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Credible Commitment in the Unites States:

Structural and Substantive Limits

on the Avoidance of Public Debt

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Institutions are crucial to economic growth. Institutions that create the right incentives, that create confidence in the economic system, that allow business to achieve productive efficiencies and to realize the gains from trade, all make the chance of economic growth more likely. Institutions that do otherwise make economic growth very difficult. Institutions come in many forms and arise from different sources -- for example, standards of behavior established by religion, ideology or culture; or customs developed by firms interacting in the same industry. Over the centuries of our country's existence, the law has been one of the most important institutions advancing economic growth. A small, but important, part of that success comes from the law's role in creating confidence in government debt. The law established in the Constitution and the Supreme Court's development of that constitutional law have made the commitment by state and local governments to repay their debt appear credible to investors. That, in turn, has built a foundation for a more general perception that governments in the United States credibly commitment to their financial obligations.

This paper will examine the historical role of the Supreme Court in preventing state and local governments from repudiating their debt obligations. The Supreme Court has used two different parts of the Constitution to limit debt repudiations. The contract clause creates a substantive limit on debt repudiation: "No State shall . . . pass any . . . Law impairing the Obligations of Contracts...."[1] The clause applies with full force to all

political units of a state, including such things as towns, public authorities, and public utility districts. The Supreme Court has vigorously applied the contract clause to limit legislative modifications of state debt obligations. But the Court has not done the same thing for impairments of debt caused by the decisions of state courts. The modern Supreme Court, and many commentators, concluded that the contract clause does not apply to state court decisions. As a result, the Court has had to deal with judicial impairments of government debt in a different way.

Since the Constitution established a separate federal court system, the Supreme Court was able to fashion a federal commercial common law as a means of enforcing state and local contractual obligations. This federal common law took precedence over any conflicting state court decisions that impaired contract rights. The Supreme Court used this procedure to enforce midwestern railroad bonds throughout the late nineteenth century, in the face of massive repudiations based on state court decisions. In the 1930's, however, the Supreme Court ended the authority of the federal courts to make their own commercial common law and closed the only method available to police judicial contract impairments. So when the Supreme Court of Washington contorted Washington bond law in order to declare the Washington Public Power Supply System ("WPPSS") bonds invalid, the bondholders were left without any way to have that decision reviewed by the United States Supreme Court.

In the first part of this paper, I will examine the use of the contract clause to control legislative impairments of bond obligations. After tracing the development of the doctrine, I will focus on the argument that the contract clause is an unnecessary judicial interference with matters properly left to the legislature, given the modern market constraints that force governments to honor their financial obligations and given the ability of bondholders to protect themselves in the political process.

In the second part of the paper, I will describe the political and social factors that led to the Supreme Court's use of federal court jurisdiction to limit judicial impairments of bond obligations, explain the death of that doctrine and attempt to put the WPPSS default into context with other losses by investors in private nuclear power projects. As part of this analysis, I will try to explain how the Supreme Court's reluctance to overrule old precedent, coupled with its occasional reinvigoration of a constitutional doctrine like the contract clause, creates an uncertainty about the scope of the constitutional limits on government. This uncertainty itself acts as a check on government action, which is a useful result when the action would be repudiation of debt. Throughout my discussion, I will try to demonstrate that the history of the Supreme Court's review of legislative and judicial impairment of government debt obligations is a history of government officials acting responsively to economic problems, in order to improve

economic growth. It is also a history of the Supreme Court's responsiveness to political factors.

I. Legislative Impairments

A. The Framers' Intent

It is not surprising that many different parts of the Constitution protect property rights. The Framers were wealthy men who wanted to spur economic growth, of which they would be part. They wrote the Constitution to correct economic problems that persisted under the Articles of Incorporation, fearing commercial disintegration from state laws that compromised the payment of private debt, such as by payment in paper currency or by commodities (like cattle, tobacco or flour).[2] Shay's Rebellion figured prominently in the Framers' concern, because many were alarmed that it marked the beginning of a trend.[3]

It is difficult to know the precise meaning the Framers intended for the contract clause. The clause first appeared three months into the convention, when it was picked up from the Northwest Ordinance, which had been recently enacted to govern the Ohio territory.[4] There was little discussion in the convention about the clause; the Committee on Style, which first wrote the clause, left no record of its purpose. It seems that the general view of the Framers was to blame the debtor relief statutes and the related problems on the lack of a stable currency.[5] Not surprisingly, the clauses dealing with legal tender figured more prominently in both the convention and

ratification debates. The contract clause appears near the end of the sentence in the Constitution dealing with legal tender, likely signifying its smaller role in dealing with the economic problems.[6]

The brief record of the debate over the contract clause in the convention and its mention in the ratification controversy do give us some generally accepted information about the clause. The clause did not literally mean that all retroactive impairments of contracts were unconstitutional. Several members of the convention expressed their belief that retroactive modifications of contractual obligations were sometimes necessary; no one disagreed.[7] Contemporaneous discussions of the contract clause, often in the ratification debates, show that the proponents of the clause feared the "democratic excesses" typified by Shay's Rebellion, believed that many of the debt relief laws were directed at out-of-state creditors who lacked local political power, and saw the nation's credit worsening on the world markets as a consequence of these problems.[8] The supporters of the clause also emphasized the immorality of retroactive impairment of contract obligations.

B. Nineteenth Century Opinions

None of the discussions about the contract clause, either at the Constitutional Convention or during the ratification debates, ever mentioned the clause as limiting government contracts. Ironically, the first use of the clause by the Supreme Court came in Fletcher v. Peck,[9] a case in which Chief Justice Marshall

ruled that the clause protected contracts to which a state was a party, as well as those between private parties. The case involved Georgia's attempt to annul land grants fraudulently procured from the state, as part of the Georgia Yazoo land frauds. In his opinion, Marshall declared that the fraudulent procurement of state land grants from the Georgia legislature was not an appropriate subject for Supreme Court review, but that the legislature's annulment of the grants was within the Court's jurisdiction. As a retroactive impairment of contract rights, the annulment was unconstitutional under the contract clause.

Although the first contract clause case decided by the Supreme Court began the use of the clause as part of the credible commitment for governmental obligations, the vast majority of the nineteenth century contract clause cases dealt with government impairment of private contracts. The Marshall court steadily developed the clause into the primary constitutional protection of property rights. In large part, this stemmed from John Marshall's strong distrust of state legislatures, coupled with his ardent desire to protect property rights. As one of the leading experts on the contract clause has explained:

> By employing a far broader conception of contract than had been prevalent in 1787, and by combining this conception with the principles of eighteenth-century natural law, [John Marshall] was able to make of the contract clause a mighty instrument for the protection of the rights of private property. His personal dominance of the Court, at least until 1827, made it possible for him to give to that clause a breadth of meaning which not only exceeds that intended by the Framers, but also goes beyond the views expressed by Wilson, Paine, the members of Congress who took part in the Yazoo lands debate, and even Paterson and Hamilton. His four great contract opinions written between 1810 and 1819

are among the most important opinions, economic as well as legal, which have ever come from the Supreme Court.[10]

The Taney court continued this use of the contract clause, although it cut back on legislative limitations in some ways. Probably the best known part of this story is the Marshall Court's determination in Dartmouth College v. Woodward[11] that a corporate charter was a contract protected by the clause, followed eventually by the Taney Court's view that these contracts between firms and a state should be interpreted to give the state the greatest unbridled discretion. (E.g., Charles River Bridge v. Warren Bridge.[12]) Very few of the antebellum contract opinions by the Supreme Court dealt with governmental financial obligations. The most frequently litigated public contract issue before Court during this period involved immunity from state taxation. Although the Taney Court followed the Marshall Court in enforcing a state's grant of tax immunity, the Taney Court created the principle that a state could not contract away certain police or regulatory powers that are attributes of state sovereignty (such as the power of eminent domain).[13] This principle grew in importance over the years and, in the modern era, became the force that led to the virtual abandonment of the contract clause as applied to private contracts.

In Home Building & Loan Association v. Blaisdell. the 1934 landmark case in which the Supreme Court upheld the constitutionality of a Minnesota law that retroactively extended the time for mortgage redemption, the Court explained that all contracts contained an implied "reservation of essential

attributes of sovereign power."[14] Moreover, Blaisdell adopted a minimal threshold for states to overcome in enacting constitutional impairments. Constitutionality requires only a rational basis for the legislature's interference with private contract rights, very much like the modern, virtually nonexistent, substantive due process limitation on economic regulation.

Most of the cases involving either the repudiation or the alteration of public debt came to the Supreme Court from the 1860's into the 1930's and raised issues of judicial, not legislative impairments. These cases will be discussed below. There were few instances of debt repudiation by states or local governments prior to the Civil War. In the early 1840's, a number of states defaulted on canal and other public improvement bonds. Three states attempted to avoid their debt by claiming that the bonds were never legally valid -- Arkansas, Florida and Mississippi.[15] As best I can tell, those repudiations never led to any contract clause litigation. Beginning in the 1880's, a few cases before the Supreme Court raised the unconstitutionality of tax statutes that impaired municipal bonds. For example, after New Orleans borrowed money as authorized by state law, Louisiana restricted the taxing power of the city so much that it could no longer pay its debt.[16] This, the Court ruled, was unconstitutional under the contract clause. In fact, whenever the issue arose over the two centuries' existence of the Supreme

Court, which was a rare event, the Court routinely ruled that states could not impair their debt contracts.[17]

C. The Modern Law of Public Contracts

Only once this century did the Supreme Court allow the alteration of a municipal bond contract. The case, Faitoute Iron & Steel Co. v. City of Asbury Park,[18] involved a New Jersey depression-era statute that allowed for the compromise of the bonds of bankrupt municipalities. Upon the approval of 85% of the bondholders (and the approval of certain government bodies), all bondholders were obligated to accept the compromise payment. The Supreme Court rejected a contract clause challenge to the statute, noting that the city could not have raised its taxes enough to pay its creditors under the old terms. The composition plan, which was adopted to help the creditors, actually caused the market value of the bonds to increase sharply.[19]

The Supreme Court last dealt with a bond impairment in 1977, in United States Trust Co. v. New Jersey,[20] a case that reaffirmed the different approaches under the contract clause for modifications of public and private contracts. U.S. Trust dealt with the repeal of a 1962 covenant between New York and New Jersey that, as security for a Port Authority bond issue, expressly limited the ability of the Port Authority to subsidize rail passenger transportation from the Port Authority's revenues. When New Jersey repealed the covenant in 1974, United States Trust sued, alleging that the repeal violated the contract clause. The Supreme Court agreed.

In addressing the question of impairment, the Court observed that the effect of the repeal was uncertain:

> The fact is that no one can be sure precisely how much financial loss the bondholders suffered.... [B]ut the question of valuation need not be resolved in the instant case because the State has made no effort to compensate the bondholders for any loss sustained by the repeal.... [The covenant's] outright repeal totally eliminated an important security provision and thus impaired the obligation of the States' contract.[21]

While the Court recognized that the impairment might be constitutional if "reasonable and necessary to serve an important public purpose,"[22] the Court concluded that it, not the legislature, had to determine if the standard was met. As the Court explained, "complete deference to a legislative assessment of reasonableness and necessity is not appropriate because the state's self-interest is at stake."[23] Thus, although mass transportation, energy, conservation, and environmental protection were important state goals, the Court declined to balance them against the rights of the bondholders. Rather, the repeal had to be both reasonable and necessary. It was not reasonable because "the covenant was specifically intended to protect the pledged revenues and reserves against the possibility that such concerns would lead the Port Authority into greater involvement in deficit mass transit."[24] Although circumstances changed, the concerns of environmental protection and energy conservation "were not unknown in 1962, and the subsequent changes were of degree and not of kind."[25] And the repeal was not necessary because the covenant could either have been less drastically modified or the state could have adopted other,

albeit perhaps politically unpopular, means to improve mass transit.[26]

The Court's approach to determining the constitutionality of the bond impairment was in marked contrast to its approach in private contract cases. In the latter, the Court appears to balance the public purposes underlying the impairment against the effects on the parties whose rights are impaired. The balance is stacked in favor of constitutionality, however, with a rational basis for impairment seeming to suffice. For claimed impairments of public contracts, the U.S. Trust court expressed the new standard of "reasonable and necessary." But, more importantly, the Court showed that it does not automatically defer to the legislature when public contracts are involved.[27]

Justice Brennan (with Justices Marshall and White) dissented in the case, taking an approach similar to that used for private contract cases. He found the 1962 covenant to be an "effective barrier to the development of rapid transit [in] the port region that squarely conflicts with the legitimate needs of the New York metropolitan community, and will persist in doing so into the next century."[1,28] He thought the Court's suggested alternatives for funding mass transit unrealistic, and he disagreed with the Court's evaluation of the reasonableness of the impairment and the foreseeability of the mass transit problems.[29] He strongly objected to the finding of impairment, because he believed the bondholders suffered only minimal damage.[30] The entire history of the contract clause, in his view, ran counter to the Court's

attempt to check New Jersey's use of the police power. Finally, he concluded that the decision was "markedly out of step" with the prevailing judicial philosophy of deference to the legislature.[31]

The majority of the Court had not deferred to the legislature because the state's self-interest was at stake. As the Court explained:

> A governmental entity can always find a use for extra money, especially when taxes do not have to be raised. If a State could reduce its financial obligations whenever it wanted to spend the money for what it regarded as an important public purpose, the Contract Clause would provide no protection at all.[32]

Brennan's response was to point out that the bondholders' financial welfare was adequately policed by both the political process and by the bond marketplace itself.[33] If he is correct in this assessment, then he is also correct in his belief that there is no need for greater scrutiny of impairments of public, rather than private, contracts.

D. Political and Financial Markets

This issue of the efficacy of the political and financial markets, raised by Brennan in one brief paragraph at the end of his dissent, is at the heart of the modern legislative impairment, doctrine. One could say that Brennan must be correct because repudiation of state and local debt is so rare. But this is the state of the world with a constitutional contract clause, historically used to enforce public debt obligations. We need to assess, as best we can, the state of a world in which public debt is policed by only political processes and financial markets. My

sense is that the contract clause adds greatly to the restraints imposed by the political and financial markets.

I have no doubt that the bond market will quickly and accurately respond to the increased risk of public repudiation. Interest rates should rise dramatically for governmental bodies that renege on their obligations. But a defaulting government would have every incentive to act strategically, claiming that' the compromised bonds were somehow unique -- perhaps illegal from their inception -- so the repudiation of the bonds could not happen again, for a new bond issue. Further, many legislators (like many people) would be willing to trade an immediate, known, short-term gain for a future, uncertain, long-term loss. To that extent, the policing provided by the bond markets could not prevent an impairment of a governmental debt. Finally, even if the bond marketplace properly disciplines a reneging governmental body, there may be spill-overs affecting other, reputable governmental bodies who now appear riskier, because they or their bond projects are similar in some way to the culprit. More serious problems arise, however, in the political marketplace.

In his dissent in U.S. Trust. Justice Brennan points out that the holders of $300 million worth of Authority bonds (in the early 1970's) are not powerless in protecting their interests before the New Jersey legislature.[34] A simple answer is that the bondholders were -- they could not stop the repeal of the covenant. But the real question is how sure can we be that either the trustees representing millions of dollars worth of

bonds or the owners of the bonds themselves will get a fair hearing in the political process. To the extent that legislators respond to voters, there will often be more voters favoring the impairment. Take, for example, the bonds involved in U.S. Trust Co. There must have been a tremendous number of voters in New Jersey who would have favored using Port Authority money for mass transit, including many people concerned about the environment. They surely could have outvoted the New Jersey bondholders. Even if we stack the value of the bonds against the number of voters who would favor the covenant repeal (as Brennan implies), it is far from clear that high value gives the bondholders much political clout. It would be virtually impossible for a bond trustee to contribute to political campaigns; to use any of the bondholders' money for this purpose would surely violate the trustee's fiduciary duty. Of course the bondholders themselves can contribute -- to the extent allowed by campaign contribution laws. A large bond issue may be bought and then traded so the bonds end up in the hands of tens or even hundreds of thousands of people. Each bondholder would have a small stake, making less likely a healthy political contribution made to protect the bonds. There is, however, an even greater impediment to the political power of bondholders.

Governments do not lightly try to avoid their debt obligations. These problems have usually arisen when governments have been pushed to extreme positions, either as a result of a depression or the failure of an expensive capital project (such

as a railroad line or a nuclear power plant). Even if the bondholders ordinarily get fair consideration by legislatures, these extreme problems make it unlikely that bondholders will be treated fairly. When the problem arises from a failed capital project, the only choices usually available to a legislature are imposing the costs on innocent taxpayers, imposing the costs on innocent bondholders, or sharing between the two groups. It seems to me that bondholders will usually lose the political battle.

These problems with the political and financial markets support the rule of U.S. Trust Co. To the extent that the markets work, contract cases will not arise. If the markets do not work, the contract clause serves as the last vehicle for assuring the repayment of public debt -- i.e., assuring the government's credible commitment for its own debt.

II. Judicial Impairments

Swift v. Tyson,[35] an 1842 decision by the Supreme Court, seldom gets the recognition it deserves. This stems in large part from the Supreme Court declaring in 1938 that the Supreme Court itself had acted unconstitutionally in Swift.[36] Although by 1938 it made sense to overturn the rule of Swift, the Supreme Court exaggerated its constitutional analysis. Swift was a great case because it created a nationally uniform commercial law throughout the federal court system, by incorporating the principles of the law merchant into federal common law. Justice

Story, when he wrote the opinion for a unanimous Court in Swift, had hoped that the state courts would follow the federal common law, resulting in a truly uniform commercial law in all courts throughout the country. Although many state courts developed commercial common law that differed from the federal law, the existence of a unified commercial law throughout the federal court system allowed lending, sales and trade to flow between states in a way that would otherwise have been impossible. Swift enabled interstate commerce during an era when the national economy was beginning to grow. By 1938, the states had adopted uniform commercial law through uniform statutes, making nationwide federal commercial common law unnecessary. Consequently, the Supreme Court could overturn Swift in 1938, for its slight to both state law and state sovereignty, without harming interstate commerce.

Why the praise of Swift in a paper dealing with government debt? It was the rule of Swift that made it possible for the Supreme Court to police judicial impairments of government bond obligations. Recall that the contract clause prohibits states from "passing" laws that impair contracts. Literally the clause seems directed at legislative action. We do not view courts as "passing" laws; today we may say that courts "make" law, while in the nineteenth century commentators would have viewed courts as "finding" the common law. Further, the economic problems that led to the drafting of the contract clause stemmed from debtor relief measures promulgated by legislatures. Yet courts can do

as much damage to contract rights as legislatures. If the Supreme Court wanted to use the contract clause to overturn a judicial impairment, it would have had to confront the barriers imposed by both the language and the history of the clause. The Supreme Court had a way out of this dilemma through a combination of federal diversity jurisdiction and the rule of Swift.

The Constitution gives the federal courts jurisdiction over suits between citizens of different states and suits between a state citizen and a subject of a foreign country. In many ways, this grant of "diversity" jurisdiction is a counterpart to the contract clause. Like the contract clause, diversity jurisdiction was created in response to the economic problems of the times. The debtor relief laws raised fears that creditors would not be treated fairly in state courts, particularly out-of-state creditors suing residents of the forum state. Foreign lenders were also fearful that they would be prejudiced in state courts. The difficulty encountered by British creditors after the Revolutionary War, notwithstanding the agreement in the Treaty of Peace to allow their debt repayments, was just one example of the problem.[37] The drafting of the grant of diversity jurisdiction at the Constitutional Convention also supports the view that the jurisdiction was designed to deal with the economic problems. The grant grew out of an earlier proposal that the federal courts hear questions involving "the national peace and harmony."[38] Some delegates to the Convention even argued that

the grant of diversity jurisdiction made the contract clause unnecessary.[39]

A federal forum would provide some protection to nonresident creditors, but the real protection would come from applying federal law, rather than state law, in the federal court. It appears that the Framers expected federal law to come with the federal forum for certain classes of cases, particularly those involving anticreditor legislation.[40] This happened under the Rules of Decision Act, enacted by the first Congress. That statute required that "the laws of the several states . . . shall be regarded as rules of decisions in trials at common law in the courts of the United States...."[41] The term "laws of the several states" meant the general law throughout the United States. It did not mean that the laws of a particular state should apply in a diversity action in a federal court located in that state. Thus, the rule of Swift was consistent with the intent of the Framers and the first Congress.

A. The Railroad Bond Cases

The mid-nineteenth century was a time of great excitement over railroads. No midwestern town wanted to miss out on the opportunity to be connected to the coming nationwide railway network. The way to lure a railroad was to support, it from the proceeds of bond sales. But too often the railroads never materialized, sometimes from fraud and sometimes from incompetence. Then the local governments tried to avoid their financial obligations. A number of state courts aided this

process by declaring the bond issues illegal, regardless of conflicting prior state law. The debt repudiations across the midwest were massive. One commentator estimated that 15 to 25 percent of the outstanding municipal debt was in default after the 1873 depression;[42] another valued the total debt in default somewhere between $100 million to $150 million.[43]

The massive defaults rekindled the same fears that existed after the end of the Revolutionary War. To many, the state judicial repudiations were an example of unprincipled democracy. The state courts were made up of elected judges, who were seen as more prone to follow popular sentiment than legal precedent. In some instances, a state's decision to switch to elected judges was promptly followed by a change of precedent that resulted in bond issues suddenly rendered illegal.[44] Further, the repudiations had spillover effects, threatening the national economy by hurting the perceived credit-worthiness of all municipal bonds and even many bonds issued by the federal government and by private companies.[45]

This problem finally came to the Supreme Court in Gelpcke v. City of Dubuque.[46] an 1863 diversity case. When Dubuque had issued its railroad bonds in 1857, numerous decisions by the Iowa state courts were consistent in upholding the power of the Iowa legislature to authorize municipal corporations to issue bonds in support of railroads. The enabling act by the Iowa legislature for the Dubuque bonds said: "The proclamation, the vote, bonds issued or to be issued, are hereby declared valid ... and neither

the City of Dubuque nor any of the citizens shall ever be allowed to plead that the said bonds are invalid." Within two years, however, Iowa elected its Supreme Court judges for the first time and those newly elected judges reversed established precedent by holding that the legislature did not have the power to authorize municipalities to issue railroad bonds. When a bondholder sued for unpaid interest (a consequence of Dubuque's economic downturn following the panic of 1857[47]), the federal trial court, sitting in diversity, relied on the recent Iowa Supreme Court decision to hold the bonds invalid. On appeal, the United States Supreme Court reversed. The Supreme Court ruled that the federal courts had to apply the interpretation of state law that was in effect at the time the bonds were issued; the validity of the bonds could not depend upon a subsequent reinterpretation of state law by the state supreme court.

Gelpcke has puzzled legal scholars because it is not a precise application of the Swift doctrine, nor is it precisely a contract clause case. It does not quite fit with Swift because the rule of Swift should have led the court either to apply federal commercial law. or to defer to the state supreme court in applying state law.[48] The Court walked a middle line, by saying that federal law required the use of the older, superseded state law. It does not quite fit with the contract clause cases because it involves judicial, rather than legislative, impairment. The opinion is actually a little bit of both doctrines. Diversity jurisdiction (which invokes the rule of

Swift) is the only way that the dispute could get into the federal court. Even though the Gelpcke Court did not build its holding on the contract clause, it invoked at least the essence of that clause. In a later opinion, which also involve Iowa railroad bonds, the Supreme Court explained:

> We are of the opinion that under the statutes of Iowa, in force when the contract was made, the [plaintiff] is entitled to the remedy he asks, and this right can no more be taken away by subsequent judicial decisions than by subsequent legislation. It is as much within the sphere of our power and duties to protect the contract from the former as from the latter, and we are no more concluded by the one than the other. We cannot in any other way give effect to the contract of the parties as we understand it.''

The repudiation of municipal bond obligations happened over and over again. With elected trial and appellate judges in the midwestern states, it was to be expected that many of the bonds were declared void. This was a turbulent problem, but the Supreme Court, constantly relying on the Gelpcke doctrine, did all it could to uphold the obligation to pay the municipal bonds. The Supreme Court heard about 300 bond cases in the thirty years after Gelpcke; many more were resolved in the lower courts. But the high financial stakes, the injustice felt by taxpayers who had to pay for railroads that never materialized, and the outrage at "pro-business" federal judges led to fierce resistance to enforcement of the bondholders' judgments. The refusal of some local tax officials to raise the money needed to pay the judgments led to further litigation, which established the power of federal judges to compel local tax increases (relevant today in cases requiring local funding, such as school desegregation

and prison overcrowding)'. Some of these tax officials were jailed. Sometimes the resistance included violence; sometimes strategic behavior:

> In at least one community in Missouri, an angry mob killed several judges who had signed railroad bonds regarded as fraudulent. Such anger was translated into laws aimed at weakening the bondholders' ability to recover. Iowa and other states attempted to deny railroads and other nonresident corporations the right of doing business within the state unless they agreed not to remove litigation into federal courts. Often, local officials charged with enforcing the creditors' rights resigned rather than carry out court orders directing the localities to levy taxes to pay off the debts. There were instances of counties reorganizing themselves in attempts to escape payment. State judges, sensitive to their public standing as elected officials, generally sanctioned or ignored these efforts, thereby favoring debtor over creditor.[50]

Regardless of the local resistance to Gelpcke and the later cases, the Supreme Court succeeded at maintaining the creditworthiness of municipal bonds. "[B]y the-late nineteenth century, municipal bonds were hailed as second only to federal bonds in the security provided -- a result the investment houses attributed to continued Supreme Court policing of state judiciaries."[51]

Even though Gelpcke wove the Swift rule and the contract clause together, in the 1890's the Supreme Court began a gradual process of separating them.[52] Finally, in 1924, the Court flatly stated that the contract clause did not apply to judicial impairments, notwithstanding "[c]ertain unguarded language" in the railroad bond cases.[53] Finally, in 1934, the Supreme Court implicitly overruled Gelpcke when it said that it was bound to follow all state court interpretations of state constitutions and

statutes, thereby eliminating the protections afforded bondholders in diversity cases.[54] Despite these changes in the law, a few legal commentators have argued recently that the Supreme Court should extend the contract clause to judicial impairments, resurrecting the essence of Gelpcke. And the bondholders who suffered from a judicial repudiation of a huge bond issue in the WPPSS case tried unsuccessfully to get the Supreme Court to hear the case under the contract clause.

B. The WPPSS Bonds

The judicial impairment of the WPPSS bonds parallels the nineteenth century railroad bond cases. The problem stemmed from a capital project that never materialized, the last two of five nuclear power plants that WPPSS planned to build. WPPSS was an agency of the State of Washington created to produce energy for local municipalities and utilities. Part of the impetus for the massive nuclear power project came from the federal Bonneville Power Authority. Everyone projected increased demand for electricity in the Pacific Northwest, that Bonneville's hydro plants would eventually be unable to fulfill. Bonneville was a strong supporter of nuclear power, as were nearly all federal and state agencies at the time. WPPSS issued the bonds for the project. Bonneville indirectly guaranteed the bonds for the first three plants. The bonds for the last 2 plants were guaranteed by 88 municipalities, public utility districts and cooperative power agencies, located primarily in Washington, but also in Idaho and in Oregon. The 88 participants assumed a great

share of the risks of the project. Their participant agreement required them to pay WPPSS all the funds necessary to meet the bond obligations even if the plants were never built. That worse case possibility turned out to be true. The two plants were cancelled after $2.25 billion in bonds had been issued. The WPPSS cancellation resulted from the same problems that befell nuclear projects across the country: the projections of increased energy demand proved false; safety standards increased drastically after Three Mile Island and the "China Syndrome" scared the public; and construction costs soared, in part, from the need to satisfy the new safety standards, but also from the unexpected inefficiencies in such large and complex construction projects.

During this time of public opposition to nuclear power across the country, immense opposition developed in Washington to the WPPSS project itself and to its costs. This "mass insurgency" stemmed from the realization that some small utility districts faced a 100% rate increase within a six-month period; one small town faced a debt of $2,000 per capita as its share of the WPPSS bonds.[55] As a result, most of the participants repudiated their obligations. The $2.25 billion in bonds then went into default, by far the biggest default in the history of the municipal bond market.

In the middle of the political turmoil, the Washington Supreme Court released the Washington participants (the vast majority) from their obligations by ruling that they acted beyond

their legal authority when they agreed to pay for the plant, even if they might never receive any electricity.[56] This was stark judicial impairment of contract obligations; the precedent in Washington and throughout the nation established the authority of utility districts to "purchase" electricity with this type of financing guarantee. It is virtually impossible to find any legal basis for the court's decision. That opinion was followed shortly by the Idaho Supreme Court reaching the same conclusion in order to free the Idaho participants from their obligations. The Supreme Court of Oregon stood fast, however, and ruled that the participants situated in Oregon were bound under Oregon law.[57] With the vast majority of the participants released, the Washington Supreme Court then released the Oregon participants on the basis of mutual mistake and commercial frustration, recognizing that they could not fairly be held responsible for all the participants' obligations.[58]

The decision by the Washington Supreme Court ruling that the participants were freed of liability because of a lack of statutory authority had many similarities to the decision by the Iowa Supreme Court in Gelpcke, as the dissenting Washington judges pointed out. Both decisions were contrary to existing precedent; both decisions were made by elected courts in a time of political turmoil; and both decisions avoided great financial loss for residents. In one way, the WPPSS decision was much worse: there was no hint of any impropriety on the part of the WPPSS bondholders, while some of the railroad bondholders were

affiliated with the railroads and the construction firms that caused the financial losses. The bondholders made these claims when they tried to get the United States Supreme Court to accept an appeal from the Washington court on the basis of the contract clause. The Supreme Court declined to hear the case without any explanation, as is its practice.

The Supreme Court would have had to have extended the contract clause to judicial impairments if it were going to reverse the Washington Supreme Court. Given the history of the clause, that would have been a major change in the Court's jurisprudence, but it would not have been an unjustifiable change. Even though WPPSS was the largest ever default of its kind, there was much about the case that made it a poor vehicle for a sea change in doctrine.

Judicial elections are not as politicized as they were in the midwest in the nineteenth century, the defeat of Supreme Court judges in California in the past decade being the rare exception. Most judges and commentators discount the danger of interstate biases in state courts these days. As a result, Congress may soon abolish diversity jurisdiction. Spillover effects of an isolated bond impairment are unlikely today. Bond rating services, analysts and investors are able to identify the risks of particular kinds of bonds and of particular issues. Studies of the bond markets after the WPPSS default showed that the prices of other municipal public power bonds (many in the Pacific Northwest) and of nonpower municipal bonds actually rose

by a statistically insignificant amount, relative to Treasury bonds.[59] Nonpower bond offerings by Washington municipalities sold well after WPPSS.[60] The lack of a spillover from the WPPSS default may also be a consequence of WPPSS being the public counterpart to the large losses private investors in nuclear power suffered during this period. There is a long list of the ways equity investors suffered from nuclear power regulation -- the delayed opening of the Seabrook plant long after construction was complete, the closure of the new, operational Shoreham plant on Long Island, the frequent refusals by state utility commissions to pass on to ratepayer the costs of prudent investments in canceled nuclear plants, the popular referendums that made financing more difficult (such as by disallowing the use of "Construction Work In Progress" for ratemaking purposes), for example. Nuclear power was an intractable economic problem because a combination of factors meant innocent people had to lose money. The WPPSS bonds may just be another nuclear power investment that investors view as a species of its own.

None of these factors does any good for the WPPSS bondholders. The default on the $2.25 billion bonds led, as one would expect, to a massive securities fraud lawsuit against investment advisors, bond counsel, rating services, contractors, architects, engineers -- just about everyone involved in any way with the financing or the construction. That suit, along with other claims, ultimately led to settlements that produced about 25 to 30 cents on the dollar, of principal. (The interest,

totalling billions of dollars, was quickly out of question.) Thousands, probably millions, of people throughout the country suffered financial losses as a result of our country's uncertainty over nuclear power. The WPPSS bondholders were among the worst of those injured. One positive consequence, however, was that the bond market remained strong after WPPSS, despite the federal courts' refusal to help.

III. Conclusion

The structural and substantive protection of government debt in the Constitution, through federal court diversity jurisdiction, coupled with federal commercial common law, and through the contract clause, have been used well by the Supreme Court to maintain the credibility of debt commitments. The WPPSS default is a valuable reminder of the need for a court system free of political influence. Lifetime tenure is an important aspect of the federal judiciary. The federal appellate courts also benefit from being located away from the scene of economic and political conflict. People complain today about Congress suffering from "inside the beltway" mentality. That serves the Supreme Court well, however, because it can maintain an emotional distance from events it must judge. Likewise, the Court's reluctance to overrule precedent and to close off potential legal doctrine creates a beneficial "play in the joints" that the Court can use when necessary. The judicial impairment doctrine is a good example of that. Enough legal scholars periodically write

in favor of that doctrine, and the history is unsettled enough, that the Court could use the contract clause someday to review a judicial contract impairment. The Supreme Court is sensitive to its limited role, relative to Congress and the States, so it is usually cautious when it makes major changes in doctrine. But its ability to do this creates a useful risk for other governmental bodies that are tempted to stretch their authority. This, too, helps the credible commitment of our government.

Notes

1. U.S. Const., art. I, § 10, cl. .1.

2. See B. Wright, The Contract Clause of the Constitution, pp. 4-5 (1938); B. Thompson, "The History of the Judicial Impairment 'Doctrine' and It's Lessons for the Contract Clause, 44 Stan. L. Rev. 1373, 1380-81 (1992).

3. Some scholars believe that Shay's Rebellion was blown out of proportion in order to generate fears of economic instability that would then lead to support of the new Constitution. George Washington's presence at the Constitutional Convention in Philadelphia was a major reason delegates came, even though the call for a constitutional convention in Baltimore the year earlier had been a failure. Supposedly Washington was induced to come to Philadelphia by overblown pleas that events like Shay's Rebellion would become common.

4. Wright, pp. 6-9.

5. Wright, p. 13.

6. "No state shall enter into any Treaty, Alliance, or Confederation; grant letters of Marque and Reprisal; coin money; emit Bills of Credit, make any Thing but gold and silver Coin a Tender in Payment of Debts; pass any Bill of Attainder, ex post facto Law, or Law impairing the obligation of contracts, or grant any Title of Nobility." U.S. Const., art. I, § 10, cl. 1.

7. Thompson, p. 1381.

8. Thompson, pp. 1382-83.

9. 6 Cranch 87 (1810).

10. Wright, p. 28.

11. 4 Wheat. 518 (1819).

12. Charles River Bridge v. Warren Bridge, 11 Pet. 420 (1837).

13. West River Bridge v. Dix, 6 How. 507 (1848).

14. 290 U.S. 398, 435 (1934).

15. Thompson, p. 1407.

16. Wolff v. New Orleans, 103 U.S. 358, 365-68 (1881). See also Murray v. Charleston, 96 U.S. 432 (1878) (tax on municipal bonds); Von Hoffman v. City of Quincy, 4 Wall. 535 (1867).

17. United States Trust Co. v. New Jersey, 431 U.S. 1, 24 (1977).

18. 316 U.S. 502 (1942).

19. Id. at 513. The result in Faitoute parallels an aberrational case under the Hope Natural Gas doctrine. Hope requires utility commissions to set rates at a high enough level to enable regulated utilities to have an opportunity to earn "fair" profits. In Market Street Railway, the Court departed from that rule for a streetcar company that was going bankrupt as a result of bus competition. See Market Street Railway v. Railroad Commission, 324 U.S. 548 (1945).

20. 431 U.S. 1 (1977).

21. Id. at 19.

22. Id. at 25.

23. Id. at 26.

24. Id. at 32.

25. Id.

26. Id. at 30.

27. See T. Merrill, "Public Contracts, Private Contracts, and the Transformation of the Constitutional Order," 37 Case W. L. Rev. 597 (1987).

28. Id. at 36.

29. Id. at 40.

30. Id. at 41-44.

31. Id. at 59.

32. Id. at 26.

33. Id. at 61-62.

34. Id. at 62, n.18.

35. 41 U.S. (16 Pet.) 1 (1842!

36. Erie Railroad v. Tompkins

37. The Treaty of Peace, Sept 80, 82, specified that "creditors on either side, shall meet with no lawful impediment to the recovery of the full value, in sterling money, of bona fide debts heretofore contracted."

38. P. Borchers, "The Origins of Diversity Jurisdiction, the Rise of Legal Positivism, and a Brave New World for Erie and Klaxon, 72 Tex. L. Rev. 79, 92-94 (1993).

39. Thompson, p. 1385.

40. See Borchers, pp. 97-98.

41. Now codified at 28 U.S.C. § 1652.

42. G. Hempel, The Postwar Quality of State and Local Debt 18 (1971), quoted in Thompson, p. 1405.

43. T. Freyer, Harmony & Dissonance: The Swift and Erie Cases in American Federalism 60 (1981).

44. Thompson, p. 1405 n.188.

45. Id., p. 1411.

46. 68 U.S. (1 Wall.) 175 (1863).

47. C. Fairman, Reconstruction and Reunion, 6 The Oliver Wendell Holmes Devise History of the Supreme Court of the United States 935 (1971).

48. In its opinion, the majority acknowledged that federal courts were usually obligated to follow state decisions construing the state's own statutes, but nonetheless, the Court concluded (in notorious commentary): "We shall never immolate truth, justice and law because a state tribunal has erected the altar and decreed the sacrifice." 68 U.S. (1 Wall.) at 200.

49. Butz v. Muscatine, 8 Wall. 575, 584 (1869) .

50. T. Fryer, p. 60. Although contemporaneous commentators all viewed Gelpcke as fair and the state decisions as biased and threatening to the national economy, see Thompson, p. 1418 n.276, a "strong" argument can be made in favor of the state courts, based on the earlier state decisions improperly expanding local authority in the early excitement over railroads. See id.. p. 1413, n.242.

51. Thompson, p. 1432.

52. Central Land Co. v. Laidley, 159 U.S. 103, 109 (1895).

53. Tidal Oil Co. v. Flanagan, 263 U.S. 444 (1924).

54. Burns Mortgage Co. v. Fried, 292 U.S. 487, 493-94 (1934).

55. W. Sugai, Nuclear Power and Ratepayer Protest: The Washington Public Power Supply System Crisis, p. 4 (1987).

56. Chemical Bank v. Washington Pub. Power Supply Sys., 99 Wash. 772, 666 P.2d 329 (1983).

57. That opinion was written by Hans Linde, a nationally renown constitutional law professor from the University of Oregon School of Law, who had gone on to the Oregon Supreme Court. A small sample of two demonstrates that serious legal scholars who go into government service can resist political pressure and remain true to their principles. Besides Linde, the other member of my sample is William Baxter, the Stanford law professor who settled the AT&T case and dismissed the IBM case when he was Assistant Attorney General for Antitrust. It cannot be that academics are not political players; any faculty meeting shows otherwise. Maybe it is the security of a tenured professorship to return to.

58. Chemical Bank v. Washington Pub. Power Supply Sys., 102 Wash. 874, 691 P.2d 524 (1984).

59. J. Peavy & G. Hempel, The Effect of the WPPSS Crisis on the Tax Exempt Bond Market, 10 J. Fin. Res. 239, 244-45 (1987).

60. Thompson, p. 1453 n.483.