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The Upside-Down Law of Property and Contract: Of Fannie Mae, Freddie Mac, and San Jose Pensions

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It's very wonderful to be here and to speak in the shadow of Roscoe Pound, who was truly one of the ubiquitous legal figures of the 20th century. And as I like to remind Dean Poser, I think he did his best work when he was at the University of Nebraska. That puts me in deep trouble because he was 37-years-old when he left this place and I, unfortunately, am now over 70, a fact which I can no longer conceal from you.

I. THE UPSIDE-DOWN LAW

Now the topic I'm going to talk about today concerns what I perceive to be the upside-down relationships in financial takings. Let me first tell you how it is that I came to this topic, by way of an initial disclosure. I first encountered this subject not as an academic, but as a part-time practicing lawyer. It turns out that if you were to identify two of the thorniest legal issues today in the world outside the academy, here is what they would be: the first addresses how large numbers of state, county, and municipal governments will handle their

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pension obligations to their public union employees and indeed to their nonunion employees as well.[1] The second of these issues tackles the ultimate treatment of the private shareholders of the once defunct and now prosperous corporations, Fannie Mae and Freddie Mac, which are collectively called "government sponsored enterprises" or GSEs.[2] These two organizations are publicly chartered organizations, which were thrown into a conservatorship when they were on the brink of bankruptcy during the financial meltdown of September 2008, but have made a strong comeback since, and are now enmeshed in extensive litigation.[3] On the other side, I have also informally advised the then-mayor of San Jose, Chuck Reed, on the many pension issues that face San Jose, most of which arose out of the litigation over Measure B, a popular referendum that passed with strong support in February 2012.[4]

I also advise several institutional investors on an ongoing basis about the progress of the litigation in the various lawsuits over the government's efforts to claim all the profits from the newly revived entities. I want to make it clear that there are both difficulties and advantages in engaging in these consulting relationships. The difficulty is, you always wonder about your own independence when you have some kind of client interest. The advantage, which I think more than outweighs this inescapable drawback, is you actually know something about the problems because you have access to people who are extremely conversant on these topics. The synergy that you hope to achieve, and can achieve, is to take the general knowledge from your academic work, and to combine it with the particular information that the clients have about the complex history of these disputes. This synergy should allow you to come to a reasonably coherent understanding of the particular problem in light of the general theory. Both these topics remain very much in the news. Indeed, I picked this topic some months ago in talking to Dean Poser, and am pleased, after a fashion, that it will continue to retain its importance going forward, as indeed

1. For a thorough overview of these issues, written prior to the recent litigation, see Amy B. Monahan, *Statutes as Contracts? The "California Rule" and its Impact on Public Pension Reform*, 97 IOWA L. REV. 1029 (2012).
2. For an account of the historical evolution of these bodies, see *History of the Government Sponsored Enterprises*, FED. HOUS. FIN. AGENCY, OFFICE OF THE INSPECTOR GEN. (last visited Oct. 16, 2014), http://fhfaoig.gov/LearnMore/History, *archived at* http://perma.unl.edu/RVM4-99F2. FHFA is now the conservator of the private shareholders of both Fannie and Freddie.
3. *Id.*
4. The full title is Article XV-A Retirement, Public Employee Pension Plan Amendments—to Ensure Fair and Sustainable Retirement Benefits While Preserving Essential City Services, which was adopted by the voters on February 8, 2012 and approved by the City Council on March 6, 2012.

it has.[5] It is propitious to talk about the connection between these two topics on this particular occasion.

Now the title that I gave on this lecture indicates that I think the whole law of financial takings is upside-down. Let me explain what the conclusion is, and then indicate my reasons for defending it. The way that the law is working today is that all too often contracts dealing with financial transactions are routinely subject to radical revisions by the government party, retroactively on a unilateral basis. That degree of flexibility is accorded to the government in the context of investments and loans made in cases where predictability and security of exchange are very important to the people who have initially committed their capital to the venture, and now have to rely on the law to secure repayment. In contrast, the labor contracts entered into by municipal governments are much more complicated arrangements in which there is no clear sequence of performance. Both parties perform in an interactive fashion, because typically the conduct of one is dependent on the actions of the other. In this setting, it is critical for business arrangements to be subject to constant modifications, at least with respect to the work that has yet to be performed by these government employees.

The position that I want to defend calls for strong protection of capital investments, whether by debt or equity. In contrast, the need for good faith adjustments in labor contracts calls for a degree of flexibility of management. The intellectual case for this approach has its origins in the Roman law distinction between bona fide contracts and contracts that were *stricti iuris*.[6] A contract for hire (whether for employment or the license of land) fell into the first category, because it was well understood that each party had to adjust his conduct to take into account what was done by the other. Put otherwise, the various promises in these cases were often dependent on each other. But *stricti iuris* contracts arose when there was a promise for the payment of a definite sum, where the complete performance by one side created the strict obligation on the other. In these cases, there is typically a simple obligation to pay, for which it may be possible to set up de-

5. For the most recent defense of the government's position, see the decision of Judge Royce Lamberth in *Perry Capital v. Lew*, No. 13–1025, 2014 WL 4829559 (D.D.C. Sept. 30, 2014). For my exhaustive critique of the decisional law, see Richard A. Epstein, *The Government Takeover of Fannie Mae and Freddie Mac: Upending Capital Markets with Lax Business and Constitutional Standards*, 10 N.Y.U. J.L. & BUS. 379 (2014) [hereinafter "Epstein, *Government Takeover*"]. For my critique of *Perry Capital*, see Richard A. Epstein, *Withdraw and Correct the Error of Thy Ways: The Perry Capital Opinion*, FORBES (Oct. 10, 2014), http://www.forbes.com/sites/richardepstein/2014/10/10/withdraw-and-correct-the-error-of-thy-ways-the-perry-capital-opinion/, *archived at* http://perma.unl.edu/ER2P-Y3C4. I shall not go into these detailed arguments in this lecture.

6. For the basic account, see BARRY NICHOLAS, AN INTRODUCTION TO ROMAN LAW 163–65 (1962).

fenses based on fraud or duress. But because one side has typically performed, there are no interactive conditions to worry about. The way in which Gaius stated the distinction was as follows:

> Likewise, in contracts of this description [consensual contracts, including sale, hire, partnership, and agency] the parties are reciprocally liable, because each is liable to the other to perform what is proper and just; while, on the other hand, in the case of verbal obligations [for payment of liquidated sums] one party stipulates and the other promises; and in the entry of claims one party creates an obligation by doing so, and the other becomes liable.[7]

Basically, the unperformed obligations in *stricti iuris* arrangements all run in one direction, which is why they were called unilateral contracts in Roman law. In contrast, the unperformed obligations in such contracts as hire and sale run in both directions, which is why "*[b]ona fides* colours every aspect of these contracts."[8]

Thus far, under current law each of these two problems has received the treatment that is appropriate to the other. Although it is too early to say what the ultimate outcome will be in either the San Jose pension litigation or the Fannie and Freddie cases, the early signs are troublesome. Right now, a lot of legal authority stands for the proposition that once a person, say a public service employee, is hired, the pension rights are vested and fixed *as of the time of initial employment*, so that they cannot be reduced even with respect to future work, even if other terms of that contract are subject to variation in the ordinary course of business.[9] In contrast, today when the discussion turns to investments in shares and bonds, the government is given much more flexibility in its ability to reduce its obligations.[10] Each subject matter area has taken the rules that seem appropriate to the other. The law needs flexibility in labor-management type situations. It needs more predictability with financial arrangements. Accordingly, any constitutional arguments that point in the opposite direction cry out for serious reflection and reexamination.

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7. THE INSTITUTES OF GAIUS bk. III, ¶ 137 (Francis de Zulueta ed., 1946). A verbal contract is created by a stipulation, or a question and answer method. It covers both payments by a debtor and a full range of guarantee obligations. *See id.* ¶¶ 92–120.
8. NICHOLAS, *supra* note 6, at 163.
9. *See, e.g.*, Allen v. City of Long Beach, 287 P.2d 765 (Cal. 1955); Kern v. City of Long Beach, 179 P.2d 799 (Cal. 1947); *see also* Monahan, *supra* note 1, at 1032 ("In particular, courts in California and the twelve other states that have adopted California's precedent have held not only that state retirement statutes create contracts, but that they do so as of the first day of employment. The practical result of this rule is that pension benefits for current employees cannot be detrimentally changed, even if the changes are purely prospective. Thus, the only readily available option for changing employee pension benefits in these states is to limit such changes to new hires.").
10. *See* Connolly v. Pension Benefit Guar. Corp., 475 U.S. 211 (1986); Pension Benefit Guar. Corp. v. RA Gray & Co., 467 U.S. 717 (1984).

II. PHYSICAL OCCUPATION AND REGULATORY TAKINGS

In order to undertake that task, it becomes necessary to figure out how best to structure the basic constitutional law of takings, including for this purpose laws dealing with the impairment of the obligation of contract. There are two ways to undertake this inquiry. One is a sort of highly normative framework that I tend to prefer in my writings on contracts and takings.[11] The other is to recount the rather messy situation on the ground with respect to the law. Under any sound normative framework, there is no ironclad distinction that can be drawn between those takings that involve government occupation of private property, which may either be kept or transferred to other persons, on the one hand, and government restrictions on how an owner may or may not use the property in question, on the other. In both settings, there is a taking of some property interest. In one case the interest is possessory: it may be the entire fee simple, or it may be a lease or life estate. And in the other case, it is a servitude, a term that covers both restrictive covenants (which limit the way an owner can use his property) and easements (which allow someone else to enter your property for some limited and specified purpose). Regardless, in both settings the correct standard of financial responsibility requires the government to compensate people for the loss that they've sustained, so that the government always faces a price equal to the loss it imposes on others whenever it exercises its unilateral option as sovereign under its eminent domain power. One of the real functions of the eminent domain law is, of course, to pay for what is taken. But equally important is a second function of the takings law, which is to send price signals to the world at large, so that when the price, measured in terms of private losses of the property owner, turns out to be too high, the government will decide not to take it, and no one will observe any transactions. If, for example, the government gains are a hundred and the private losses are a thousand, the deterrent effect is dominant, so that the social gains from *not* taking are very large, even though there's no legal dispute, no intervention, and no valuation problem to be dealt with.

Unfortunately, this uniform framework is not the way in which the current takings law is organized. With respect to what the courts call occupations or per se takings, *Loretto v. Teleprompter CATV*,[12] decided over 30 years ago, adopts a per se compensation requirement to the extent that the government has taken, or authorized a private party to occupy, property, either in whole or in part. However, in what is surely the single most important regulatory takings case of the last

11. *See* RICHARD A. EPSTEIN, TAKINGS: PRIVATE PROPERTY AND THE POWER OF EMINENT DOMAIN (1985); Richard A. Epstein, *Toward a Revitalization of the Contract Clause*, 51 U. CHI. L. REV. 703 (1984).

12. 458 U.S. 419 (1982).

seventy-five years, *Penn Central Transportation Co. v. City of New York*,[13] a very different rule has emerged for actions that restrict the use that an owner can make of his own property, without the government entering into occupation of any fraction of it.

The concrete dispute involved the decision of New York City to impose a landmark designation on Grand Central terminal, which prevented the construction of a Breuer Tower in what New York law recognized as a full-fledged property interest, namely, the air rights over the terminal building.[14] No one doubts that the restriction on construction for aesthetic purposes is done for a public use. But the operative question remains: must the government pay compensation to the owner whose air rights are taken in order to improve the overall situation for society? On that question, the per se rule of *Loretto* did not overcome the basic rule in *Penn Central*, which celebrated the ad hoc balancing of the burden of the restriction against the public gains in question. That formula has led to interminable legal disputes as to what should be done when the legal restrictions reduce sharply (but do not wipe out) the value of the property in question.[15] The standard formulation of that test is said to look at three factors, none of which are conceptually justified in Justice Brennan's *Penn Central* opinion. The first of these examines the economic impact of the regulation. The second asks whether the regulation interferes with "investment-backed expectations"—a mysterious term that the Court never defined. And the third looks to the nature and character of the government action, which is code for saying that occupation is subject to

13. 438 U.S. 104 (1978). For my most recent critiques of this most troublesome development, see Richard A. Epstein, *The Common Law Foundations of the Takings Clause: The Disconnect Between Public and Private Law*, 30 TOURO L. REV. 265 (2014); Richard A. Epstein, *The Takings Clause and Partial Interests in Land: On Sharp Boundaries and Continuous Distributions*, 78 BROOK. L. REV. 589 (2013).

14. *Id.*

15. For a tiny fraction of the materials that grapple with this issue, see Tahoe-Sierra Pres. Council, Inc. v. Tahoe Reg'l Planning Agency, 535 U.S. 302 (2002); Nollan v. California Coastal Comm'n, 483 U.S. 825 (1987); First English Evangelical Lutheran Church v. Cnty. of Los Angeles, 482 U.S. 304 (1987); Keystone Bituminous Coal Ass'n v. DeBenedictis, 480 U.S. 470 (1987). For a defense of the doctrine, see Margaret Jane Radin, *The Liberal Conception of Property: Cross Currents in the Jurisprudence of Takings*, 88 COLUM. L. REV. 1667 (1988) (introducing the term "conceptual severance" to justify the *Penn Central* result). For my criticism of the doctrine, see Richard A. Epstein, *From* Penn Central *to* Lingle*: The Long Backwards Road*, 40 J. MARSHALL L. REV. 593 (2007); Richard A. Epstein, *Takings: Descent and Resurrection*, 1987 SUP. CT. REV. 1 (1987); Richard A. Epstein, *The Ebbs and Flows in Takings Law: Reflections on the* Lake Tahoe *Case*, 1 CATO SUP. CT. REV. 5 (2002). For useful discussions of the issue, see Benjamin Allee, *Drawing the Line in Regulatory Takings Law: How a Benefits Fraction Supports the Fee Simple Approach to the Denominator Problem*, 70 FORDHAM L. REV. 1957 (2002); John E. Fee, *Unearthing the Denominator in Regulatory Takings Claims*, 61 U. CHI. L. REV. 1535 (1994).

higher standards than restrictions on use or disposition.[16] On the facts of the case, the government was able to prevail in large measure because Grand Central terminal was already up and running and making money, so that the proposed use of the air rights could be regarded (wrongly) as icing on the cake.[17] But that narrow set of facts leaves uncharted the way in which the test will be applied when the restrictions are imposed on vacant land, for which that proposition is not true.

On the question of what kind of loss is too large for a property owner to sustain without compensation, there has been no definitive general answer. Indeed, the only clear guidance at the Supreme Court level is found in *Lucas v. South Carolina Coastal Council*,[18] which imposes a clear duty to compensate only when the regulation wipes out all viable economic use. But that principle itself opens a royal road of government evasion. No one quite knows what counts as viable economic use, so that the prudent local government steps back an inch or two from the brink, and appropriates for itself 90% of the value of any given asset, say, for no cost to itself at all. It is well understood that confiscation would become a common art form if the government could take land or other forms of private property without any compensation to the original owner. The same factional dynamic of political overreach is very much at work in the regulatory takings area. Yet the Supreme Court has done nothing to clean up the intellectual mess in the 37 years since *Penn Central* was handed down.

So the challenge that one has to meet under the modern law, unfortunately, is not how these two cases would be decided if Richard Epstein were Tsar and everybody in the room bent to his will, however admirable a state of affairs that might be. Instead, the sad truth is that the arguments just summarized have, as best I can tell, been completely unpersuasive to members of the current United States Supreme Court. There, liberals and conservatives may differ on points of detail with respect to the rules, but both sides seem united in their defense of the basic distinction between physical and regulatory takings, which are then subject to very different standards of judicial scrutiny. For the constitutional experts in the audience, the gap between the two halves is enormous: there's a strict scrutiny rule for physical occupation, but a rather forgiving rational basis standard for regulatory takings, even though the risk of political machination is every bit as large in the latter case as in the former one.

16. *Penn Central*, 438 U.S. at 124.
17. *Id.*
18. 505 U.S. 1003 (1992).

III. THE THIRD LEG OF THE STOOL: FINANCIAL TAKINGS

At this point, it is imperative to note that I have thus far spoken about physical and regulatory takings as if they exhaust the entire domain of takings law, but that is not the case. Recall that our topic is, in fact, financial takings. And the question that one has to ask is, where do these financial transactions fit into the overall picture? The effort to understand what is at stake in this area leads into obscure and often unexplored corners of takings law. But one useful place to start is with the common lien used to secure a mortgage, which is neither a possessory interest on the one hand nor a land use restriction on the other.

Start with the fundamentals. These liens are a divided interest in property. If the debt is paid off in the ordinary course of business, the lender never goes into possession. If it is not paid off, then foreclosure can put the lender in possession of the property at some future time. So if I have a lien on your property for $20, and you do not pay me the $20 from your other funds, I can foreclose on the lien, sell the underlying property, recover my expenses, get paid my accrued interest, and get repaid my $20 loan. You then get whatever is left over. To use the traditional property rights language, on the creation of the mortgage, the borrower has what is called the "equity" or "the equity of redemption"—so called because the borrower's interest was protected in the English Courts of equity—that is the matching part with my lien. The two together comprise the entire property. And so the question is, how do we start thinking about liens within the property and takings context?

The second area has to do with contract rights. It turns out, for example, that I have a contract right to enforce a particular agreement against you. The government then forces me to sell that right to it, so that it can enforce the right in my place. The question then arises whether they have to pay for the assignment, and if so, how much it is going to cost. At the outset it looks as though you're dealing with property interests called liens and contract rights, but, in fact, if you go through the takings law, I think most courts have come to the right conclusion that there is, in fact, no categorical distinction between the ways in which these two kinds of interests ought to be treated. Both of them have some degree of purchase on the legal imagination, so that the only question is what should be done to protect those interests.

When I talk about this issue with many people, their first instinct in dealing with the Fannie and Freddie situation is that when you are looking at these kinds of rights, one should by all means put the shareholder claims into the framework of the regulatory taking, so that there is a relatively low standard of review that will attach to the examination of government behavior. Just that position was taken in the Government's motion to dismiss in *Fairholme v. United States*:

> Even if conservatorship of a regulated financial institution could give rise to a takings claim, which it cannot, plaintiffs fail to explain how the Government's actions could be a taking under the Fifth Amendment. Because plaintiffs do not allege a physical taking of their property, the complaint can only be understood to allege, at best, a regulatory taking.[19]

Its first argument was that this regulation did not amount to a taking because it did not deny "all beneficial or productive use of land."[20]

In order to evaluate these claims with some degree of care, it is important to stress at the outset that the supposed distinction between physical and regulatory takings offers a wrong description and a wrong analysis of the underlying problem.[21] In order to set out the proper framework, it is important to revert to a 1960 case called *Armstrong v. United States*,[22] which involved the common situation of a ship lien that is imposed upon several vessels owned by the United States Navy. For those people who are deeply versed in the law of material-man's liens and mechanic's liens, this case offers a treasure trove of information. But to the vast majority it will simply elicit blank stares. To get the blankness out of those expressions, I want to stress that in the study of constitutional law, if the courts do not get the law of property correct, they will always misfire on the constitutional doctrine, which is predicated on a strong understanding of that basic private substrate. In essence, my plea is for lawyers to remember their first year classes in property, contracts, restitution, and torts as the foundations for constitutional law, which are ignored only at their peril.

What happens in *Armstrong* is that navy boats are subject to repair in Maine under the supervision of a general contractor. That general contractor is essentially the maestro, the conductor, whose job it is to make sure that all the subcontractors do their work in the appointed fashion, for which he then pays them. In this particular case, a given subcontractor properly did his work on the boat. The general contractor may have been a splendid maestro, but he was a lousy paymaster, and he did not pay so much as a penny of the money owed to the subcontractor. The applicable rule for these cases is well established: a subcontractor who is not paid by the general contractor can impose his lien on the property on the theory of unjust enrichment. The owner of the boat got the benefit of the work for which he has to pay, unless the subcontractor signed a valid lien waiver, which is typi-

19. Motion to Dismiss for United States at 41, Fairholme Funds, Inc. v. United States, 114 Fed. Cl. 718 (2014) (No. 13-465 C).
20. *Id.* at 32.
21. For a lengthy treatment, see Epstein, *Government Takeover*, *supra* note 5, at 420–24.
22. 364 U.S. 40 (1960).

cally completed only when the money is paid over. But here, the money was not paid, and the lien was allowed to prevent the owner of the boat, the Navy, from being enriched by getting its labor and materials for free. Once the lien was properly imposed, the United States did not do the honorable thing. It did not pay the lien. Instead, it sailed the boats out of Maine waters and thereby dissolved the lien, because the boats were now outside Maine's jurisdiction. In response, the lienholder went to the United States claiming, as it were, it may be able to sail this boat out of Maine waters to defeat the lien, but it cannot get off scot-free, for now the Navy becomes a general debtor and the subcontractor a general creditor whose claim is equal to the value of the lien. The government could dissolve the lien but only if it paid the debt out of general funds. Justice Hugo Black, who decided the case, made this sensible observation. His basic position was that these vessels were built for the benefit of all the citizens in the United States. It would be rather odd if some huge fraction of the cost of these repairs should be saddled on this lonely subcontractor in Maine, so the public that benefits from the repairs should pay for them even if they dissolve the lien. His famous and oft-quoted sentence reads as follows: "the Fifth Amendment's guarantee that private property shall not be taken for a public use without just compensation was designed to bar Government from forcing some people alone to bear public burdens which, in all fairness and justice, should be borne by the public as a whole."[23]

Note that he phrases this as a categorical rule. That result, moreover, seems exactly the right result, for the ultimate purpose of any lien imposed upon property is to be reduced to possession in the event that the underlying debt is not paid. Any such lien is best thought of as a future possessory interest; it should be understood to create a per se right under *Loretto*, which the government removes only at its peril. In contrast, if one treated the lien destruction as a regulatory taking, then the so-called mere diminution in value would not generate any government obligation to compensate. But can anyone believe that the government could dissolve unilaterally any lien on its property so long as it is prepared to pay, say, twenty, thirty, or forty percent of the debt that this lien secures? Indeed, the approach in *Armstrong* is followed in the bankruptcy context, where the holder of a secured interest in bankruptcy can be denied the benefit of its lien only if it is given an "indubitable equivalent" for the property that is left within the bankruptcy organization.[24] The distribution of gains from this pro-

23. *Armstrong*, 364 U.S. at 49.
24. *See* 11 U.S.C. § 361(3) (1996). For discussion, see Douglas G. Baird & Thomas H. Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy*, 51 U. Chi. L. Rev. 97 (1964).

cess runs as follows: the reorganized firm gets to keep some property in the business subject to a secured loan, and can claim the profit from that interest. The basic rule is that you could keep the property and get the gains from it, but you have to give the lienholder a consideration equal to the full value of the lien itself that has been surrendered.

Now this position applies not only to the cases where the government simply dissolves the lien, but equally well to other situations. Suppose one contractor has a first lien on the boat. The government then awards some other party priority over the first lien, so that the first lien is now demoted to a second lien. The value of the first lien is sure to be diminished by its subordination, and the result is a taking equal to the difference in the value, be it large or small, of the lien between its first and second positions. In some cases, large sums of money could turn on the lien priority, especially in cases where the value of the underlying property is either low or highly variable. It need not follow that the reduction in priority results, however, in an uncompensated taking. It could well be that the higher priority is awarded for advancing new money to the venture, which increases its value by more than the amount of the lien. Essentially the whole system is organized around the principle that loans are protected in the order in which they are perfected, subject to new liens with higher priority that are offset by new value that functions as the just compensation required under the Fifth Amendment. The only way that this system can operate is if the consistent set of priorities created at the outset survives throughout the life of the loan. The basic logic of takings that applies to the taking of land for government use also applies to liens, without missing a beat. If the government can defeat the priority system with the stroke of a pen, the entire system of commercial credit will be at risk. And for these purposes, two points do not matter: first, whether we are dealing with traditional liens or with sailing a boat into international waters, and second, whether we are dealing with physical takings or the conscious alteration of the capital structure of Fannie and Freddie.

IV. THE FANNIE AND FREDDIE BAILOUT

This somewhat lengthy exposition of the law of mortgages helps clarify the events that surround the government's bailout of Fannie and Freddie from 2008 to the present.[25] Go back to July 2008 when the financial markets in the United States became edgy. There are many explanations as to how the mortgage markets took the hit, but here are two factors that contributed to the difficulties.[26] The first is

25. For my exhaustive account of these transactions, see Epstein, *Government Takeover*, *supra* note 5.
26. For discussion, see *id.* at 385–89.

the creation of a lot of cheap money, i.e. money that is available at low rates of interest. But the only way that people could get access to the money was through the mortgage market. This led to two destructive behaviors. First, market participants bid up the price of residential homes, the complementary asset, in order to take advantage of these low-interest loans. Second, many of these mortgages were underwritten by Fannie and Freddie, such that the bank that made the loan could turn to the government if the debtor was unable to make payments on the loan. Lenders thus lent on the strength of the government guarantee, not on the value of the security, which often is residential real estate bought with as little as three percent down. When the market tops out, the decline does not occur slowly and serenely. It takes place with a magnificent thud. And the question is, what are we to do?

The government response came in the form of the Housing and Economic Recovery Act (HERA), passed in the summer of 2008,[27] which created a new government agency called the Federal Housing Finance Agency[28] that was charged with developing the government response to a possible mortgage meltdown. Just that happened in September 2008, in the midst of the Obama/McCain presidential campaign. In response to the difficulties, the Treasury Department, under the leadership of then-Secretary of the Treasury Henry Paulson, and FHFA, under the leadership of a former Treasury official Edward DeMarco, negotiated a comprehensive bailout of the Fannie and Freddie operations.[29] Ultimately, the total lent reached about $188 billion, on lines of authorized credit that reached $400 billion: real money, even today.

That government bailout was negotiated when the FHFA, acting as a conservator, displaced the private boards of directors of Fannie and Freddie, and gave Mr. DeMarco exclusive and extensive powers to manage their affairs.[30] At that point, FHFA and the Treasury entered into a deal known as the Senior Preferred Stock Purchase Agreement (SPSPA).[31] Under that deal, the government agreed to lend large sums of money to the two GSEs to allow them to stabilize their balance sheets. In exchange the Treasury took back a senior preferred issue. The senior preferred, in effect, received the first priority

27. Pub. L. No. 110-289, 122 Stat. 2654 (2008).

28. For information about FHFA, visit http://www.fhfa.gov/, *archived at* http://perma.unl.edu/9KZT-F8VU.

29. For his account, see EDWARD J. DEMARCO, FED. HOUS. FIN. AGENCY, ZILLOW AND THE BIPARTISAN POLICY CENTER: GETTING OUR HOUSE IN ORDER (2013), *archived at* https://perma.unl.edu/X58G-34CW. This is also discussed in Epstein, *Government Takeover*, *supra* note 5, at 385–86.

30. *See* 12 U.S.C. §§ 4502(9), 4617(a) (2012).

31. The basic SPSPA and its three amendments can be found at http://www.fhfa.gov/Conservatorship/Pages/Senior-Preferred-Stock-Purchase-Agreements.aspx, *archived at* http://perma.unl.edu/7948-4B3B.

against future cash flows from the mortgages. The former preferred in both Fannie and Freddie became a junior preferred, and the common stock remained common stock. The senior preferred did not come cheap to Fannie and Freddie. When interest rates were generally low, it carried annual interest at 10% for interest payments made on time, and 12% if Fannie and Freddie decided at their own option to defer the interest payments in order to husband the cash for their own operations, which is a perfectly common commercial arrangement.[32] The SPSPA issued to the government warrants it to purchase 79.9% common stock for the nominal sum of $0.00001 (that's four zeros) per share. They stopped at 79.9% of the common because the government did not want to include the Fannie and Freddie liabilities on the consolidated balance sheet for the federal government.[33]

So, is this a good or a bad deal for the parties? The point is hard to decide as of 2008, but I think it is possible to explain why issuing the senior preferred stock in 2008 made sense for everyone. The government is saying "look, we have certainly taken your property by putting a first lien on the assets through the senior preferred, but that result is just fine." Recall that under the general analysis, anytime a new creditor subordinates an old creditor, a taking of the initial lien occurs. The exact logic applies to senior and junior preferred as it does to first and second mortgages. But this senior preferred was created for the best of reasons, because it was payment for the receipt of what turned out to be cash advances to Fannie and Freddie of $188.5 billion.[34] The senior preferred at an attractive interest rate makes sense from the point of view of the taxpayers. The rescue operation makes sense from the point of view of the private holder of the preferred and common stock, because at the end of the day the new junior preferred is worth more after the infusion of capital than the old top-priority

32. The key provision of the stock certificates for both Fannie and Freddie read:

> "Dividend Rate" means 10.0%; provided, however, that if at any time the [GSE] shall have for any reason failed to pay dividends in cash in a timely manner as required by this Certificate, then immediately following such failure and for all Dividend Periods thereafter until the Dividend Period following the date on which the Company shall have paid in cash full cumulative dividends (including any unpaid dividends added to the Liquidation Preference pursuant to Section 8), the "Dividend Rate" shall mean 12.0%.

FED. HOUS. FIN. AGENCY, CERTIFICATE OF DESIGNATION OF TERMS OF VARIABLE LIQUIDATION PREFERENCE SENIOR PREFERRED STOCK, SERIES 2008-2 § 2(c) (2008), *archived at* http://perma.unl.edu/EKW6-5KW9.

33. FED. HOUS. FIN. AGENCY, AMENDED AND RESTATED SENIOR PREFERRED STOCK PURCHASE AGREEMENT § 1 (2008), *archived at* http://perma.unl.edu/265A-AVMM ("'Warrant' means a warrant for the purchase of common stock of Seller representing 79.9% of the common stock of Seller on a fully-diluted basis . . . .").

34. *See* Nick Timiraos, *Why Fannie and Freddie Are Paying Back Uncle Sam*, WALL ST. J., Nov. 6, 2013, *archived at* http://perma.unl.edu/6ZAQ-39AR (giving an account of the $188 billion bailout).

preferred was worth in the precarious state prior to that rescue operation. The just compensation principle is therefore satisfied by this initial transaction because the money received is worth more to Fannie and Freddie than the subordination of the existing private shareholders. Looked at from this point of view, the SPSPA becomes a win-win transaction, which is exactly how government rescue operations are supposed to work. Things are much more complicated with respect to the nominal price for the warrants on the common stock. I'm not a great fan of those bargain purchases that seem to put a disproportionate burden on the common shareholders, but, as warrants are often issued in private commercial arrangements, I will not dwell on my doubts about this practice, especially since the government has not exercised that option, instead thinking that it already has the exclusive rights to all the revenues under the Third Amendment to the SPSPA signed by FHFA's then-Acting Director Edward DeMarco and then-Treasury Secretary Timothy Geithner on August 17 2012,[35] which I shall discuss shortly.

As of 2008 the government bailout seemed to make sense, if only because the alternatives were worse. More specifically, it would also have been possible to throw both Fannie and Freddie into a receivership that would be used to wind down the companies with an eye to their eventual liquidation. The decision to forego the receivership made sense because any foreclosure proceeding requires a snapshot picture to determine whether Fannie and Freddie are indeed insolvent at the moment the foreclosure kicks in. With markets moving so rapidly, it made good sense on all sides to sidestep the valuation that would be required to determine whether some residual value was left over for the preferred or common shareholders after what would have been a tortuous liquidation of these vast enterprises. That evaluation is exceedingly difficult to make because there is no thick market that allows for accurate pricing of the mortgage portfolio. Perhaps one could have argued that the values were not quite commensurate. But it would be difficult to determine in the abstract whether the government took too little or too much from the deal. On valuation matters this murky, courts ordinarily should accept good faith adjustments between the parties.

The preference given to the government in this case, however, is less clear because government officials were on both sides of the deal. By way of contrast, the key difference between the Fannie and Freddie bailouts and the AIG bailout is that in the latter, the deal in question was negotiated by AIG's board of directors, so that a conflict of inter-

35. FED. HOUS. FIN. AGENCY, THIRD AMENDMENT TO AMENDED AND RESTATED SENIOR PREFERRED STOCK PURCHASE AGREEMENT (2012), *archived at* http://perma.unl.edu/33KN-V2A4.

est did not arise.[36] The case was therefore much cleaner than the Fannie and Freddie situation. All in all, there is some sense that the numbers of the SPSPA look about right. The arrangement, however, is more complicated than the observations thus far suggest, because the deal was made between FHFA and the Treasury, and not with the shareholders of Fannie and Freddie through their independent boards of directors.[37] At the same time the deal was made, FHFA had dismissed from operating control those private directors, so the SPSPA was the product of two government agencies dealing with each other, where the specter of self-dealing loomed large. With the 2008 SPSPA, that charge was answered reasonably well because the terms of the deal seemed (with the possible exception of the warrants) to be about right.

The same cannot be said of the Third Amendment to the SPSPA entered into in August 2012 between Edward Demarco for FHFA and Timothy Geithner for the Treasury, which occurred only after the housing market started to improve.[38] Now the conflict-of-interest issues were acute because of the manifest imbalance that was apparent on the face of the deal. In plain terms, Geithner and Demarco (himself a former treasury official) cut the following deal: on the one side, the Treasury released FHFA and Fannie and Freddie from the obligation to pay that ten percent dividend. So far so good. But the kicker was that in its place both parties agreed to a "dividend sweep" whereby all net profits of Fannie and Freddie were paid out to the Treasury as a dividend, whatever their amount, in ways that were intended to make sure that Fannie and Freddie were never in a position to redeem the senior preferred.[39] That ten percent dividend turned out to be small

36. *See* Starr Int'l v. Fed. Reserve Bank of N.Y., 906 F. Supp. 2d 202, 217–18 (S.D.N.Y. 2012), *aff'd* 742 F.3d 37 (2d Cir. 2014) ("It is centrally important that those decisions were made by AIG's Board. And, both on September 17 and September 22, 2008, AIG's Board consisted solely of directors who had been elected, well before the financial crisis, through the ordinary mechanisms of corporate democracy.").

37. *Statement by Secretary Henry M. Paulson, Jr. on Treasury and Federal Housing Finance Agency Action to Protect Financial Markets and Taxpayers*, U.S. DEP'T OF TREAS. (Sept. 7, 2008), http://www.treasury.gov/press-center/press-releases/Pages/hp1129.aspx, *archived at* http://perma.unl.edu/9A2N-MVVN. This is discussed in Epstein, *Government Takeover*, *supra* note 5, at 389–90.

38. *See* Epstein, *Government Takeover*, *supra* note 5, at 406–09 (discussing a memo from Jeffrey Goldstein to Timothy Geithner, referring to the administration's commitment to ensure existing common equity holders will not have access to any positive earnings from the GSEs in the future).

39. *See* FED. HOUS. FIN. AGENCY, *supra* note 35, § 3 ("For each Dividend Period from January 1, 2013, through and including December 31, 2017, the 'Dividend Amount' for a dividend Period means the amount, if any, by which the Net Worth Amount at the end of the immediately preceding fiscal quarter, less the Applicable Capital Reserve Amount, exceeds zero."). Similar provisions apply for post January 1, 2018 distributions. *Id.*

change in comparison with the dividend of over $150 billion that has been paid over to the Treasury since that time.[40] The exact numbers are not what matter here. What is important is the principle that in effect wipes out the junior preferred and common stocks by this dubious strategy. What the government essentially declared in this self-dealing transaction is that the common and junior preferred stock are worthless if this deal is allowed to go through, since the dividend sweep means that the senior preferred shares can never been redeemed.

Needless to say, this strong-arm maneuver has met with fierce resistance. Indeed the Third Amendment brought forth multiple lawsuits by firms who said that the Third Amendment is either a taking or a breach of fiduciary duty or both combined.[41] In its role as conservator, the statutory mission of FHFA is to preserve the assets of both companies with an eye toward their return to the private market. More specifically, the relevant statutory language provides for the development of a plan that will allow for "the orderly resumption of private market funding or capital market access."[42] Nonetheless, the government has stoutly defended its position in litigation to date, in ways that call into question the proper scope of the takings law.

The first line of argument from the government is that under HERA it succeeds to all rights of the shareholders in the management of the businesses similar to that of junior preferred and common shareholders.[43] That position may hold with respect to claims against third parties, but it cannot possibly be the case that this statute immunizes the conservator from all liability for its own misdeeds. So read, the statute itself would constitute a clear taking of property without due process of law and without just compensation. It has never been the law, for example, that the government could announce that it owned a private home so that its former owner could not sue for the taking. To avoid these complications, it is only proper to read the statute as allowing all actions against FHFA for breach of its statutory duty to conserve assets for the junior preferred and common shareholders.

40. *Id.*

41. For a full list of the cases, see Appendix, Fairholme Funds, Inc. v. Fed. Hous. Fin. Agency, 2014 WL 4829559 (D.D.C. Sept. 30, 2014) (No. 1:13-cv-01053-RCL); Perry Capital, LLC v. Lew, 2014 WL 4829559 (D.D.C. Sept. 30, 2014); Cacciapelle v. United States, No. 13-466 C (Fed. Cl. filed July 10, 2013).

42. 12 U.S.C. § 1719(g)(C)(iii) (2012).

43. *See* 12 U.S.C. § 4617(b)(2)(A) (2012) (providing that FHFA shall "as conservator or receiver, and by operation of law, immediately succeed to—(i) all rights, titles, powers, and privileges of the regulated entity, and of any stockholder, officer, or director of such regulated entity with respect to the regulated entity and the assets of the regulated entity.")

The heart of the government case, however, rests on the proposition that there has been no taking of property that requires payment of compensation. As noted earlier, these takings challenges can be for either a physical or regulatory taking. The government's response denies both. As to the former it insists: "There is no allegation of a physical invasion-type taking, nor could there be, given that the Third Amendment did not eliminate plaintiffs' preferred shares, which continue to be freely traded like any other equity."[44] The first point is surely true, for these shares are not land, and hence *Loretto's* language of physical invasion is not appropriate. But it is a genuine non sequitur to say that the per se rules cannot apply to any form of intangible property. The proper analysis asks this question: does the government make use of the assets that were once in private hands, at which point the per se rules should apply? If, on the other hand, it only restricts the use of property, as in the conventional *Penn Central* situation, then the lower rational basis test is applied. Thus in connection with patent and trade secrets, it would be quite impossible if the government decided to make exclusive use of a private trade secret and would not have to compensate its owner for the loss.[45] The same analysis should apply to patents. In the context of corporate shares the two major attributes deal with control on the one hand and the right to cash flows, whether by dividend or liquidation, on the other. If both of these rights are taken over by the government, then the complete taking has occurred. It would simply be absurd to argue that for nonphysical forms of property, the class of per se takings is necessarily empty even in cases where assets that have huge market values are subject to the exclusive use and control of the government.

But even if the government's odd classification is accepted, the regulatory taking claim has a lot of bite under the current law. The case here is one in which the junior preferreds and common shareholders will not receive a dime in dividend if the Third Amendment is given its full effect. The government tries to escape this rule by taking the position that the "total wipeout" analysis in *Lucas* only applies to land cases, without ever explaining why that analysis should not extend to other types of assets, including financial holdings.[46] The total wipeout of the value of shares raises exactly the same concern of government overreach.

The government then seeks to bolster its argument by pointing to the fact that no regulatory taking is actionable under *Penn Central*

44. Motion to Dismiss for United States, *supra* note 19, at 2.
45. Philip Morris, Inc. v. Reilly, 312 F.3d 24, 35 (1st Cir. 2002) (describing *Loretto* as "a case which announced a per se rule in a physical takings context"); Richard A. Epstein, *The Constitutional Protection of Trade Secrets under the Takings Clause*, 71 U. CHI. L. REV. 57 (2004).
46. Motion to Dismiss for United States, *supra* note 19, at 32–34.

because "plaintiffs still own their preferred shares, the shares retain value as traded equities, and the share prices have fluctuated since FHFA placed the Enterprises into conservatorships."[47] What this argument fails to recognize is that the *sole* reason that these private shares retain value rests on the perceived value of the lawsuits that are being brought against the United States. If these lawsuits are eventually dismissed, the value of the share will plummet instantly to zero, and cease to be traded. It is the height of irony that the government points to the active market in shares as evidence that the stock is not worthless, when that fact only proves that the lawsuit against the government has some serious chance of success.[48]

The government then seeks to bolster its case by noting that the Federal Circuit has held that "regulatory agencies do not interfere with the reasonable investment-backed expectations of owners and shareholders when the regulators place a financial institution into conservatorship or receivership."[49] What the government position does not acknowledge, however, is that the cases cited in support of this position all deal with cases in which a bank is thrown into receivership pursuant to the government's power to regulate banks in the shadow of insolvency, where there is perhaps too much deference given to the decisions of the public authorities. But the Third Amendment is not a regulatory action by the government. It is a contractual amendment to a purchase agreement, so the validity of its actions have to be tested by ordinary principles of contract law under the rule of *United States v. Winstar Corp.*,[50] which stands for this proposition: "In evaluating the relevant documents and circumstances, we have, of course, followed the Federal Circuit in applying ordinary principles of contract construction and breach that would be applicable to any contract action between private parties."[51] Among those rules are rules that prevent the renegotiation of terms in a self-dealing transaction that are inconsistent with the fiduciary duties that one of the parties owes to its beneficiaries. One can only imagine what would happen if any private trustee entered into a contract with a related party in which it agreed to turn over all the profits from the enterprise to that

47. *Id.* at 33.

48. Defendants FHFA, Watt, Fannie Mae, and Freddie Mac's Combined Reply in Support of Their Motion to Dismiss with Alternative Motion for Summary Judgment, and Opposition to Plaintiffs' Cross-Motion for Summary Judgment at 43, Perry Capital, LLC v. Lew, 2014 WL 4829559 (D.D.C. Sept. 30, 2014) (No. 13-1025), 2014 WL 3616085 ("Plaintiffs' claim is *not* that the government took their shares—Plaintiffs still own the shares which still trade over the counter.").

49. Motion to Dismiss for United States, *supra* note 19, at 35 (citing, e.g., Golden Pac. Bancorp v. United States, 15 F.3d 1066, 1074 (Fed. Cir. 1994)).

50. 518 U.S. 839 (1996).

51. *Id.* at 870–71.

party and receive nothing in exchange. The Securities and Exchange Commission would surely brand that transaction as criminal.

Lastly, the government tries to brush over these arrangements by noting that these corporations were insolvent in 2008, a proposition that is asserted but not proved.[52] But even if that point were true, it would only justify a decision to throw Fannie and Freddie into receivership in 2008. Once it made the decision to let these companies survive, it knew that it had created a market in which their shares were freely tradable post-2008. Therefore, it follows that it cannot treat the GSEs as if they were insolvent in 2012 when it knew that the contrary was true. The government hints that the plaintiffs in these cases are guilty of opportunism because they chose to bring their suit "only after Fannie Mae and Freddie Mac have shown signs of recovery."[53] Yet the point really cuts in the other direction. The only reason that the government entered into the Third Amendment with itself was because it had strong intimations not only that there were "signs of recovery" but also that both of these entities would turn substantial profits, which both parties to the Third Amendment hoped to deposit in the Treasury to the exclusion of the shareholders.

In the more global sense, the government claims on its FHFA website that "[c]onservatorship is intended to stabilize troubled institutions with the objective of maintaining normal business operations and restoring financial safety and soundness."[54] More specifically, it says of the Third Amendment that:

> In addition to requiring a faster wind-down of their portfolios, the 10 percent fixed-rate dividend was replaced with a variable structure, essentially directing all net income to the Treasury. Replacing the current fixed dividend in the agreements with a variable dividend based on net worth helps ensure stability, fully captures financial benefits for taxpayers, and eliminates the need for Fannie Mae and Freddie Mac to borrow from the Treasury Department to pay dividends.[55]

In effect, this announcement of high purpose should be regarded as a clear admission of the government's breach of its fiduciary duty. FHFA does not owe a duty to the taxpayers. It owes a duty to the shareholders. It is the Department of Treasury that owes a duty to taxpayers, and its mandate is set out under § 1117 of HERA, which gives the Treasury the temporary authority to purchase obligations

52. *Statement by Secretary Henry M. Paulson, Jr. on Treasury and Federal Housing Finance Agency Action to Protect Financial Markets and Taxpayers*, *supra* note 37.

53. Defendant's Motion to Dismiss, *supra* note 44, at 2.

54. *Conservatorship*, FED. HOUS. FIN. AGENCY, http://www.fhfa.gov/Conservatorship, *archived at* http://perma.unl.edu/6TVH-Y8VT (last visited Jan. 31, 2015).

55. *Senior Preferred Stock Purchase Agreements*, FED. HOUS. FIN. AGENCY, http://www.fhfa.gov/Conservatorship/Pages/Senior-Preferred-Stock-Purchase-Agreements.aspx, *archived at* http://perma.unl.edu/3QXN-ECPS (last visited Jan. 31, 2015).

and securities from Fannie and Freddie Mac on terms that do not prejudice the taxpayers,[56] but only with their agreement.[57] The protection of the taxpayers comes from the Treasury under § 1117 of HERA, which mentions both by name.[58] The protection of the junior preferreds and the common come from FHFA, so long as it fulfills its duties. What the FHFA announcement confirms is that the private shareholders have no protection at all from either FHFA or the Treasury. In essence, therefore, the current government strategy has been to degrade, indeed wipeout, all the contractual protections that were built into the SPSPA. Cast in the language of mortgages, the structure and tone of the Third Amendment could not be further removed from the 2008 agreement. With the original SPSPA, the demotion in priority was offset by what looks to be full and fair consideration. With the 2012 Third Amendment, the interests of the junior preferred and the common shareholders are being wiped out entirely without the most elementary form of due diligence on the one hand or objective valuation of the terms of the deal on the other. It is hard to see how markets can continue to trade stocks if the government always has up its sleeve a trump that allows it to seize without objection all the control and the cash rights to any corporate entity. The litigation over first the 2008 SPSPA, and especially the 2012 Third Amendment, will help shape whether the long-term integrity of credit markets can survive the machinations of multiple government departments and agencies. My hope is that the much-read judicial rejection of the Third Amendment will help restore public confidence in the securities markets.

V. THE SAN JOSE PENSION SITUATION

The overall dynamics could not be more different when the discussion shifts to employment contracts and their pension provisions. It is for that reason that I have switched sides and thus seek to defend the ability of San Jose, like other cities facing similar problems, to manage its multiple obligations to its residents and its employees in a coherent fashion.

56. Federal National Mortgage Association Charter Act, *id.* § 1719(g) (2012) (Fannie Mae); Federal Home Loan Mortgage Corporation Act, *id.* § 1455(l) (Freddie Mac).
57. *Id.* § 1719(g)(1)(A) ("Nothing in this subsection requires the corporation to issue obligations or securities to the Secretary without mutual agreement between the Secretary and the corporation.").
58. *Id.* § 1719(g) ("Temporary Authority of Treasury to Purchase Obligations and Securities; Conditions: (1) AUTHORITY TO PURCHASE (B) EMERGENCY DETERMINATION REQUIRED In connection with any use of this authority, the Secretary must determine that such actions are necessary to (i) provide stability to the financial markets; (ii) prevent disruptions in the availability of mortgage finance; and (iii) protect the taxpayer.").

The basic problem is well set out in Proposition B, which bears the title: "Public Employee Pension Plan Amendments—to Ensure Fair and Sustainable Retirement Benefits While Preserving Essential City Services."[59] The list of services considered "essential to the health, safety, quality of life and well-being of San Jose residents" include: "police protection; fire protection; street maintenance; libraries; and community centers."[60] There is no question that budgets are finite, even after tax increases, which become counterproductive at a certain point, particularly in local governments where major exit of businesses and high net worth individuals could erode the current tax base, while the same high tax structure induces outsiders to set up shop in any one of the nearby towns—Cupertino, Mountain View, Los Altos—that are not burdened by these heavy obligations. If exit and entrance rights mean a lot in competition among states, they count for even more with municipal governments that face steep competition close at hand within states.

It follows therefore that the Mayor and City Council in San Jose face a true juggling act. Their finite resources cannot be used to pay pension obligations to past, present, and future workers, yet still be available to discharge their essential public functions. At this point we are far from the situation where the government has to make good on its loans under a *stricti iuris* regime. Instead, when there are competing legitimate claims on scarce resources, the business judgment rule takes effect, which imposes a bona fide obligation binding on all partnership members and all officers and directors of corporations. Any conscientious mayor—and Chuck Reed is as conscientious as they come—has to make sensible trade-offs between rival claims in order to govern.

Ideally, any social planner when faced with this scarcity constraint would like to see all expenditures satisfy an equal-marginal condition, such that the movement of any dollar to any other use would result in a reduction in overall social utility. The business judgment rule is used in these cases precisely because no one can be confident about the ideal tradeoff among multiple competing claims. The good faith standard of judgment is employed in the absence of any form of self-dealing, including that which was all too evident in the Third Amendment. Quite simply, the correct marginal calculations can change daily, which is why conscientious mayors, like conscientious deans, have to exercise these trade-offs day in and day out. Proposition B was drafted with just this consideration in mind. Indeed, its strong passage by referendum adds a note of democratic legitimacy to the

59. San Jose, Cal., Public Employee Pension Plan Amendments—To Ensure Fair and Sustainable Retirement Benefits While Preserving Essential City Services § 1501-A (Feb. 8, 2012), *archived at* http://perma.unl.edu/E3XM-EJ9V.

60. *Id.*

overall process. Thus, whatever the ideal distribution of resources, there is little doubt that the current austerity with essential public services is far removed from that ideal.

It would have been a travesty if Proposition B had repudiated all past pension obligations to either retired or current workers. But the very title of Proposition B rejects that extreme position, with an eye to making responsible trade-offs that avoid imposing wipeouts on any group of beneficiaries: "Public Employee Pension Plan Amendments—To Ensure Fair and Sustainable Retirement Benefits While Preserving Essential City Services."[61] Its key provisions protected all vested property rights of current and retired city employees, including their cost of living increases. Instead the Proposition focused solely on the future contributions and benefits to be paid out under the program. Its key provision in § 1506-A sought to preserve the current level of benefits for these employees by increasing their retirement contributions "in increments of 4% of pensionable pay per year, up to a maximum of 16%, but no more than 50% of the costs to amortize any pension unfunded liabilities" subject to certain adjustment for so-called Tier 2 employees—that is, those who are hired after the adoption of this ordinance.[62] In addition, in § 1507-A, the city employees were given a one-time Voluntary Election Program (VEP) that would allow them to avoid any increases in contributions in exchange for receiving a lower level of retirement benefits, consistent with their smaller contributions.[63] In essence, the City rightly announced that it was indifferent to whether the employees chose the high contribution/high pension package or the low contribution/low benefit package, so long as the overall reduction in the City's contingent pension obligations was the same either way. The differences between these two programs cannot, by definition, be large, but it does give workers the option to choose the alternative that best suits their personal circumstances. The proposition also gradually raises (six months each calendar year) the retirement ages to 57 for police and firefighters, and 62 for other employees. One more year's contribution and one less year's benefits makes a substantial difference in the overall budget position. For the Tier 2 employees, § 1508-A's new program raises retirement age to police and firefighters in defined benefit plans to 60 and 65 respectively.[64]

Thus far the key provisions of Proposition B have not survived judicial challenge in a law suit, *San Jose Police Officers' Association v.*

61. *Id.*
62. *Id.*
63. *Id.*
64. *Id.*

City of San Jose.[65] When the matter was tried before Judge Patricia Lucas in the Superior Court for Santa Clara County, the key compromise provisions of Proposition B were struck down on the ground that they violated the vested contract rights of the workers.[66] In reaching this conclusion, Judge Lucas described the major budget cuts in all the areas set out under Proposition B, but held that they could not withstand the breach of contract, contracts clause, takings, and due process claims that were brought against them.[67] Judge Lucas started with the usual presumption in favor of the validity of statutes, but held that this presumption was overcome by the creation of the relevant contract rights.[68] At this point, the critical element in the case was: "A public employee's pension constitutes an element of compensation, and a vested contractual right to pension benefits accrues upon acceptance of employment. Such a pension right may not be destroyed, once vested, without impairing a contractual obligation of the employing public entity."[69]

In one sense, this result is odd because it creates the result that one term of an arrangement is regarded as vested even if all other aspects of the contract dealing with salary, promotion, dismissal, and the like are subject to modification over time. I am not aware of any theory of contracting under which one would impose this degree of rigidity on this particular provision, but no such limitation on other portions of the contract, including matters such as hiring, firing, promotion, and redefinition of job responsibilities. In a sense, however, this obligation is not absolute; as the San Jose Charter says, the City retains the power to alter and amend the pension obligation.[70] But that section itself has received a very narrow interpretation so that, as stated in *Betts v. Board of Administration*, "changes in a pension plan which result in disadvantage to employees should be accompanied by comparable new advantages."[71] The decision in question is in part a reaction to the situation that arose in *Kern v. City of Long Beach*,[72] which raised the question of vested pension rights in the most graphic form when the City Council passed a law revoking Kern's entire pension benefits about one month before he reached

65. No. 1-12-CV 225926 (Consolidated with Nos. 1-12-CV 225928, 1-12, CV-226570, 1-12-CV 226574, 1-12-CV 227864 & 1-12-CV-233660) (Super. Ct. Santa Clara Cnty. Dec. 20, 2013) (unreported tentative decision).
66. *Id.*
67. *Id.* at 4–5.
68. *Id.* at 7.
69. Betts v. Bd. of Admin., 582 P.2d 614 (1978). The decision does not stand alone. *See also* Allen v. City of Long Beach, 287 P.2d 765 (1955) (cited in *San Jose*, No. 1-12-CV 225926, at 7–8).
70. *San Jose*, No. 1-12-CV 225926, at 9. For the particular provisions of the San Jose City Charter, see *infra* note 74.
71. *Betts*, 582 P.2d at 617.
72. 179 P.2d 799 (Cal. 1947).

twenty years of service, at which time they would vest. The Court rejected that position on the ground that "the right to a pension vests upon acceptance of employment."[73] Without question, the Long Beach decision was taken in manifest bad faith, because the City Council assigned no reason for its passage apart from its wish to pay nothing to its long-term employees. The bill of particulars set out in Proposition B was nowhere to be found. Nonetheless, it hardly follows that it is necessary to throw out the baby with the bath water. There were all sorts of less intrusive ways for the Court in *Kern* to protect these workers against an opportunistic termination without migrating to the opposite extreme, by vesting the pension right at the time of contract formation. A simple statement that total terminations of earned benefits on the eve of retirement are presumed to be in bad faith could control the serious abuses without going further. Indeed I am aware of no system of voluntary contracts that takes that aggressive vesting position on pension rights.

The rule in *Kern*, *Allen*, and *Betts* is even more inexplicable because the question of the vesting of pension rights does not arise in a vacuum. There are also explicit charter provisions that do reserve rights in § 1500 to "amend or otherwise change" retirement plans, or in § 1503 to "repeal or amend" any retirement system.[74] The question is how to square the decision in *San Jose Police Officers* with this basic provision. The first point to note is that the literal text cuts against the position taken in *Kern*, *Allen*, and *Betts* because those provisions authorize changes that are inconsistent with the notion of vesting of pension rights on hiring. Professor Amy Monahan has made this pointed criticism of the California rule:

> California courts have put in place a highly restrictive legal rule that binds the legislature without the court ever finding clear and unambiguous evidence of legislative intent to create a contract. This break with traditional contract clause analysis is potentially the most troubling in that it infringes on the power of the legislative branch without apparent authority.[75]

The point seems well taken. These powers to alter and amend are inserted, of course, for the benefit of the party who is in a position to exercise it, so that the one interpretation that seems clearly wrong is the categorical view that blocks any change in pension benefits that

73. *Id.* at 801.

74. *See* San Jose, Cal., City Charter, Article XV. Retirement § 1500 (amended Nov. 2, 2010) ("Subject to other provisions in this Article, the Council may at any time, or from time to time, amend or otherwise change any retirement plan or plans or adopt or establish a new or different plan or plans for all or any officers or employees . . . ."); San Jose, Cal., City Charter, Article XV. Retirement § 1503 ("However, subject to other provisions of this Article, the Council shall at all times have the power and right to repeal or amend any such retirement system or systems, and to adopt or establish a new or different plan or plans for all or any officers or employees . . . .").

75. *See* Monahan, *supra* note 1, at 1071.

works to the detriment of employees. This is especially true when the unfunded pension obligations create a $3.7 billion structural deficit for San Jose, which no simple timing mechanism could begin to touch. No vesting doctrine should render the City helpless to take any steps that are calculated to cut into that deficit. A city that is given the flexibility to alter and amend has to be able to gain from it. Such powers are common in various trust instruments and their purpose is always to allow at least some shifting of benefits back and forth between beneficiaries, which in this instance means the funding of other city projects, not simple tax rebates to all or some taxpayers. Proposition B lets the City keep its library and parks open, hire more teachers, not lay off a large portion of the local police force, and so forth.[76]

Yet this is not the whole story. The combination of these two powers cannot be read to justify the position that the City government can do whatever it wants, including the revocation of the plan in its entirety. Note that § 1500 speaks of "amend or otherwise change," which cannot be fairly read to include the power to revoke without cause. Similarly, § 1503 does allow for the "repeal or amendment," which could cover revocation, but it is then qualified by the obligation "to establish a new or different plan," which is not satisfied by bad faith plans that wipe out the benefits for any or all participants.[77]

Clearly then, there has to be a way between the two extremes, and that way can only be that the City is in a position to alter or amend the plans in good faith, including cuts for employees, present or future, that are needed to ensure that the City can cover its other essential obligations. No one can deny that there are always some cases that will hover close to the margin, but Proposition B is not one of them. It does not cut any benefits for retired workers, and it limits the cuts for current workers only to future employment earnings, and then only to the extent needed to provide for other essential services. In light of these particulars, the California Supreme Court should not follow a set of precedents that was crafted in connection with a particular set of abuses far removed from the current situation. The Proposition should survive under a City Charter that, sensibly read, has made ample provision for its passage.

The second question is whether the City necessarily loses if the powers to alter and amend are given the readings that they have received in *Kern, Allen*, and *Betts.* The correct answer to that question

76. San Jose, Cal., Public Employee Pension Plan Amendments—To Ensure Fair and Sustainable Retirement Benefits While Preserving Essential City Services, § 1501-A (Feb. 8, 2012), *archived at* http://perma.unl.edu/E3XM-EJ9V ("The following services are essential to the health, safety, quality of life and well-being of San Jose residents: police protection; fire protection; street maintenance; libraries; and community centers.").

77. *Id.* § 1503.

is, I believe, no, because there is the serious question of whether the City is entitled to surrender its sovereign capacity to govern by entering into these long-term arrangements that impair its ability to discharge its other essential governance functions. The argument in this case is one that works as well with a small government laissez faire state or a modern social democratic one. The key point here is that there are certain functions that only government can discharge, and it cannot bind itself to private parties in derogation of those powers. Thus to give a simple core example, the government cannot enter into a private contract under which it refuses to supply a police force, by turning over perpetually that power to some private party, which now enjoys the monopoly of force within the state. These forms of delegation remove essential government functions from public control and create undue concentrations of power in particular groups. That is exactly what happens here. The pension rights (under a most dubious contractual interpretation) are vested as soon as they are made and cannot be put aside in order to discharge other essential government functions.

The legal authority on this distribution of power goes back a long way. Perhaps the most notable nineteenth century case on point is *Stone v. Mississippi*, under which the State entered into a contract for Stone to operate a lottery for a period of twenty years.[78] The terms of the agreement were clear, but the entire matter was disposed of on the ground that the state did not have the power to bind itself in this transaction for that period of time. The key proposition in *Stone* was that:

> All agree that the legislature cannot bargain away the police power of a state. 'Irrevocable grants of property and franchises may be made if they do not impair the supreme authority to make laws for the right government of the State, but no legislature can curtail the power of its successors to make such laws as they may deem proper in matters of police.'[79]

At that point the Court refused to give a comprehensive definition of the police power, knowing it to be a limited notion, but it concluded by holding that it surely covered the ability to deal "to all matters affecting the public health or morals."[80] The lottery fit into the last category, because it was evident that "the wide-spread pestilence of lotteries . . . enters every dwelling; it reaches every class; it preys upon the hard earnings of the poor; and it plunders the ignorant and simple."[81]

By the same token it is clear that the police power cannot cover any and all government transactions. Indeed, the Court in *Stone* noted

78. Stone v. Mississippi, 101 U.S. 814 (1879).
79. *Id.* at 817–18 (quoting Metropolitan Board of Excise v. Barrie, 34 N.Y. 657, 668 (1866); Boyd v. Alabama, 94 U.S. 645 (1876)).
80. *Id.*
81. *Id.* at 818 (quoting Phalen v. Virginia, 49 U.S. (8 How.) 163, 168 (1850)).

that in the famous case of *Trustees of Dartmouth College v. Woodward*,[82] where Chief Justice Marshall upheld a perpetual charter that the state had issued to the Trustees of the College for the operation of a private institution. The obvious ground of distinction is that the Dartmouth Charter did not pose any threat to public morals remotely similar to those created by lotteries, so that the creation of a long-term, indeed perpetual, contract was within the power of the state to execute. This was especially true since Dartmouth College, by virtue of its grants, was not exempt from any form of valid general police power regulation that applied to other institutions of the same class. The inherent police power of the state does not block it from chartering corporations or entering into long-term contracts.

At this point, it is possible to place cases sensibly on one side of the line or the other. Long-term financial commitments, whether in the form of long-term bonds or construction commitments, are surely transactions that the government can enter into, which, by the way, include arrangements like the Senior Preferred Stock Purchase Agreement in the Fannie and Freddie context. But by my calculation any decision on payments that compromises the basic ability of municipal government to discharge basic functions of government falls on the other side of the line, which means that the pension programs in question are all properly subject to restructuring.

The modern case law on this subject tends to support that result, albeit for reasons that are often surprising. One case that illustrates the twists and turns of the current situation is the Ninth Circuit decision from 2004 in *RUI One Corp. v. City of Berkeley*[83] that raised just these questions in a different but instructive context. In 1968, *RUI*'s predecessor in interest, Manning's Inc., had entered into a fifty-year lease, expiring in 2018, of a portion of a 4,388 acre plot that the City held in public trust, on which Manning's was to build and maintain a first-class restaurant and other facilities.[84] In 2000, the Berkeley City Council amended its living wage ordinance so that it covered certain employees who worked at that facility.[85] "Unlike their state and federal counterparts, local wage ordinances tend to be more restrictive in scope; rather than setting citywide minimums applicable to all employers, public and private, most cities have chosen a piecemeal approach, targeting only recipients of city contracts or lessees or larger businesses with more employees and higher earnings."[86] The original lease contained no provision, express or implied, that dealt with the

82. 17 U.S. (4 Wheat.) 518 (1819).
83. 371 F.3d 1137 (9th Cir. 2004).
84. *Id.* at 1144–46.
85. *Id.* at 1143–44.
86. *Id.* at 1142.

wages that were to be offered to workers at the facility.[87] Indeed, many long-term deals have floundered precisely because municipal governments have insisted that living wage provisions be supplied to all or some of the workers and that they be protected by these living wage provisions in excess of federal and state minimum wage laws.[88] None of these concerns was able to deter the Berkeley City Council, which acted, in ways of which the majority of the Ninth Circuit evidently approved, because it believed that the skyrocketing cost of living required that the City intervene in order to make sure that wages advanced in rough proportion to the high costs of living in that locality.[89] One question was whether this decision counted as an impairment of the existing lease arrangement. It was agreed that the contract contained no explicit provision that guarded against the imposition of the living wage ordinance. But that left open the question of whether the ordinance violated some implied term that no such limitation would be imposed, which is a fair point given that these clauses have often proved deal breakers in government leasing deals. To that point, the Court reached the emphatic conclusion that the inherent police power of the state prohibited any such limitation, either express or implied.

> [T]o the extent that RUI contends that the lease agreement contains an implied term providing that the City would not enact any ordinances imposing an economic burden upon RUI during the period of the lease, such a contractual term would be void as against public policy. For "'the legislature cannot bargain away the police power of a State.' . . . [T]he Contract Clause does not require a State to adhere to a contract that surrenders an essential attribute of its sovereignty."
>
> "Otherwise, one would be able to obtain immunity from the state regulation by making private contractual arrangements. . . . [As] summarized in Mr. Justice Holmes' well-known dictum: 'One whose rights, such as they are, are

87. *Id.* 1148–51.

88. *See* Bill Egbert, *Bronx Leaders Demand Living Wage at Kingsbridge Armory Development Even if It Scuttles Deal*, DAILY NEWS (Aug. 27, 2009, 1:53 AM), http://www.nydailynews.com/new-york/bronx/bronx-leaders-demand-living-wage-kingsbridge-armory-development-scuttles-deal-article-1.399130#ixzz3AC5YNgKz, *archived at* http://perma.unl.edu/963U-4JDT (recognizing that the deal was killed for just that reason).

89. *See RUI One Corp.*, 371 F.3d at 1141 (Wardlaw, J.: "As the cost of living skyrockets around the country, and in the San Francisco Bay Area in particular, the face of American poverty is changing dramatically. More and more frequently, full-time, minimum-wage workers are unable to support their families' basic needs. . . . Recognizing the plight of its own working poor, the City of Berkeley, California, has joined dozens of other cities nationwide to help bridge the gap between federal and state laws setting the minimum wage—the real value of which has decreased over the past few decades—and the costs of modern urban living by enacting 'living wage' ordinances.").

> subject to state restriction, cannot remove them from the power of the State by making a contract about them.'"[90]

It is important to quote the full passage from *RUI* because it tells something about the transformation of the police power from the pre- to the post-1937 period. As noted already, the Court in *Stone* offered a very specific explanation as to why lottery contracts fell within the scope of the police power. The decision in *Hudson County Water Co. v. McCarter*, cited in *RUI*, addressed a water law question of whether New Jersey riparians, by agreement among themselves, could authorize a diversion of water outside its stream for use in New York.[91] In order to make that claim, the riparians had to demonstrate the unconstitutionality of a New Jersey statute that provided: "it shall be unlawful for any person or corporation to transport or carry, through pipes, conduits, ditches, or canals, the waters of any fresh water lake, pond, brook, creek, river, or stream of this state into any other state, for use therein."[92] The answer was in the negative and Holmes was absolutely right to say that no agreement between the water company and parties in Staten Island, New York could justify a diversion, on the familiar principle that no contract between A and B can block the rights of C, which in this instance are ironclad.

It is also instructive to observe that in *United States Trust v. New Jersey*,[93] which quotes the language in *Stone*, the Court held that New Jersey did run afoul of the contracts clause when it stripped away the essential security that had backed the long-term bonds that it had issued. The discussion of *Stone* was intended to show correctly that under "the reserved power doctrine" of *Stone*, no essential attribute of sovereignty was surrendered by the state when it entered into this long-term transaction.[94] The case is thus consistent with the view taken here that long-term financial arrangements should be respected. In addition, it hardly helps the court's reasoning in *RUI*, which takes the position that the issues of health and prosperity allow for a state to unilaterally revise the term of its contracts for public health reasons.

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90. *Id.* at 1149 (citations omitted) (quoting U.S. Trust v. New Jersey, 431 U.S. 1, 22, 23 (1977) (quoting Hudson Cnty. Water Co. v. McCarter, 209 U.S. 349, 357 (1908); Stone v. Mississippi, 101 U.S. 814, 817 (1879))); *see also* Avco Cmty. Developers, Inc. v. S. Coast Reg'l Comm'n, 553 P.2d 546 (1976) ("[I]t is settled that the government may not contract away its right to exercise the police power in the future.").
91. *Hudson Cnty. Water*, 209 U.S. 349.
92. *Id.* at 353 (quoting New Jersey Laws of 1905, chap. 238, p. 461).
93. 431 U.S. 1 (1977).
94. *Id.* at 23 ("When a State impairs the obligation of its own contract, the reserved-powers doctrine has a different basis. The initial inquiry concerns the ability of the State to enter into an agreement that limits its power to act in the future. . . . In short, the Contract Clause does not require a State to adhere to a contract that surrenders an essential attribute of its sovereignty.").

The last of these decisions in *Avco* held that "neither the existence of a particular zoning nor work undertaken pursuant to governmental approvals preparatory to construction of buildings can form the basis of a vested right to build a structure which does not comply with the laws applicable at the time a building permit is issued."[95] That decision thus deals with the question of when a right to build becomes vested. It is also worth noting that in sharp contrast to the *Kern, Allen*, and *Betts* line of cases, it pushes vesting too far back—long after major reliance expenditures have been made—instead of too far forward where it governs future performances of both sides of the contract. But one clear implication of this rule is that once the permits have been approved, the right vests. As applied to *RUI*, it does not undermine the position that vested rights are surely created with the execution of the lease.

At this point, we have *RUI*'s basic conclusion that this long-term lease may be unilaterally subject by the city to the living wage law that was no part of the original deal. There is no question in my mind that if there were some general law passed by either the national, state, or local government that provided for a living wage, RUI's lease with the city would not insulate it from its provisions. But that is not what happened in this case, which involves a targeted ordinance directed only to persons who already had signed lease contracts. That "piecemeal approach" makes all the difference because it is in reality no different from a tactic whereby the city simply inserts unilaterally the added term into its leases. That option is never available for general legislation, which could not pass precisely because of popular opposition to such provisions from other parties that would be subject to the full ordinance, which is an opposition that vanishes when the burden of the legislation is targeted only to parties with leases and other contracts. The so-called "piecemeal approach" should never be allowed precisely because it allows a city council to select its targets in ways that are ripe with the potential for abuse.

Nor is there any limiting principle on the use of targeted legislation limited to existing leases. If a $15 per hour living wage is possible, why not $25 or $50 per hour? The point here is that the landlord, who has heavy sunk costs into the project, may find that it loses more if it tries to abandon the lease than to stay on. Indeed, the open-ended nature of the supposed police power leaves open the possibility that the next wage increase is combined with a new requirement that the tenant pay an exit fee to escape from a losing lease.[96] Nor are the only terms that can be imposed cash terms. If higher wages are justified on

95. *Avco*, 553 P.2d at 551 .
96. These exit rights have been imposed in insurance contexts, where parties who wish to throw up their licenses to sell insurance have often been charged with an exit fee equal to their loss. For a description and attack on this practice, see

the grounds of health, nothing prevents the city council from going the next step by requiring that the employer provide free health care to all of its employees, covering such vital issues as vaccination and prenatal care, but by no means limited to them. Perhaps at some point the weak limitations associated with substantive due process rational basis review kicks in, but if so, no one can quite say where this line of thinking ends.[97] But a more accurate account of the police power limits the general heading of the health and safety regulation to what that term meant before the rise of rational basis review: in other words, it means that the city can prevent RUI from polluting public waterways or selling contaminated food. It does not include the subsidies that the city deems appropriate on its very one-sided view of the desirability of the living wage.

For these purposes, however, I have no need to distinguish *RUI* from the current pension imbroglio. If *RUI* is in fact correct, it follows that in this situation where the City of San Jose has made a detailed case as to how the heavy pension burdens have hampered its ability to discharge its essential public functions, it has to render them under the line of cases from *Stone* to *RUI* as void against public policy. It must do so, moreover, even if *Kern*, *Allen*, and *Betts* are correct, for in none of those cases were any public exigencies mentioned, let alone proved. It is impossible to assume that it violates public policy for a city to bind itself not to impose unilateral obligations on a private party when it acts as a landlord of property held under public trust, which under *Winstar* (nowhere cited or distinguished in *RUI*) holds that ordinary rules of contract construction should apply to contracts of this sort.[98] So we are then led to this absurdity. The only time that the Contracts Clause imposes an absolute obligation on the state is for pension obligations that are said, without foundation, to vest at the formation of a contract, even for work as yet unperformed. But in those cases where the state wishes to implement its view of public policy, it can do so by imposing special obligations on its trading partners, which are no part of the general law. If *RUI* represents the current law, the earlier decisions are wrong. And if *RUI* is wrong, as it surely is in principle, the San Jose pension cases are clearly distinguishable on the strength of the very authorities that are cited and misunderstood in *RUI*. Surely, the entire theory of property and contract rights is upside down when fixed and unconditional financial ob-

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Richard A. Epstein, *Exit Rights and Insurance Regulation: From Federalism to Takings*, 7 GEO. MASON L. REV. 293 (1999).

97. *See, e.g.*, Williamson v. Lee Optical of Okla., Inc., 348 U.S. 483 (1955); Nebbia v. New York, 291 U.S. 502 (1934).

98. United States v. Winstar Corp., 518 U.S. 839, 870–71 (1996) ("In evaluating the relevant documents and circumstances, we have, of course, followed the Federal Circuit in applying ordinary principles of contract construction and breach that would be applicable to any contract action between private parties.").

ligations can be disregarded with the drop of the hat, while unearned pension benefits for work that may never be done are rock solid even when they rob municipal governments of their ability to provide essential government services. Clearly it is time for a fundamental reassessment of both pension and financial obligations under the Contracts and Takings Clauses. The current litigation offers a good opportunity to correct what has become a contradictory intellectual quagmire.