other hand, is a regulatory or prohibitive measure which can very drastically displace state fiscal policy. If the SEC were able to bring a proceeding to enjoin a course of municipal financing, it would apparently be able to impose upon a city the entire gamut of ever-changing federal standards of disclosure, scienter, causation, and materiality in an antifraud action. The expense of compliance with disclosure responsibilities would be a substantial fiscal burden, perhaps a crushing one in some localities, and would appear to constitute a disruption sufficient to invoke application of a balancing test. Nonetheless, the federal interest in protecting investors and ensuring the integrity and viability of the national municipal securities market should certainly be regarded as sufficient to justify this imposition upon the state borrowing power.

---

94 In this respect, it appears that New York City's suit for declaratory and injunctive relief was premature, for the only issue germane at the time suit was filed related to the SEC's power to compel testimony from city officials. The SEC pointed out that the city had cooperated in the investigation, and that no decision had been made by the SEC to take any action against the city. See S.E.C. Digest, 176 N.Y.L.J. 23, Aug. 3, 1976, at 1, col. 5, at 3, cols. 2, 3.

95 In the New York City case, this possibility was anticipated by the SEC, which sought to minimize the deleterious effects of the inevitable leakage of facts concerning the investigation by taking the unusual step of publicly announcing the commencement of the investigation. See Commission Press Release, Jan. 8, 1976; note 11 supra.

96 A serious threshold doubt exists as to the extent of the availability of injunctive relief against states and municipalities. Considerations of federalism act as a restraint upon federal equity power where a state or municipality is engaged in a governing function. In this situation "appropriate consideration must be given to principles of federalism in determining the availability and scope of equitable relief." Rizzo v. Goode, 423 U.S. 362, 379 (1976). This consideration may take the form of strict scienter requirements for subjecting to an injunction, or the unavailability of ancillary relief in the context of an injunctive proceeding. See generally Farrand, Ancillary Remedies in SEC Civil Enforcement Suits, 89 Harv. L. Rev. 1779 (1976); Comment, Equitable Remedies in SEC Enforcement Actions, 123 U. Pa. L. Rev. 1188 (1975).


98 See Casey & Smith, supra note 2, at 662.

99 Cf. Chazen, More Regulation of Municipals, Greater Disclosure on the Horizon, 176 N.Y.L.J. 112, Dec. 13, 1976, at 35, col. 1, col. 3 (civil enforcement action "would seem to have a very good chance of withstanding Constitutional attack"); Doty & Petersen, The
Constitutionality of Proposed Legislation

Although renewed congressional interest in the need for increased regulation of municipal issuers did not produce any legislation in 1976, proponents of federal controls continue to support such legislation. Federal regulation of municipal issuers has heretofore been foreclosed by political constraints and federalism concerns, but, barring the applicability of a tenth amendment limitation to any new enactments, it would appear that such an enactment would be a constitutionally viable exercise of the commerce power.

Legislation first proposed in 1976 by Senator Williams would require extensive disclosure by all large municipal issuers as well as a distribution statement for all issues of significant size. It would also mandate that disclosure reports and distribution statements be maintained for public examination in accordance with SEC requirements. The bill would delegate to the SEC broad rulemaking power to facilitate implementation of the disclosure


See notes 17-18 and accompanying text supra.


Section 13A(a)(1) of the proposed statute would characterize as a large municipal issuer one whose principal outstanding aggregate amount of securities exceeds $50 million. S. 2969, 94th Cong., 2d Sess., § 13A(a)(1) (1976). Such issuers would be required to prepare annual reports pursuant to SEC guidelines, including therein if applicable: (a) identification and description of the issuer; (b) legal limitations upon the incurrence of indebtedness by, or taxing authority of, the issuer; (c) debt structure of the issuer; (d) contingent liabilities or commitments; (e) a 20-year history of defaults; (f) a 5-year record of tax authority and structure; (g) a description of the issuer's major taxpayers; (h) the governmental and other services provided by the issuer; (i) the nature and extent of federal and other assistance programs; and (j) recent financial statements audited and reported upon by an independent public accountant. Id. § 13A(a)(2).

Issues with a principal amount exceeding $5 million would have to prepare a distribution statement, id. § 13A(b)(1), containing: (a) an offering description; (b) the security offered; (c) description of the project(s) or enterprise(s) to be financed; (d) description of the intended use of the proceeds; (e) statement of counsel's opinion regarding legality; (f) statement of the availability of the required reports; and (g) whatever else the SEC should require. Id. § 13A(b)(2).

Id. § 13A(f)(3).
scheme.\textsuperscript{106} In an effort to accommodate those states which already regulate disclosure by municipal issuers,\textsuperscript{107} however, issuers whose disclosure scheme has been approved by a duly authorized state authority would be exempted from the distribution statement requirement.\textsuperscript{108}

Applying the previously suggested constitutional analysis, it appears that the Williams proposal would not be barred by the tenth amendment. Clearly, the disclosure requirements in the bill would impose substantial costs upon municipal issuers. In many circumstances such expenses could, either directly or indirectly, disturb state fiscal policies.\textsuperscript{109} Municipal governments require short-term financing to anticipate tax revenues and long-term financing to facilitate capital development. Increased offering costs could significantly affect state fiscal resources, thereby foreclosing certain state policy options and disrupting state autonomy interests to an extent sufficient to support the institution of a tenth amendment challenge.

Having satisfied the threshold "impact" test under the proposed analysis, the competing federal and state interests must be balanced to ascertain the constitutionality of the proposed legislation. It would appear that state interests in deficit financing unfettered by federal disclosure requirements are substantial. State interests in a secure financial status as well as in governmental and political autonomy clearly are compromised by the proposed requirements. On the other hand, the substantiality of the state interests involved is balanced by the practical need for disclosure sufficient to instill investor confidence in the municipal securities mar-

\textsuperscript{106} For example, the SEC would be empowered to adjust the minimum dollar standards for applicability of the proposed legislation, and to prescribe the form of financial statements and the applicable accounting methods. \textit{Id.} § 13A(f).

\textsuperscript{107} For an interesting discussion of North Carolina's efforts in the area of state regulation of municipal issuers, see \textit{Hearings on S. 2574 & S. 2969 Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs, 94th Cong., 2d Sess., 117-19, 136-37, 204-05 (1976)}.

\textsuperscript{108} \textit{S. 2969, 94th Cong., 2d Sess., § 13A(c) (1976)}.

\textsuperscript{109} States provide critical services which are at best marginally profitable and do not attract private enterprise. The tax-exempt status of most municipal bonds, \textit{see Industrial Development Bonds, supra note 1}, is at least in part a reflection of the realization that the added burden of tax or regulation could impose difficult choices upon the state:

Many state activities are in marginal enterprises where private capital refuses to venture. Add to the cost of these projects a federal tax and the social program may be destroyed before it can be launched. In any case, the repercussions of such a fundamental change on the credit of the States and on their programs to take care of the needy and to build for the future would be considerable.

Also weighted against the state interests are the federal interests in a uniform national market for municipal deficit financing and the protection of individual investors. The interest in national uniformity of disclosure regulation is also sufficient for the more efficient utilization of capital which would be promoted as investors became better able to evaluate the relative merits and liabilities of competing issues. As a result, after balancing, it would appear that the federal interests in this legislation far outweigh the competing state interests. In view of the comparatively minimal intrusion upon state autonomy likely to be caused by the additional cost of disclosure requirements, the Williams bill would appear to be well within the limits of congressional power under the commerce clause.

A more drastic regulatory measure, however, has been proposed by Senator Eagleton, who would repeal entirely the general exemption for municipal securities presently contained in the 1933 Act. Such a measure would subject municipal issuers to the full panoply of registration requirements, including SEC review of disclosure documents. In comparison to the Williams proposal, the Eagleton bill appears to be a far more drastic means of effectuating substantially identical federal interests in the regulation of municipal issuers. The constitutionality of the Eagleton bill, as contrasted to the Williams bill, would be a much more difficult proposition if evaluated under the broad balancing test previously suggested. Yet, if the federal interests which it is intended to promote can be considered more substantial than the competing state interests, perhaps this regulatory measure also would be sustained.

---

110 Restoration of the investor confidence lost due to the New York City financial crisis is a major motivation for the imposition of disclosure standards. One presumed effect of disclosure would be, in contradistinction to the state claim of financial hardship, lower interest rates and a consequent lessening of borrowing costs to the state. The SEC contends that regulation “facilitates the creation of a viable municipal securities market in which States can raise funds with which to carry out their traditional function.” SEC, Underwriters Voice Support for Municipal Full Disclosure Act, SEC. REG. & L. REP. (BNA) No. 368, at A-3 (Sept. 1, 1976).

111 See Federal Regulation, supra note 3, at 590.


115 The Williams bill would require preparation and maintenance of disclosure documents, but apparently the process would not ordinarily involve SEC review. S. 2969, 94th Cong., 2d Sess. § 13A(f)(3) (1976).
Determination of the precise effect of the tenth amendment upon the municipal securities field will become a necessity if Congress seeks to provide more comprehensive federal regulation of municipal securities. The present subjection of municipal issuers to the antifraud provisions alone, however, is a minimal intrusion with practically no disruptive impact upon municipal administration, particularly since the disclosure necessary to comply with the antifraud provisions is, as a practical matter, being forced upon municipal issuers by market pressures.

**Actions Under the Securities Laws and the Eleventh Amendment**

The eleventh amendment operates to bar suits brought in federal court by private citizens against the states and their instrumentalities. Although by its terms it does not shield a state from suits by its own citizens, the amendment has long been construed to achieve that effect. In regard to private actions brought pursuant to the securities laws, it thus appears that state issuers can avoid liability absent a waiver of their eleventh amendment immunity. The question of waiver is complicated, however, by the Court's willingness to imply consent to suit on the part of the state.

The eleventh amendment has never been thought to prevent suits against states by the United States. Consent to suit by the federal government is considered implicit in the states' adoption of a federal system wherein certain powers are delegated to the central government along with sufficient judicial authority to enforce their exercise. Since Congress has delegated to the SEC responsibility

---

114 U.S. Const. amend. XI provides: "The judicial power of the United States shall not be construed to extend to any suit in law or equity, commenced or prosecuted against one of the United States by Citizens of another State, or by Citizens or Subjects of any Foreign State."

115 In Hans v. Louisiana, 134 U.S. 1 (1890), the Court declined jurisdiction over a suit by a citizen of Louisiana against that state for recovery of interest accrued upon bonds which the state had repudiated. The plaintiff had argued that the plain language of the amendment did not bar his action, inasmuch as it was not addressed to actions by citizens against their own states. Id. at 10. The Hans Court, noting the origin of the amendment as a reaction to the literal construction of the Constitution in Chisolm v. Georgia, 2 U.S. (2 Dall.) 419 (1793), wherein it was held that the judicial power extended to controversies "between a State and citizens of another State," believed it anomalous to construe it strictly so as to permit an action which had been unknown to the law. 134 U.S. at 15 (1890). See also C. Jacobs, The Eleventh Amendment and Sovereign Immunity 109-10 (1972).

116 See notes 124-29 and accompanying text infra.

117 See, e.g., United States v. Mississippi, 380 U.S. 128, 140-41 (1965). Suits by states against states are similarly justified, for such jurisdiction was conferred upon the Court as a substitute for the diplomatic settlement of controversies between sovereign governments. See, e.g., North Dakota v. Minnesota, 263 U.S. 365, 372-73 (1923). The eleventh amendment is
for enforcement of the securities laws and investigation of suspected violations,\textsuperscript{120} the Commission acts as the alter ego of the United States with regard to securities regulation. Although the SEC has not yet had occasion to utilize its powers in an action against state issuers of municipal securities, it is apparent that the states may not invoke the immunity to defeat such actions.\textsuperscript{121} It seems that, at present, all municipal issuers otherwise immune from suit under the eleventh amendment can be subjected to the SEC investigation and antifraud enforcement provisions absent a finding of tenth amendment immunity.\textsuperscript{122} Moreover, should Congress abolish the exempt status of municipal issuers under the securities acts and extend the coverage of their substantive regulatory measures to municipal securities, the eleventh amendment should present no impediment to SEC enforcement actions.\textsuperscript{123}

\textit{Exceptions to the Immunity}

As previously indicated, a state can waive its immunity from private suit. In the past the Supreme Court had shown a willingness to construe as a waiver a state’s involvement in an area of activity regulated by Congress under the commerce clause.\textsuperscript{124} This doctrine effective, however, against suits by foreign states against states. In Monaco v. Mississippi, 292 U.S. 313 (1934), the Court distinguished a suit by a foreign government as not within the exceptions to the amendment necessitated by the federal system:

The foreign State lies outside the structure of the Union. The waiver or consent, on the part of a State, which inheres in the acceptance of the constitutional plan, runs to the other States who have likewise accepted that plan, and to the United States as the sovereign which the Constitution creates. We perceive no ground upon which it can be said that any waiver or consent by a State of the Union has run in favor of a foreign State. As to suits brought by a foreign State, we think that the States of the Union retain the same immunity that they enjoy with respect to suits by individuals . . . .

\textit{Id.} at 330.


\textsuperscript{121} Cf. Brennan v. Iowa, 494 F.2d 100 (8th Cir. 1974), cert. denied, 421 U.S. 1015 (1975), wherein the court found that a suit brought pursuant to congressional authority by the Secretary of Labor to enforce the wage and hour provisions of the FLSA was not barred by Iowa’s assertion of immunity. It was held that the action, although brought in the public interest, was a suit by the United States. 494 F.2d at 103, citing Employees of the Dep’t of Pub. Health & Welfare v. Department of Pub. Health & Welfare, 411 U.S. 279, 285-86 (1973) (dictum) (although private action is barred, Secretary of Labor can bring suit on behalf of individuals). For a suggestion that the dictum in Employees yields anomalous results under the federal system, see Tribe, supra note 1, at 698 n.79.

\textsuperscript{122} See notes 92-99 and accompanying text supra.

\textsuperscript{123} The statute would, however, be subject to scrutiny under federalism principles. See notes 92-103 and accompanying text supra.

\textsuperscript{124} See Parden v. Terminal Ry., 377 U.S. 184 (1964). In that case, the Court held that by operating a railroad in interstate commerce Alabama had necessarily waived its sovereign
of constructive waiver reflected the Court’s conviction that Congress’ plenary commerce power brooked no restrictions by the states, so that congressional authorization of enforcement of federal regulation by private actions necessarily abrogated the immunity.\(^{125}\) Subsequently, however, the Court has determined that a waiver of the immunity will not be presumed absent a clear statement of congressional intent.\(^{126}\) It thus appears that private actions under the antifraud provisions,\(^{127}\) since they are judicially implied remedies,\(^{128}\) will not lie against a state issuer unless and until Congress expressly authorizes them.\(^{129}\)

The eleventh amendment immunity extends to a state officer acting in his official capacity, for he is in that instance an alter ego of the state. To subject the officer to a judgment for damages would contravene an important purpose of the amendment, the prevention of diminution of the state’s fiscal resources, for such damages ultimately would be the financial responsibility of the state.\(^{130}\) Under the doctrine of *Ex parte Young*,\(^{131}\) however, courts may enjoin state officials from enforcing unconstitutional state laws and from administering valid laws wrongfuly.\(^{132}\) Moreover, Congress could provide

---

\(^{125}\) Id. at 192.


\(^{128}\) Neither of the antifraud provisions, see note 127 supra, expressly provides for private damage actions, and whether such an action does or should exist under the 1933 Act is still a matter of serious controversy. See 6 L. Loss, SECURITIES REGULATION 3913-14 (2d ed. Supp. 1969); Horton, Section 17(a) of the 1933 Securities Act — The Wrong Place for a Private Right, 68 NW. U.L. REV. 44, 44-53 (1973).


\(^{130}\) See *In re Ayers*, 123 U.S. 443, 491 (1887). It has been suggested that a state’s voluntary assumption of an official’s liability should not be a sufficient predicate for extention of eleventh amendment immunity to such an official. See Tribe, supra note 1, at 686 n.25.

\(^{131}\) 209 U.S. 123 (1908).

\(^{132}\) Such an injunction does not in theory operate against the state, for it does not interfere with the officer’s discretion regarding the enforcement of state law since “the officer is simply prohibited from doing an act which he had no legal right to do.” Id. at 159. See also Greene v. Louisville & Interurban R.R., 244 U.S. 499, 506-07 (1917) (state officials may be enjoined where valid laws are wrongfully administered).
for private actions against officers in their individual capacities for material misstatements or omissions in disclosure documents.\(^{133}\) State subdivisions receive varied treatment under the eleventh amendment, reflecting the degree to which they are perceived to be distinct from the state. State agency liability under the securities laws thus must be resolved on an individual basis. Agencies which lack financial independence will generally be regarded as instrumentalities of the state, while those with the power to raise capital and sue or be sued in their own right will be unable to participate in the state's immunity.\(^{134}\) Political subdivisions, on the other hand, clearly do not enjoy eleventh amendment immunity from suit.\(^{135}\) Although states delegate to counties and municipalities the power to perform governmental functions on behalf of the state, these subdivisions are considered politically distinct, and thus beyond the express language of the amendment.\(^{136}\) It would therefore appear that eleventh amendment immunity is never a bar to the liability of counties and municipalities under the antifraud provisions of the securities laws.

**Private Actions Against Municipal Issuers Under Rule 10b-5**

Problems of local issuer liability to suit are sufficiently unclear to raise serious questions in a series of cases arising from the recent New York City fiscal crisis and the alleged "bailout" by certain bondholders from their municipal security holdings with the knowledge and aid of city officials. A total of four actions were instituted,

---

\(^{133}\) See Hearings on S. 2574 & S. 2969 Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs, 94th Cong., 2d Sess. 522-24 (1976). For a discussion of the propriety of subjecting elected officials to personal liability for violations of the securities laws, see Federal Regulation, supra note 3, at 592-94.

\(^{134}\) The test of a state agency's amenability to suit is the presence or absence of the state itself as a real party in interest. Of the factors which may be considered in determining presence, "'ultimate State liability' is the most determinative." George R. Whitten, Jr., Inc. v. State Univ. Constr. Fund, 493 F.2d 177, 180 (1st Cir. 1974). See Soni v. Board of Trustees, 513 F.2d 347 (6th Cir. 1975), cert. denied, 96 S. Ct. 2623 (1976) (amenability of state universities to suit must be determined individually on basis of circumstances).

\(^{135}\) Lincoln County v. Luning, 133 U.S. 529 (1890). The Lincoln County Court quickly disposed of the county's contention that, as an integral part of the state, it enjoyed immunity under the eleventh amendment, stating:

> [W]hile the county is territorially a part of the State, yet politically it is also a corporation created by and with such powers as are given to it by the State. In this respect it is a part of the State only in that remote sense in which any . . . municipal corporation may be said to be a part of the State.

*Id.* at 530 (citation omitted).

all currently seeking class action status. In these actions, holders of New York City notes and bonds alleged that they were injured when the defendant commercial banks and brokerage houses, aware that the city was on the verge of default, undertook to conceal the true financial condition of the city and to market further issues of notes and bonds, using the proceeds from these issues to reduce their own enormous holdings in New York City securities. The city, its mayor, and comptroller allegedly were aiders and abettors in this scheme.

Professionals in the municipal securities industry are apprehensive that the courts in these suits will hold that municipal issuers or officers have no liability to purchasers, since a finding of no issuer liability might visit upon underwriters the spectre of enormous liability under the securities laws. The result of such fears will likely be increasing pressure by underwriters upon municipal issuers to make full disclosure of all circumstances surrounding the issuance of securities.

Private pressure, if successful in impelling voluntary disclosure, will be a major step towards skirting the dilemma of commerce power limitations in the area of securities regulation, while simultaneously increasing the impetus for a statutory limitation of liability for underwriters. Should political pressures induce some states to impose liability upon municipal issuers, it may become economically expedient for other issuers to waive immunity so as to compete with municipal issues which are better secured by reason of the issuer’s liability.

139 Id. For a discussion of the potential civil liability of municipal officers in this context, see Sykes, Civil Liability of Public Officers Under Federal Securities Statutes for Municipal Bond Misrepresentations, 2 Urban Law. 219 (1970).
141 Id. at 250.
142 Such a limitation was proposed as part of Senator Williams' bill: "in no event shall any underwriter of an issue of municipal securities (unless such underwriter shall have knowingly received . . . some benefit . . .) be liable in, or as a consequence of, any suit for damages in excess of the total price at which the issue was sold by it to the public." S. 2969, 94th Cong., 2d Sess., § 13A(g)(3) at 8-9 (1976). See notes 102-08 and accompanying text supra.
CONCLUSION

In *National League*, the Supreme Court has embarked upon the elucidation of a heretofore unrecognized affirmative limitation upon Congress' power under the commerce clause to impose regulation upon the states as states. The standards which will guide the application of this limitation await clarification in future decisions. Nonetheless, it seems clear that the nature of the municipal finance function will mandate reevaluation of the Court’s analysis of the availability of tenth amendment regulatory immunity should Congress decide to enact stringent controls over municipal issuers.

It is submitted that pursuant to the analytical framework proposed above for consideration of tenth amendment challenges, a court should focus upon the “bottom line” and consider whether a particular course of regulation impairs state capacities by imposing increased costs upon the state. While the governmental-proprietary approach would involve the courts in a conceptual maze of formidable proportions, the suggested standard offers ease of application and more relevant gauge of the state interests which merit protection. Application of this approach to the municipal financing function indicates that federal regulatory efforts in the field do constitute an appropriate occasion for a balancing of competing interests.

From a national viewpoint, the federal government has an overriding interest in preserving the stability of the municipal securities market. The commerce power was a result of the recognition that a uniform economic policy is often essential to national survival. In *National League*, the Court has indicated that it will carefully scrutinize attempts to use the commerce power as a predicate for imposing federal regulation on state functions in furtherance of social interests such as wage and hour policy. Clearly, however, the commerce clause should exert a particularly compelling force when the federal interest advanced is that policy of national commercial unity which was the *raison d'etre* for state delegation to a central government of the power to regulate interstate commerce.

From the state viewpoint, the securities market constitutes not a commercial enterprise engaged in for profit, but an instrument essential to financing government and services. The state’s interest in freedom from fiscal manipulation certainly is of the first order. For the federal system to serve as it was intended to, state economic autonomy must be jealously guarded from all unnecessary intrusions by the central government. Yet in the federal system vital national interests should supersede all conflicting state interests, no matter how essential.
Because the field of municipal securities involves such important interests from the state viewpoint, it is an appropriate area for careful consideration of the state interests implicated in any program of federal regulation. In view of the heightened awareness of the municipal securities market, Congress is quite likely to be fully apprised of state interest in this regard, and it may safely be anticipated that the state interests will be fully voiced and appropriately represented in any new federal enactment. Regardless of National League of Cities v. Usery, the primary limitation upon the commerce power is, and must remain, the political process.

Robert J. Brady