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SUMMARY

April 27, 1977

CONTRACT CLAUSE PROHIBITS NEW JERSEY'S REPEAL OF COVENANT WITH PORT AUTHORITY BONDHOLDERS

A closely divided Supreme Court rules that the Contract Clause of the United States Constitution prohibits the New Jersey legislature's retroactive repeal of a covenant with Port Authority Bondholders that limited the uses to which revenues pledged as security for Port Authority bonds could be put. Four of seven participating Justices conclude that the state's action impairing the contract was neither reasonable nor necessary in light of circumstances. (United States Trust Co. of New York, Trustee v. New Jersey, No. 75-1687, 4/27/77) (Page AA-8)

NOTIFICATION REQUIREMENT PROPOSED FOR RULE 146

The SEC proposes to amend Rule 146 to require that issuers making private placements report the offerings to the Commission. The changes are proposed in response to apparent abuses by some issuers and to provide data for the Commission's inquiry into whether the rule should be withdrawn. (Release No. 33-5822, 4/18/77) [The full text of the release appears at Page E-1.]

At the time Rule 146 was adopted, the SEC indicated that, while it was not imposing a filing or notification requirement in connection with the rule, such a move might prove necessary in time. The Commission has become aware that the rule has apparently been abused by some issuers, most notably in connection with oil and gas partnership offerings. Consequently it proposes that a report be filed within 10 days after the first sale of securities in an offering, and that a second report be filed within 10 days of the offerings conclusion. (Page A-1)

TREASURY, SEC DISAGREE ABOUT RESPONSIBILITY FOR ENFORCING CURBS ON OVERSEAS BRIBERY

The Treasury Department and the SEC disagree about who should have primary enforcement responsibility under a bill to outlaw bribery of foreign officials by U.S. companies. During hearings on the House version of legislation to prohibit foreign bribery, SEC Chairman Harold M. Williams endorsed the bill's grant of primary enforcement responsibility to the Commission, while Treasury Secretary W. Michael Blumenthal urged that the Justice Department be given the power to handle both civil and criminal action. (Page A-1)

Full text of documents reported on in the News and Comment Section of this Report will be loaned to subscribers on request. Copies of SEC No Action and Interpretative Letters can be obtained for a modest fee through BNA's research office.

SECURITIES ENFORCEMENT: SEC'S EXPANDING PROGRAMS

Two years ago, unbeknownst to the general public, the Office of Management and Budget criticized the effectiveness of the SEC's enforcement program. But the Enforcement Division disputes such criticism, contending the agency has a workable, sensible enforcement strategy that gets results and furthers the SEC's commitment to full disclosure. In this last of a series of Special Reports on securities enforcement, BNA reveals how the Division initiates a new enforcement program; the philosophy behind its choice of targets; and the agency's current enforcement goals. (Page AA-1)

OTHER ITEMS OF INTEREST

- ▶ Rep. Fernand J. St. Germain (D-RI) asks the SEC to investigate whether U.S. banks have bribed foreign officials to gain overseas business. (Page A-4)
- ▶ The Structure Committee of the Financial Accounting Federation issues a report on the organization and operations of the FASB (Page D-1)
- ▶ Issuers are alerted by the SEC to screen requests for annual and periodic reports and press releases in order to ascertain whether these requests are coming from stockholders of record or persons otherwise representing beneficial owners. (Page A-6)
- ▶ The AICPA issues a Statement of Position recommending changes in its Guide on Audits of Investment Companies. (Page D-3)
- ▶ The temporary exemption from the Advisers Act for broker-dealers registered under the '34 Act on May 1, 1975, is extended until April 30, 1978. (Page A-7)
- ▶ An Exposure Draft of a proposed statement on defined benefit pension plans is issued by the FASB. (Page D-4)
- ▶ The SEC proposes to amend Regulation S-X with respect to form and content for consolidated and unconsolidated financial statements of banks and bank holding companies. (Page D-2)
- ▶ The Metcalf staff's recommendation for federal accounting standards-setting is attacked by the FASB. (Page D-5)
- ▶ The FASB launches a study to determine the effect of accounting standards on the assessment of securities by investors and creditors and on management's decision making process. (Page D-6)

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NEWS & COMMENT

Securities Enforcement: A Growth Industry

SEC's Expanding Programs *Last of a Series*

Two years ago, unbeknownst to the general public, a battle was being waged between the SEC and the White House over the effectiveness of the Commission's enforcement program.

A 1975 letter to the then-chairman Ray Garrett, Jr., from Paul O'Neill, deputy director of the President's Office of Management and Budget, stated that productivity in several important SEC programs "may be leveling off or even falling." O'Neill contended that the agency wasn't providing efficient enforcement support for its all-important disclosure programs.

O'Neill also told Garrett that the Commission lacked "an effective strategy" for maximizing its enforcement resources, and he recommended that the Commission begin eliminating some staff positions, and downgrading others. The states, said O'Neill, should assume more securities enforcement responsibility.

As might be expected, the Enforcement Division disputes such criticism. Late last year, a position paper illustrating staff opposition to such OMB criticism was distributed internally to the Commission and to Division personnel. The staff paper contended that the Division has a workable, sensible enforcement strategy that gets results and furthers the SEC's commitment to full disclosure.

The trend for future enforcement actions, the paper recommended, should be to focus on persons "providing access to the securities markets and professionals practicing in the industry." The Division paper noted concern about the increasing number of respondents who are litigating SEC actions instead of offering to settle. The staff was advised, in the paper, to stand ready to litigate, and told that the enforcement trend was toward cases more complex and sophisticated than those the Division had encountered in the past.

For the past several months, a BNA investigative reporting team has scrutinized the Division of Enforcement to assess the quality of securities regulation. For this final installment of a four part series, BNA wanted to know how the Division initiates a new enforcement program; the philosophy behind its choice of targets; and the agency's major enforcement goals. BNA also wanted to know how the Division will be allocating its scarce enforcement resources in the future. Among other things, BNA found:

● The Division will often begin enforcement programs in areas where there are few federal laws, or court guidelines. The enforcement goal, in such instances, is often to show Congress where state regulation breaks down, so that federal action can be taken.

● The SEC's home office Enforcement Division chooses cases to illustrate public exposure to abusive practices affecting geographically-dispersed investors who cannot unite for purposes of filing their own lawsuits.

● New enforcement programs currently being pushed are aimed at professionals, issuers, and underwriters involved in Industrial Development Revenue Bond offerings. Also being developed is a casualty and life insurance enforcement program that will disclose abuses in portfolio management. Various forms of undisclosed executive compensation will be examined, as well as undisclosed "swap deals" involving corporate assets.

Municipal Securities

The municipal securities enforcement program is one of the newer Enforcement Division projects. It is now entering a second phase in which the Commission hopes to demonstrate the need for new federal legislation requiring improvement in the uniformity of accounting standards used and the comparability of financial data disclosed by municipalities. Also needed, the SEC says, is a "central repository" for information on public bond offerings. Professionals are being chosen as investigative targets, and the courts and administrative panels will be asked to judge them in accordance with "due diligence" standards obligating professionals to ensure that statements made in connection with a municipal offering are complete and accurate.

The Division first attacked the emerging municipal bond problem in 1970, when neither municipal securities nor dealers handling only municipal offerings were required to be registered with the SEC. The states alone were responsible for regulating and policing the municipal market. According to Associate Enforcement Division Director Wallace L. Timmeny, "there were so many grave abuses" in municipal offerings that you "couldn't sit back and wait to have a public hearing, draft rules, and suggest a legislative program. It had to be a combination of enforcement plus the rulemaking and the legislation."

The Division decided to initiate an enforcement program because investors were attracted to sometimes risky industrial development revenue bonds by their tax-free status and the "safety" customarily associated with government offerings. Unsavory individuals also were attracted, Timmeny says today. The resulting problem was that gullible institutional investors were buying securities that were destined for default, or in some cases, already in default.

In late 1970, Timmeny formed a task force drawn from the home office and Atlanta regional office staffs, and conducted a field investigation of broker-dealer office conditions in Nashville and Memphis to "get a first hand look at what they were doing." Timmeny found broker-dealers who were buying municipal securities "at a cheap discount and then boiler-rooming them out at par or even above par. There were excessive mark-ups, there were misrepresentations as to quality and yield." Moreover, "I talked to some of the regulators in one state who were responsible for regulating municipal securities dealers and found essentially that they had little inclination to regulate and they also had little in the way of regulatory tools.

"It was obvious that this was a national problem. It wasn't centered in Nashville or Memphis or in the Southeast. There were boiler room operations in the South that were popping up and they were selling throughout the country . . . Investors were being victimized left and right by these unsavory practices. We found more than our fair share of little old ladies."

Timmeny returned to the SEC's Washington headquarters and attempted to organize an enforcement program that would show the Commission and Congress the need for registration of municipal broker-dealers and an increased federal role in setting disclosure standards for municipal offerings. "It was an orchestrated process," Timmeny says, "that would illustrate the big problem and illustrate the need for legislation."

The first stage in municipal enforcement was thus directed at broker-dealers who were dealing exclusively in municipal issues and touting them as safe, high yield investments. In all, the Commission brought 10 cases in which 21 firms and 50 individuals were enjoined, then made a legislative recommendation to Congress that resulted, through enactment of the Securities Acts' Amendments of 1975, in SEC registration of broker-dealers exclusively handling municipal securities.

That was the first enforcement phase. Phase II actually began in 1974 with an administrative proceeding against bond counsel J. M. Ferguson and a companion civil proceeding against the Senex Corporation. So far, the division has filed 12 cases, 7 administrative and five injunctive. "Due diligence" is an issue in almost all of them.

Although the SEC has no set definition of due diligence, the courts are being asked in several cases to rule that certain conduct on the part of bond counsel did not constitute a diligent effort to ensure that all the claims made in offering statements were true and complete.

The Division of Enforcement, for its part, told BNA that due diligence might entail the type of "detailed research that should be performed by counsel for the underwriters or counsel for the issuer" if there were a formal registration process for municipal offerings.

Such research would include, but not be limited to, investigating any security pledged to guarantee performance by a municipal issuer who defaults. For example, suppose the issuer says its revenues are pledged as security for the offering. Due diligence on the part of bond counsel, the SEC contends, would require an investigation to ensure that the issuer collects enough revenues from taxes or from the operation of public facilities to pay off the offering. If a local issuer says the state in which it is located "backs" the bonds, then it would be bond counsel's job to make sure the state has, indeed, pledged its financial backing. The SEC asserts that the interests of the parties involved in a bond issue should be disclosed.

Senex

In the Senex case, the SEC found that bond counsel didn't investigate fully an offering of bonds that would pay for the construction of a geriatric health care facility for the City of Covington, Kentucky. The bond counsel consented to the Commission's findings in mid-1974 and, because he was not an "experienced" bond counsel, was ordered to attend workshops and seminars on municipal securities. On May 11, 1976, the Commission finally won, on appeal, preliminary injunctions against Senex and one of its founders, A. J. Jolly.

The SEC thus asserted, in Senex, an expanded federal enforcement role to include new municipal offerings. Today, these offerings are regulated by the states, with local municipal offerors following their own state's guidelines for disclosure. According to the SEC's Timmeny, disclosure for each offering varies from state to state, just as do conditions by which each state will guarantee payment in case the local issuer defaults. Industrial development revenue bonds often are issued by local governing bodies. Pay-back revenues can come from local taxing authority. In the case of the Covington Health Care facility, the revenues derived from operating the facility, once it was constructed, were expected to meet payments on \$4,425,000 of development bonds.

What wasn't disclosed in the offering circular for the Covington Health Care Corporation's industrial development revenue bonds was a series of relationships and events that allegedly led to the City's decision to build a nursing home.

According to Commission papers, A.J. Jolly and Arthur Jay Tarley in January 1971 formed the Senex Corporation for purposes of planning and developing geriatric health care facilities which would be financed through municipal issues. Later in 1971, Claude Hensley, the mayor of Covington, contacted Jolly about the development of such a nursing home for the city. An agreement was made by which Senex would develop a health care facility for Covington if feasibility studies proved the city needed it, and if the studies also showed revenues from operating the facility would be sufficient to meet bond payments and operating expenses. The city did not want to pledge its general credit.

The "City of Covington Health Care Corporation" was incorporated as a non-profit corporation. The Health Care Corporation authorized Senex to formulate a health care program, and implied that Senex would be awarded the grant for constructing facilities if they were found feasible. Jolly, the Commission says, then "drafted a proposed resolution for the City of Covington" in which the city agreed to issue its revenue bonds for constructing the facility, should it be feasible, on the condition that the bonds would "impose no liability or obligation on the City of Covington." The city passed the resolution on May 20, 1971. In June 1971, Jolly sold his 1/2 interest in Senex to his partner, Tarley. The Commission, however, says Jolly and Tarley agreed that Jolly would retain "a half interest as developer" in the Covington project.

In August, Jolly submitted a preliminary feasibility report to the city which recommended that a nursing home be built, and said a 360-bed facility could meet debt service on a \$4,000,000 bond issue. The city didn't make a decision, and then A.T. Kearney and Company, Inc., a nationally known consultant commissioned by an existing nursing home in Covington, presented to Jolly and a local private health care planning council the results of its study which concluded that there was only a limited need for additional health care facilities in Covington.

The Health Care Corporation then commissioned Arthur D. Little, Inc., to examine the Senex program to determine its feasibility. The contract with Little stipulated that Jolly and Tarley would provide the firm's consultant with "direction and coordination" as he prepared his report. Jolly and Tarley, through Senex and a consulting firm Jolly had recently formed, Mentor Corporation, guaranteed payment of Little's fee should the Senex project be found not feasible -- which is what the Little report found.

Jolly and Tarley, however, did not give the city planning council a copy of the Little report. Instead, the Commission claims, Mentor Corporation, the consulting firm Jolly had incorporated shortly after relinquishing his interest in Senex, issued two reports which, like Jolly's earlier report, said the project was feasible. One of these reports directly refuted the Kearney report and claimed "a sophisticated investment banker "was "willing and anxious" to invest in the project "with no security other than the project itself." Neither report mentioned Little's findings. And another report, issued by the Silver Spring, Md. consulting firm Block, McGibony & Associates, Inc., supported the project.

The Health Care Corporation then entered into a contract with Stemac Management Corporation on May 1, 1972. Stemac, which would act as the corporation's financial advisor on the nursing home project, was purchased three months earlier by Tarley, for \$1,000. Previously an inactive broker-dealer, Stemac was represented in the contract as a "recognized expert in the field of Municipal Finance." Stemac then prepared a prospectus for the \$4,425,000 bond offering, and asked Standard & Poor's for a rating. The rating agency declined because there was no "disclaimer as to financial relationships, if any, among the financial consultant, those that have done the feasibility study and the prime contractor." A small rating agency then gave the bonds an 'A' rating which was sent, along with copies of the prospectus, final Mentor report, and Block McGibony report to broker-dealers in Atlanta, Mississippi, and New Jersey.

The bonds sold quickly, but the SEC initiated proceedings, contending investors relied on the 'A' rating and Mentor feasibility reports without knowing that other reports didn't find the project financially feasible. According to Commission briefs, announcement of the Commission's action resulted in a drastic drop in the asking price of the bonds. Investors "felt that the facts brought out" by the enforcement action were important, the SEC stated, but Jolly, who fought a preliminary SEC injunction on appeal, said that the Commission merely "thought Mentor's profits from the project were excessive."

The project's promoters and developers did make substantial undisclosed profits. Tarley and Jolly split \$650,000, which represented Senex Corporation's profit for arranging a sole bid construction contract given to Boggs Construction Corporation, and Tarley's Stemac Management Corporation received an additional \$135,000 for acting as the project's financial adviser. All Jo Ferguson, the bond counsel, got, however, besides his fee for drafting a city resolution supporting the project and reviewing the prospectus that went with the bonds, was an SEC sanction for not investigating and ordering disclosed the various interrelated roles Jolly and Tarley played, "and other factors that had come to his attention." Senex has consented to the Commission's findings, and Jolly lost his appeal.

Timmeny is encouraged by favorable judgments in the Senex and Ferguson cases. He says these cases represent a Division effort to show the need for an expanded federal role in forcing disclosure in the new issues market -- especially for industrial development revenue bonds. Many of these cases, Timmeny adds, contain allegations that the bond counsel has not used "due diligence" to ensure full disclosure.

Reclamation District

In one such recent case, SEC v. Reclamation District 2090, County of Contra Costa, California (C76-1231 SAW, DC NCA), an attorney is charged with aiding and abetting a fraud in the sale of general obligation bond anticipation and promissory notes. Urban J. Schreiner, the bond counsel for the District, prepared and disseminated a legal opinion on the District's promissory notes and bond anticipation notes. The Commission is alleging that Schreiner's opinion neglected to disclose that the District's tax base could not "generate enough funds to meet the obligations evidenced by the bond anticipation notes," and that there was no liability on the part of the State of California to meet the obligations created by the bond anticipation notes (several dealers in the notes, the Commission has alleged, said in their sales pitches that the notes were "backed by" the state).

The Reclamation District also issued \$1 million in promissory notes. Schreiner's comments as to the revenues and sources of funds available to meet payments were favorable. This opinion, the Commission alleges, omitted to state that California had no obligation to meet payment on the notes in case the Reclamation District defaulted.

Although Schreiner had unsuccessfully sought data reflecting the District's current financial and operational condition, the Commission charges that he "had knowledge that the District was not producing revenues from operations." The Commission says Schreiner made "misrepresentations of material facts" and omitted to state that he was to receive 1 percent of the face amount of promissory notes sold, and that he kept track of how many of the notes were sold "to ascertain the amount of money due him."

In another recent case, SEC v. Astro Products of Kansas, et al (DC Kan, Civ. 76-359-C6) bond Counsel Herbert M. Kohn is accused of aiding and abetting violations of the Trust Indenture Act and other federal securities laws.

In SEC v. Washington County Utility District, (DC ETenn., CA-2-77-15) the Commission has alleged that bond counsel Hertz N. Henkoff never asked to see the District's financial statements (the SEC says the District hasn't produced any to this day), even though the offering circular proclaimed that the District maintained publicly-audited books and records.

The District, located in Tennessee, is in default on five revenue bond offerings totalling \$3,675,000 -- all of which were allegedly sold with guarantees that the bonds were backed by the state. The state of Tennessee, however, had no obligation to pay off the bond holders and, according to the SEC, prohibits such guarantees. The proceeds from the bond sales, the SEC charges, were used for "unauthorized purposes such as loans" to the District's manager, and to companies controlled by him or his relatives.

The SEC's Timmeny claims there is not a "due diligence tradition" in the municipal securities industry -- perhaps because such issues are not registered with the Commission and are subject to varying controls by state enforcement agencies. Timmeny commends the Municipal Finance Officers Association for its efforts to set disclosure guidelines, but he nonetheless feels MFOA -- which advocates a "disclosure check-list" to solve the problem -- hasn't gone far enough. The MFOA solution, Timmeny says, would provide the needed uniformity of disclosure among municipal offerings but would not necessarily mean that full disclosure has been made. "Full disclosure," Timmeny claims, "will depend on each and every deal. You can't have a cook-book practice of law in the municipal securities area."

Timmeny says there is a need for more federal legislation before municipal securities abuses can be controlled. Yet there is the touchy problem of states' rights and stipulations in some states' constitutions requiring that specific standards be applied in conducting municipal audits. Municipal securities legislation in Congress, HR 2969, would require, among other things, that municipal offerings be registered with the Commission. But Timmeny is skeptical of this approach because he thinks registration has become an easily-practiced "Mandarin Art." Certain law firms, he says, specialize in preparing registration statements and are able "to string together the required boilerplate."

"An occasional enforcement action" is better for advancing disclosure, Timmeny contends, and the recent Hochfelder decision "established a standard that should relieve most responsible professionals of any thoughts they had about Draconian liability." Another solution, Timmeny adds, may lie with an increased SEC participation in the establishment of uniform municipal government accounting standards.

Life and Casualty Insurance

Municipal securities is not the Enforcement Division's only emerging program. Associate Director Irwin M. Borowski says, for example, that he now has three staff attorneys investigating, on a part time basis, "looting and self-dealing" on the part of life and casualty insurance company managers. Borowski claims the Division soon will be bringing a series of cases, many of which will originate in the Southwest, to illustrate the need for a stronger federal role in the regulation of insurance companies.

As it is now, insurance companies are regulated primarily by the states, with their securities offerings subject to SEC control. Borowski, however, says that an insurance company, especially one that sells life insurance, can be considered an investment company subject to SEC regulation.

Many insurance companies, he adds, even claim in their advertisements that when you buy a policy, you buy a share in the company. Prudential Insurance Co. of America, for example, in its television ads says that, when you buy Prudential, you get "a piece of the rock."

Currently, the Division sees the most potential for problems in small life and casualty companies. "Mismanagement" sometimes takes the form of portfolio substitution -- replacing portfolio securities with high risk investments and also juggling books and records to depreciate cash reserves and inflate profit statements. A profitable corporation is an attractive investment, Borowski notes. But profits can be swiftly absorbed by claims against the deflated reserves. Policy holders and shareholders, alike, Borowski adds, are often subjected to more risk than they should be. Sometimes, management is just siphoning money from the corporation.

Looting

Borowski predicts more cases will be filed focusing on the looting of corporations by management. So far, only one such case has been filed. In SEC v. National Pacific Corp., DC DC, 9/29/76, the Commission alleges that numerous individuals acquired control of a publicly held insurance company in order to loot its assets. Subsequently, the Commission said, at least \$1 million in pension fund insurance premiums were siphoned off.

Swap Deals

In still another area, the SEC's Timmeny says that, contrary to prior reports, the Division will never end its program for the voluntary disclosure of questionable payments. An offshoot of this program, however, is the Division's new program for forcing disclosure of heretofore-hidden forms of executive compensation and of swap deals arranged between corporations but not disclosed on either's books.

In SEC v. Potter Instrument Corp., DC DC 3/9/77, the Commission charged that, prior to Potter's financial demise, it violated the '34 Act by failing to disclose that board chairman John T. Potter had received substantial corporate benefits over and above his salary. The benefits, the SEC charged, included payments to maintain the chairman's yacht, domestic servants, and crew. The payments covering salaries for the servants and crew were reflected on the company's books as payroll expenses for "maintenance personnel and engineers" the Commission said. According to Enforcement Director Stanley Sporkin, more cases of this sort soon will be filed.

This new direction in the "questionable payments" program was first announced by Sporkin during a recent "SEC Speaks" program. Sporkin said then that the Division would be investigating corporate swap deals in which trades are effected without inclusion on corporate books. Recently, Sporkin told BNA that the government "has a responsibility and a duty to present a climate in which an honest business should be able to proceed without having to pay tribute to anyone." In the Potter case, a tribute purportedly was in the form of executive compensation.

For the most part, corporations and the courts have cooperated with Sporkin in his quest to force questionable payments disclosure. Over 400 corporations have stepped forward and disclosed unrecorded or disguised payments, and fewer than 40 enforcement actions have been brought to make corporate officials confess. When Charles Jacquin Cie., Inc., et. al., resisted an SEC subpoena seeking access to the corporations books and records, the court not only ordered Jacquin to produce the books for the Commission, but found two corporate officers in contempt, fined them, and ordered the appointment of an independent compliance officer to "enter the premises of Jacquin for the purpose of identifying, assembling and producing material responsive to the Commission's subpoenas."

The Jacquin case, decided favorably for the Commission, does point out a growing Division concern. Even though to date most corporations have cooperated in Division probes into questionable payments, Borowski told BNA that more firms are resisting. Subpoenas now are being contested more frequently than at any other time in the Commission's history. The concern within the Division is that, if fewer corporations voluntarily comply with SEC subpoenas and subsequently resist efforts to reach swift settlements, the abundance of formal enforcement actions that would result would reduce the scope of the Division's entire enforcement program.

Timmeny says the average SEC staff attorney is batting a good average if he can litigate one case a year. With no more than 190 home office attorneys in the Division, the overall enforcement impact of an increase in litigation would be quite severe.

SUPREME COURT RULES CONTRACT CLAUSE BARS NEW JERSEY REPEAL OF COVENANT WITH PORT AUTHORITY BONDHOLDERS

In a four to three decision, the U.S. Supreme Court rules that the Contract Clause of the Constitution prohibits New Jersey's retroactive repeal of a statutory covenant requiring Port Authority bondholder approval before either New York or New Jersey could use Port Authority funds for rail passenger transportation. (United States Trust Co. of New York, Trustee v. New Jersey, No. 75-1687, 4/27/77) [The full text of the opinion appears at Page I-1.]

In 1962, New York and New Jersey enacted a covenant with holders of Port Authority bonds limiting the authority of the Port Authority to subsidize rail passenger transportation from revenues and reserves pledged as security for consolidated bonds issued by the Port Authority. The covenant was thought necessary to promote investor confidence in the Port Authority in view of the predictable deficits that would result from any increasing involvement in mass transit operations.

In 1974, while the national energy crisis was developing, New Jersey's legislature repealed the covenant to clear the way for expansion of the Port Authority's role in mass transportation. Existence of the covenant requiring bondholder approval of railroad expenditures had posed a barrier to the planning and implementation of commuter railroad service as part of a coordinated approach to mass transit. The New Jersey Supreme Court upheld the legislature's action, calling it a reasonable exercise of the state's police power.

Contract Clause

Writing for the majority, Mr. Justice Blackmun begins with the observation that, while the Court has "eschewed a rigid application of the Contract Clause to invalidate state legislation," it has not indicated that the Contract Clause is "without meaning in modern constitutional jurisprudence, or that its limitation on state power [is] illusory."

The Court has no doubt that the 1962 covenant "has been properly characterized as a contractual obligation of the two States." With respect to the value of the covenant to the stockholders, the Court, leaving aside the question of actual financial loss, notes that "[a]s a security provision, the covenant was not superfluous; it limited the Port Authority's deficits and thus protected the general reserve fund from depletion. * * * Its outright repeal totally eliminated an important security provision and thus impaired the obligation of the States' contract."

Impairment

Having established that repeal impaired the contractual obligation, the Court, turns to the question whether that impairment violated the Contract Clause. The trial court concluded that repeal was a valid exercise of New Jersey's police power because repeal served important public interests in mass transportation, energy conservation, and environmental protection. "Yet the Contract Clause limits otherwise legitimate exercises of state legislative authority," Mr. Justice Blackmun observes, "and the existence of an important public interest is not always sufficient to overcome that limitation."

"Whatever the propriety of a State's binding itself to a future course of conduct in other contexts," the Court continues, "the power to enter into effective financial contracts cannot be questioned." Here, "the States promised that revenues and reserves securing the bonds would not be depleted by the Port Authority's operation of deficit-producing passenger railroads beyond the level of 'permitted deficits.' Such a promise is purely financial and thus not necessarily a compromise of the State's reserved powers."

To say that the financial restrictions of the covenant were valid when adopted, however, does not resolve the case. "The Contract Clause is not an absolute bar to subsequent modification of a State's own financial obligations," the Court states. "As with laws impairing the obligations of private contracts, an impairment may be constitutional if it is reasonable and necessary to serve an important public purpose. In applying this standard, however, complete deference to a legislative assessment of reasonableness and necessity is not appropriate because the State's self-interest is at stake."

New Jersey contends that the goals of mass transportation, energy conservation and environmental protection are so important that any harm to bondholders from repeal of the covenant is greatly outweighed by the public benefit. The Court, however, does not "accept this invitation to engage in a utilitarian comparison of public benefit and private loss," adding that it can sustain the repeal only if the impairment "was both reasonable and necessary to serve the admittedly important purposes claimed by the State." It concludes that repeal was neither necessary nor reasonable in light of the circumstance.

Necessity, Reasonableness

With respect to necessity, the Court concludes that "a less drastic modification would have permitted the contemplated plan without entirely removing the covenant's limitations on the use of Port Authority revenues and reserves to subsidize commuter railroads." Further, "without modifying the covenant at all, the States could have adopted alternative means of achieving their twin goals of discouraging automobile use and improving mass transit."

Nor can the Court conclude that repeal was reasonable in light of the surrounding circumstances. When the covenant was adopted in 1962, there was full knowledge of the need for mass transit in the New York metropolitan area, and it was well known that publicly owned commuter railroads would likely produce substantial deficits. The covenant was in fact adopted to protect pledged revenues and reserves against the possibility that such concerns would lead the Port Authority into greater involvement in deficit mass transit. After 1962, changes with respect to energy and environmental concerns "were of degree and not of kind. We cannot say that these changes caused the covenant to have a substantially different impact in 1974 than when it was adopted in 1962. And we cannot conclude that the repeal was reasonable in the light of changed circumstances."

Chief Justice Burger, in a concurring opinion, notes for emphasis "that the Court pointedly does not hold that, on the facts of the case, any particular 'less drastic modification' would pass constitutional muster."

Dissent

Mr. Justice Brennan, joined by Mr. Justice White and Mr. Justice Marshall, dissents. In his view, the Court has, for at least a century, "construed the Contract Clause largely to be powerless in binding a State to contracts limiting the authority of successor legislatures to enact laws in furtherance of the health, safety, and similar collective interests of the policy. * * * [The majority's decision] rejects this previous understanding and remolds the Contract Clause into a potent instrument for overseeing important policy determinations of the state legislature. At the same time, by creating a constitutional safe haven for property rights embodied in a contract, the decision substantially distorts modern constitutional jurisprudence governing regulation of private economic interests. I might understand, though I could not accept, this revival of the Contract Clause were it in accordance with some coherent and constructive view of public policy. But elevation of the clause to the status of regulator of the municipal bond market at the heavy price of frustration of sound legislative policy-making is as demonstrably unwise as it is unnecessary."

Mr. Justice Stewart and Mr. Justice Powell took no part in the decision in this case.

-- End of Section AA --