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OF FAIRNESS AND MIGHT:
The Limits Of Sovereign Power
To Tax After Winstar

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"The power to tax is . . . the most pervading of all the powers of
government."¹

"A legal duty with no legal remedy is an illusion."²

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1. Loan Ass'n v. Topeka, 87 U.S. (20 Wall.) 655, 663 (1874) (striking tax to pay for
   "donation" of bonds to corporations in exchange for doing business within the jurisdiction as a
   perversion of taxation powers and "robbery").

2. 6 ARTHUR LINTON CORBIN, CORBIN ON CONTRACTS § 1343, at 418 n.4 (1962).
I. INTRODUCTION

The government depends upon taxes to function. In support of this proposition, the U.S. Supreme Court declared the power to tax an inherent and omnipresent aspect of government. A corollary of this principle is the government’s equally broad power to protect itself against any threats to its power to tax, even at the expense of taxpayers’ natural and instinctual concepts of fairness. The government’s power to tax is seemingly unlimited, befitting its description as a “taxing machine.”

Against this backdrop, it is equally undisputed that the government must enter into contracts to operate. Using contracts, the government delegates decisional and “coercive authority over others” to contractors. Both the contracts and the delegations are necessary to fulfill the responsibilities of government to provide goods and services to its constituents. Though it must contract, the government is required to do so wisely and with a certain amount of flexibility to gain the approval of and to meet the changing needs of its citizens. In reality, the government strikes an uneasy balance between securing an advantageous contract for its citizens and remaining an attractive party with which to contract.

4. Martinez, supra note 3, at 541.
5. 2 THOMAS CARLYLE, Signs of the Times, in CRITICAL AND MISCELLANEOUS ESSAYS 56, 67 (1904); see also People v. Adirondack Ry., 54 N.E. 689, 692 (N.Y. 1899), aff’d, 176 U.S. 335 (1900) (“The power of taxation [and other powers] underlie the constitution, and rest upon necessity, because there can be no effective government without them. They are not conferred by the constitution, but exist because the state exists . . . . They are . . . rights inherent in the state as sovereign. . . . The state cannot surrender them . . . . They are as enduring and indestructible as the state itself.”).
7. According to one commentator, “the essential economic role of local government is to provide . . . those public services for which [its citizens] are willing to pay.” Richard M. Bird, Threading the Fiscal Labyrinth: Some Issues in Fiscal Decentralization; Symposium on Fiscal
The government’s power to contract also may involve long-term commitments. Of course, the government should honor these commitments whenever possible. However, there is little advantage to forcing one generation to be controlled by or be locked into a preceding generation’s misguided or outdated contracts, and the government should remain flexible to adapt its policies to the changing needs of its constituents. After all, the government should represent its current citizens, not long-gone citizens. Such concerns, however, directly affect the perception of the government as a reliable and predictable party with which to contract.

The Supreme Court’s most recent pronouncement on government contracts, United States v. Winstar Corp., affirmed that, when acting in its contracting capacity, the government should be held to ordinary contract principles in order to remain a reliable contracting party. However,
Winstar does not address contracting situations that implicate the government's sovereign powers. This article focuses on an unanswered question—circumstances where the government's contracting powers collide with its sovereign powers of taxation.

When a venture generates gross income, the government's exercise of its power to tax such income inevitably affects the contractual advantage gained by the private party. Private parties accept this not because of a diminution in contractual advantage but because there is tacit assent to the government's authority to do so. The question then becomes what limitations have been placed or should be placed on the government's authority to tax when a contract or a joint venture carried on with the government becomes the target of taxation.

This article probes the contours of the government's exercise of its sovereign powers in the context of its power to tax government contracts. By following a basic theme premised on the need for the government to remain a valued contracting party, small scale considerations of contract law are fleshed out in order to focus on the larger picture of the government's role as a contracting party. Concerns about separation of powers and fairness in the tax system underlie the discussion.\(^\text{12}\) Sovereign powers are examined in situations involving federal and state government contracts along with tax cases and principles. This article demonstrates how the Court's decisions to uphold the government's power to tax government contracts support the basic idea of the government as a sovereign at the necessary expense of fundamental contract law.

II. THE POWER TO TAX

A. Government's Broad Powers of Taxation

The power of the State to decide and to describe those exactions its citizens must pay is among the most fundamental and wide-reaching powers of government.\(^\text{13}\) It is axiomatic that any government needs the financial

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12. Separation of powers is implicated because contracts are usually negotiated and signed by agents of the executive branch, but the legislative branch may later attempt to tax through statute.

support of its citizens, whether voluntarily or involuntarily obtained, to function efficiently or even to function at all. 14 Given the vital role of taxes to the perpetuation of government, Cicero aptly stated that “[t]axes are the sinews of the state.” 15 Recognizing this concept, the United States Constitution expressly gives Congress the “power to lay and collect taxes, duties, imposts and excises.” 16

Throughout its history, the U.S. Supreme Court widely acknowledged the powerful and fundamental nature of the power to tax. 17 From McCulloch v. Maryland 18 to the present, the Court has affirmed this necessary governmental power. 19 In McCulloch, the fundamental nature of taxation was recognized implicitly by Chief Justice Marshall’s celebrated dictum regarding state taxation and sovereign immunity:

That the power to tax involves the power to destroy; that the power to destroy may defeat and render useless the power to create; that there is a plain repugnance in conferring on one government a power to control the constitutional measures of another, which other, with respect

constant refrain of political and constitutional history treats taxation as an inherent and indispensable power of the sovereign.”).

14. See Nichols v. United States, 74 U.S. (10 Wall.) 122, 129 (1868) (stating that “[t]he prompt collection of the revenue, and its faithful application, is one of the most vital duties of government”).

15. Marcus Tullius Cicero quoted in BERNARD WOLFMAN & JAMES P. HOLDEN, ETHICAL PROBLEMS IN FEDERAL TAX PRACTICE xviii (2d ed. 1985). Cicero believed nothing was more noble than the law of the State. Laws were “originally made for the security of the people, for the preservation of the state, [and] for the peace and happiness of human life.” HUNTINGTON CAIRNS, LEGAL PHILOSOPHY FROM PLATO TO HEGEL 142 (1949). Taxes helped to achieve that level of security. Id. Justices Holmes and Brandeis expressed a similar thought: “Taxes are what we pay for civilized society.” Compania de Tobacos v. Collector, 275 U.S. 87, 100 (1927) (Holmes & Brandeis, JJ., dissenting). The Supreme Court, in 1935, also declared that “taxes are the lifeblood of government.” Bull v. United States, 295 U.S. 247, 259 (1935). “A world without taxation is a world without government.” Epstein, supra note 13.


17. See, e.g., Minneapolis Star & Tribune Co. v. Minnesota Comm’r of Revenue, 460 U.S. 575, 585 (1983) (explaining that differential taxation power is a “powerful weapon against the taxpayer selected”); Providence Bank v. Billings, 29 U.S. (4 Pet.) 514, 563 (1830) (arguing that the power to tax “operates on all the persons and property belonging to the body politic” and “has its foundation in society itself”).


19. See, e.g., Regan v. Taxation With Representation, 461 U.S. 540, 547 (1983) (“Legislatures have especially broad latitude in creating classifications and distinctions in tax statutes.”); Loan Ass’n v. Topeka, 87 U.S. (20 Wall.) 655, 663 (1874) (“The power to tax is . . . the most pernicious of all the powers of government.”); United States v. Coite, 73 U.S. (6 Wall.) 594, 606 (1867) (stating that the “power [to tax] resides in government as part of itself”).
to those very measures, is declared to be supreme over that which exerts the control, are propositions not to be denied.\textsuperscript{20}

In United States v. Coite, the Court took pains to articulate that the taxation power "resides in the government as a part of itself" and is "never presumed to be relinquished."\textsuperscript{21} Because the taxing power exists "for the benefit of all" including the government itself, the Court allows seemingly unbridled taxation of all taxpayers over which the government has "sovereign power."\textsuperscript{22}

Barclays Bank PLC v. Franchise Tax Board\textsuperscript{23} is consistent with the idea that government taxation power has no meaningful limits. In Barclays, the Court upheld California’s imposition of a franchise tax using a "worldwide combined reporting" method.\textsuperscript{24} The tax required corporations operating in California to aggregate the income of their parent corporations, affiliates, and subsidiaries, including entities operating in other states and foreign countries. The state then taxed a percentage of the worldwide income equal to the average proportion of worldwide payroll, property, and sales in California.\textsuperscript{25} For example, in the first of the cases consolidated in Barclays, the state used the income of Barclays Group, a multinational banking enterprise composed of over 220 corporations, to determine the tax liability for two independent members operating in California. The state found that the two members were part of a "worldwide unitary business" and assessed them approximately $153,000 in additional tax liability.\textsuperscript{26} Although petitioners pointed out that multinational corporations may be subject to "multiple taxation" in different countries, the Court still was willing to uphold the tax as an inherent state power.\textsuperscript{27}

Barclays stands for the proposition that along with the broad power to tax comes the equally wide ability to "guard against" taxpayer manipulations of tax laws that almost avoid taxes altogether.\textsuperscript{28} The Court

\textsuperscript{20} McCulloch v. Maryland, 17 U.S. (4 Wheat.) 316, 431 (1819).
\textsuperscript{21} Coite, 73 U.S. (6 Wall.) at 606 (upholding the state’s power to impose a franchise tax on bank deposits reinvested into U.S. tax-exempt securities).
\textsuperscript{22} Id.
\textsuperscript{23} 511 U.S. 298 (1994).
\textsuperscript{24} Id. at 304.
\textsuperscript{25} Id.; CAL. REV. & TAX CODE § 25128 (West 1992). Once the average percentage was determined, that percentage of the total income of the large corporate entity as a whole would be the tax liability for the subsidiary. Barclays, 511 U.S. at 304-05.
\textsuperscript{26} Barclays, 511 U.S. at 307.
\textsuperscript{27} Id. at 316-20.
\textsuperscript{28} Id. at 305. Using the "worldwide combined reporting method," California was attempting to stop larger corporations from reducing their tax liability by manipulating their value among the subsidiaries. Id.
acknowledged that upholding the state's power to tax meant that some taxpayers were at risk for or would be subject to "multiple international taxation."\textsuperscript{29} The rights of taxpayer-citizens must yield to "tax uniformity" and "state autonomy."\textsuperscript{30}

In Nordlinger v. Hahn, another recent case, the Court approved a property tax creating disparities in taxes paid by persons owning similar pieces of property.\textsuperscript{31} The case challenged California's Proposition 13, a constitutional amendment which required that property taxes be assessed based on each owner's acquisition cost rather than assessing the tax based on the property's estimated current market value. This assessment method resulted in newer buyers paying considerably more taxes than long-term owners because of escalating real estate prices. In fact, the petitioner was paying five times more in property taxes than some of her neighbors.\textsuperscript{32} The Court upheld the tax because it rationally furthered a legitimate state interest although it "appear[ed] to vest benefits in a broad, powerful, and entrenched segment of society."\textsuperscript{33} Even though the tax unfairly burdened some members of the public, judicial intervention was not warranted.

\section*{B. Limitations on the Power to Tax}

Notwithstanding a consistent theme of unbridled government power to tax, the power is subject to some limitations. A basic theme is that taxes are for the public or common good. A tax must be levied for a public purpose and not merely to benefit private enterprise or to "build up private fortunes."\textsuperscript{34} This limitation is implicit, as the public is generally subject to taxes "to raise money for public purposes" and not to support the private needs of individuals.\textsuperscript{35} Thus, initially, the validity of a tax should be tested by determining who is benefited by the tax and whether the tax was initiated

\begin{itemize}
\item \textsuperscript{29} \textit{Id.} at 318.
\item \textsuperscript{30} \textit{Id.} at 330-31.
\item \textsuperscript{31} 505 U.S. 1 (1992).
\item \textsuperscript{32} \textit{Id.} at 7.
\item \textsuperscript{33} \textit{Id.} at 17.
\item \textsuperscript{34} Loan Ass'n v. Topeka, 87 U.S. 655, 664 (1874) (striking a tax levied to create a city fund for the purpose of donating money to a private manufacturer to encourage the establishment of its business in Topeka). The Court recognized that "[o]f all the powers conferred upon government that of taxation is the most liable to abuse." \textit{Id.} at 663. The use of the power to tax by Topeka in this instance was "robery" because although the city claimed to support the public good with the tax by encouraging the growth of business, the benefit vested too remotely. \textit{Id.}
\item \textsuperscript{35} \textit{Id.} at 664.
\end{itemize}
with proper authority or as a perversion of the government's taxation powers.\footnote{36}

The government's power to tax is further limited by fairness or equity.\footnote{37} A postulate of any system of taxation is that the burden of paying the tax should be borne equally or that the burden should at least be levied in a consistent and rational fashion.\footnote{38} The tax system in the United States is a major vehicle of social and economic policy.\footnote{39} It exists to raise revenue and to ensure stable economic growth while maintaining vertical equity (distributing the incidence of tax fairly by income classes) and horizontal equity (distributing the incidence of tax evenly among those in similar circumstances).\footnote{40} Thus, lawmakers emphasize that fair distribution of the tax burden is a central concern in the enactment of tax legislation.\footnote{41} A primary reason for enacting fair tax legislation is that it promotes in the taxpayer a \textit{perception} that obedience of the tax laws, as well as punishment for violation of the tax laws, is morally grounded. This perception facilitates tax collection.\footnote{42} Fairness is essential to the system because it increases taxpayer morale and enhances voluntary compliance with the tax laws.\footnote{43} Such limitations are viewed as part of the "essential

\begin{footnotesize}
\footnote{36}{\textit{Id.} at 665.}
\footnote{37}{\textit{Martinez, supra} note 3, at 549 n.3.}
\footnote{40}{\textit{See Harper v. Virginia Dept. of Taxation, 509 U.S. 86, 87 (1993) (holding that the state must apply the Court's interpretation of new federal tax law and its retroactive application of a rule, and that the state's selective application of the new rule violates the principle of treating similarly situated parties in a like manner); see also Memphis Bank & Trust Co. v. Garner, 459 U.S. 392, 397 (1983) (striking a tax that discriminated in favor of securities issued by the State of Tennessee over those issued by the federal government).}}
\footnote{41}{\textit{See, e.g., STAFF OF JOINT COMM. ON TAXATION, 99TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 7 (Comm. Print 1987) (stating that the primary objective of the Act is to ensure that individuals with similar income pay similar amounts of tax); SENATE FINANCE COMM. REPORT ON THE TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982, S. REP. NO. 97-494, at 97 (1982) (stating that the Act is designed to improve tax equity).}}
\footnote{42}{Chief Justice Marshall was of the opinion that the power to tax required popular confidence that it would not be abused. McCulloch v. Maryland, 17 U.S. (4 Wheat.) 316, 431 (1819).}
\end{footnotesize}
nature of all free governments, coexisting with the protection of individual rights.\textsuperscript{44} At the same time, the Court has still made it clear that differential taxation schemes are not unconstitutional so long as they do not invoke First Amendment concerns and the taxes are imposed in a nondiscriminatory manner.\textsuperscript{45} Justice Rehnquist, in his dissent to \textit{Minneapolis Star & Tribune Co. v. Minnesota Commissioner of Revenue}, wrote that the state can impose different taxes upon products and professions and can devise classifications for the groups taxed: “[T]here is no [constitutional] infringement . . . unless the State’s classifications significantly burden . . . specially protected rights.”\textsuperscript{46} This article will show that the power to tax can be circumscribed if it serves a deterrent purpose seeking to completely bar an activity, if it is used exclusively to punish, or if it is harsh and oppressive. As will be developed, even in the face of these articulated limitations, the Court is still hesitant to declare a tax unconstitutional unless it is a gross manipulation of the power to tax.

1. Deterrent Taxes

A court will uphold a tax that results in the deterrence of an activity unless deterrence is its exclusive purpose. A tax cannot bar an activity, but the Supreme Court has upheld taxes that discourage an activity or make it difficult or expensive.\textsuperscript{47} The Court defers to the taxing authority and will

\textsuperscript{44} Loan Ass’n v. Topeka, 87 U.S. (20 Wall.) 655, 663 (1874).

\textsuperscript{45} In \textit{Minneapolis Star & Tribune Co. v. Minnesota Commissioner of Revenue}, the Court held that the “use tax” on the cost of paper and ink products enacted by Minnesota violated the First Amendment because it singled out the press as a whole and, because of exemptions, a small group of newspapers in particular. 460 U.S. 575, 579 (1983). The Court feared that vesting this type of power in the state would allow the state to indirectly regulate and suppress the press. \textit{Id.} at 585; see also Arkansas Writers’ Project, Inc. v. Ragland, 481 U.S. 221 (1987).

The Constitution also prohibits direct taxes unless they are levied in proportion to the populations of the states. U.S. CONST. art. I, § 9, cl. 4. This requirement is often termed “geographic uniformity.” TRIBE, \textit{supra} note 6, at 245.

\textsuperscript{46} \textit{Minneapolis Star}, 460 U.S. at 599 (Rehnquist, J., dissenting).

\textsuperscript{47} See Sonzinsky v. United States, 300 U.S. 506 (1937).
often search for means to label the tax a “revenue raising” operation, thereby making deterrence merely a side effect of the tax.\textsuperscript{48} According to the Court, legitimate taxes “generate government revenues, impose fiscal burdens on individuals, and deter certain behavior."\textsuperscript{49} The amount of a tax is apparently not a factor the Court focuses on, even if the excessive amount demonstrates a deterrent purpose.\textsuperscript{50} In fact, the Court has expressed the idea that even a tax with a particularly steep rate or an “obvious deterrent purpose” does not necessarily evince an inappropriate use of the power to tax.\textsuperscript{51} So long as revenue generation can be labeled as the main purpose for the tax, the Court likely will disregard the high rate and the deterrent effect.\textsuperscript{52} Mixed-motive taxes, such as high “sin taxes” imposed on lawful products like cigarettes to reduce consumption and increase government revenue, also are not illegitimate uses of the power to tax.\textsuperscript{53} Although the legislature is exercising its power in a persuasive manner and attempting to control the actions of some citizens, the taxes themselves are still geared toward revenue generation.

The Court will defer to the legislature’s power to tax even if “enforcement might be oppressive or . . . the legislature’s motive was somehow suspect.”\textsuperscript{53} The Court lacks the competence, or perhaps the willingness, to inquire into “hidden motives” the legislature may have when exercising the constitutional power to tax.\textsuperscript{54} A deterrent tax will be upheld if the Court concludes its purpose is to discourage, as opposed to completely

\textsuperscript{48} See Department of Revenue v. Kurth Ranch, 511 U.S. 767, 779-80 (1994). According to dissenting Chief Justice Rehnquist, “[t]axes are customarily enacted to raise revenue to support the costs of government” but also “may be enacted to deter or even suppress the taxed activity.” Id. at 787 (Rehnquist, C.J., dissenting).

\textsuperscript{49} Id. at 778.

\textsuperscript{50} Id. at 780. In Kurth Ranch, the Court struck down the Montana drug tax statute that imposed a tax on the possession and storage of dangerous drugs after the defendants were arrested on drug charges. The Department of Revenue attempted to collect almost $900,000 in taxes from the Kurths independent of any criminal penalties. The Court found the Montana statute unconstitutional because it placed the Kurths “in jeopardy a second time for the same offence [sic].” Id. at 784. This was the first time the Supreme Court held that a tax violates the Double Jeopardy Clause of the Constitution. Id. at 779, 783-84. Worth noting is the fact that the tax liability in Kurth Ranch was nearly eight times the worth of the marijuana, obviously a deterrent tax, yet this was not the basis for the statute’s unconstitutionality. Id. at 780.

\textsuperscript{51} Id. at 780-81.

\textsuperscript{52} Id. at 791 (Rehnquist, C.J., dissenting); see also WEBBER & WILDAVSKY, supra note 13, at 553 (“[T]he taxation of ‘luxuries’ or of commodities deemed to be bad for you, like tobacco and liquor, is very old indeed.”).

\textsuperscript{53} Kurth Ranch, 511 U.S. at 779.

\textsuperscript{54} Sonzinsky, 300 U.S. at 513.
bar, an activity because the economic benefits of continuing the activity outweigh any resulting harm.\textsuperscript{55}

Even when confronted with a tax that is "prohibitive in effect" and seems to be imposed to suppress an activity, the Court remains hesitant to declare the tax unconstitutional.\textsuperscript{56} For example, in \textit{Sonzinsky v. United States}, the taxpayer challenged the constitutionality of a firearms tax under the National Firearms Act that required him, as a dealer in firearms, to pay an annual $200 licensing tax.\textsuperscript{57} He urged the Court to strike the tax because it was not a "true tax," but was an example of Congress' legislative purpose to suppress trafficking of firearms.\textsuperscript{58} The Court espoused the idea that every tax in some way regulates an activity and "to some extent . . . interposes an economic impediment to the activity taxed as compared with others not taxed."\textsuperscript{59} Also, the Court viewed the tax narrowly; not reviewing the entire statute but, instead, looking only at the provisions that were directly applicable to the case.\textsuperscript{60} In reality, the Court concluded that when a tax falls within the gray area, unless it is obvious from the legislation itself that the tax was not intended to be a "true tax," it is within the legislature's legitimate exercise of its power to tax.\textsuperscript{61}

In \textit{Montana v. United States}, the Court upheld an arguably deterrent tax that Montana imposed on public, as opposed to private, contracts as a means to prevent contractors from evading their tax obligations.\textsuperscript{62} In

\begin{itemize}
\item \textsuperscript{55} \textit{Id.} at 513-14.
\item \textsuperscript{56} \textit{Id.} at 513.
\item \textsuperscript{57} \textit{Id.} at 511.
\item \textsuperscript{58} \textit{Id.} at 512.
\item \textsuperscript{59} \textit{Id.} at 513.
\item \textsuperscript{60} \textit{Id.} at 511. The National Firearms Act imposed three levels of taxation on the firearms business: a tax on the dealer, on the importer, and on the transferor. \textit{Sonzinsky} used this three-level taxation scheme in an attempt to establish Congress' "true intent," demonstrating that the amount of taxation on the firearms was exorbitant considering its relatively small value. \textit{Id.} at 512-13. The Court dismissed this argument by refusing to look at the three levels of taxation as a whole. Instead, the Court only addressed the level of taxation that applied to Sonzinsky directly, which was the tax on the dealers. \textit{Id.} at 513. This approach indicates that the Court's position is not to interfere with legislative actions unless the legislature clearly abuses its taxation power.
\item \textsuperscript{61} \textit{Id.} at 513-14. The tax in \textit{Sonzinsky}, for example, was constitutional because the court found it to be a revenue-producing mechanism, characteristic of a "true tax." Even if the tax in \textit{Sonzinsky} did operate as a deterrent to the sale and import of firearms, the Court was compelled to uphold the measure essentially because it was labeled a tax. The Court refused to infer any purpose other than revenue generation. Unless the tax completely barred the sale of firearms, or was accompanied by "offensive regulation[s]" that could prove some other congressional motive, it had to be declared constitutional. \textit{Id.}
\item \textsuperscript{62} \textit{Montana v. United States}, 440 U.S. 147, 164 (1979). Montana imposed a one percent gross receipts tax on federal and state public contractors who were allowed to then credit their tax payment against various other tax obligations. The remainder of the tax was usually passed on to the governmental agency as an increased cost. \textit{Id.} at 149, 152. However, when the state
upholding the tax, the Court, "without reaching the merits," found that the United States was subsequently bound by a Montana Supreme Court decision holding that the tax and its distinction were consistent with the Equal Protection and Supremacy Clauses. 63 However, the Court explained that the tax was neither discriminatory nor ostensibly deterrent because it taxed state and federal contractors alike—that state and private contractors could virtually avoid the tax and Montana could recoup its losses, while federal contractors and the federal government could not, was of no moment. 64

The tax was able to pass constitutional muster labeled as a "revenue-enforcing" tax, and thus the Court dismissed any resulting harm against public contractors as inconsequential. 65 The Court characterized the tax as merely "removing any incentive" for public contractors to evade their tax liabilities. 66 In sum, it appears that the Court allows the government to use "taxation [as] a primary instrument for regulating individual behavior" under its contracts. 67

2. Punitive Taxes

The legislature cannot use tax laws as tools to inflict punishment or assess penalties. If a tax is imposed in such a manner and punishment is an obvious goal, then it is likely an exaggeration of the legislature's taxing

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63. Id. at 153; U.S. CONST. art. VI, cl. 2; U.S. CONST. amend. XIV. In earlier state court proceedings, the Montana Supreme Court upheld the constitutionality of the tax. See Peter Kiewit Sons' Co. v. State Bd. of Equalization, 505 P.2d 102, 108-10 (Mont. 1973). In the separate federal proceedings, the U.S. Supreme Court held that the state court decision on this issue was binding under collateral estoppel. Therefore, the Court did not question the constitutionality of the tax. Montana, 440 U.S. at 152-53.

64. Montana, 440 U.S. at 152-53.

65. Id. at 159-60. Interestingly, in Montana, the district court believed that the result of this tax, that public contractors would merely include this tax as a cost of performance and thus pass the state tax onto the U.S. government, was irrelevant. United States v. Montana, 437 F. Supp. 354, 358 (Mont. 1977), rev'd, 440 U.S. 147 (1979); accord Peter Kiewit Sons', 505 P.2d at 110 (finding the burden on the federal government was "indirect and not substantial").


67. WEBBER & WILDAVSKY, supra note 13, at 553.
authority. The Court closely scrutinizes taxes with punitive characteristics, and is less willing to allow a punitive tax to pass constitutional muster. 68

In Department of Revenue v. Kurth Ranch, the Court struck a drug tax because it was “imposed on criminals and no others, [and] depart[ed] so far from normal revenue laws as to become a form of punishment.” 69 The Kurth Ranch majority rejected the more lenient test for civil penalties, which states that such penalties are constitutional if they “merely reimburse[] the government for its actual costs arising from the defendant’s criminal conduct.” 70 The Court’s characterization of a legitimate tax focuses on the requirement of revenue generation, even if deterrence or regulation is a result. 71 In Kurth Ranch, both the dissent and majority seemed to agree and arguably took for granted that tax laws lack a moral component and, as such, cannot be imposed to punish.

The Court will not allow government to impose prohibitive taxes: “‘[T]here comes a time in the extension of the penalizing features of the so-called tax when it loses its character as such and becomes a mere penalty


69. Id. at 783 (emphasis added). That the tax was labeled civil as opposed to criminal was of no moment. A tax subsequent to and in addition to criminal penalties is inappropriate if its purpose “may not fairly be characterized as remedial, but only as a deterrent or retribution.” United States v. Halper, 490 U.S. 435, 448-49 (1989).

70. Kurth Ranch, 511 U.S. at 777 (citing Halper, 490 U.S. at 449-50, 452). The test for civil penalties, first articulated in Halper, provides that a penalty is punitive, thus inappropriate, if its purpose “bears no rational relation to . . . compensating the government for its loss.” Halper, 490 U.S. at 449. The Kurth Ranch Court distinguished Halper by characterizing its task as analyzing whether a tax, as opposed to a penalty, is punitive. Kurth Ranch, 511 U.S. at 784. Chief Justice Rehnquist dissented in Kurth Ranch but agreed that Halper was inapplicable because taxes “need not be based on any benefit accorded to the taxpayer or on any damage or cost incurred by the Government as a result of the taxpayer’s activities.” Id. at 787 (Rehnquist, C.J., dissenting). Rehnquist noted that the Court previously found a drug tax to be a “true tax” rather than a penalty because “[i]t is beyond serious question that a tax does not cease to be valid merely because it regulates, discourages, or even definitely deters the activity taxed.” Id. at 788 (quoting United States v. Sanchez, 340 U.S. 42, 44 (1950) (upholding a tax on marijuana transfers as a civil sanction)); cf. Rev. Martin T. Crowe, The Moral Obligation of Paying Just Taxes, in 84 THE CATHOLIC UNIVERSITY OF AMERICA STUDIES IN SACRED THEOLOGY, at 23 (1944) (theorizing that “a tax on Mass wine for the purpose of hindering or hampering its use, would be an unjust tax” in that it “interferes with rights which are outside the competence of the civil government”). The Kurth Ranch majority also refused to address whether “an ostensibly civil proceeding that is designed to inflict punishment may bar a subsequent proceeding that is admittedly criminal in character” as that issue was not raised by the Kurth Ranch tax statute. 511 U.S. at 781 n.21.

71. The Court further stated that mixed-motive taxes (i.e., taxes imposed to deter an activity as well as raise revenue) and taxes that do have a steep rate will also be upheld. Kurth Ranch, 511 U.S. at 780-81.
with the characteristics of regulation and punishment.” This was the case in Kurth Ranch. 73

The Court explained that “unusual features” distinguished the punitive tax from legitimate taxes. 74 For example, a tax may be illegitimate if it is “conditioned on the commission of a crime. That condition is ‘significant of penal and prohibitory intent rather than the gathering of revenue.’” 75 In addition, any economic and morally neutral purpose behind a mixed-motive tax and the tax itself are rendered illegitimate if the tax only is imposed on criminal activity. “[J]ustifications [for such a tax] vanish when the taxed activity is completely forbidden, for the legitimate revenue-raising purpose that might support such a tax could be equally well served by increasing the fine imposed upon conviction.” 76 A tax is also inappropriately punitive if it serves an apparent purpose that is “arbitrary” or “shocking.” 77

The Child Labor Tax Case illustrates further that a tax is illegitimate if it is imposed purely as a means of punishment and governmental

72. Id. at 779 (quoting Magnano Co. v. Hamilton, 292 U.S. 40, 46 (1934)). The proposition that taxes are inappropriate if used as penalties (i.e., taxes that are imposed for the commission or omission of an act) is in accord with the opinion of some scholars who assert that “one is obligated to pay only those taxes that are not penal in nature.” Robert W. McGee, Is Tax Evasion Unethical?, 42 Kan. L. Rev. 411, 417 (1994) (citing Crowe, supra note 70, at 75).

73. In Kurth Ranch, the Court held that the tax “had an unmistakable punitive character,” illustrated by its high rate and because the tax was imposed for “‘possession’ of goods that no longer exist[ed] [the drugs had been destroyed by authorities] and that the taxpayer never lawfully possessed.” 511 U.S. at 783.

74. Id. at 781.

75. Id. (quoting United States v. Constantine, 296 U.S. 287, 295 (1935)); see also United States v. La Franca, 282 U.S. 568 (1931) (barring a liquor tax assessed only against persons prosecuted for illegal manufacture of liquor).

76. Kurth Ranch, 511 U.S. at 782; see also id. at 787 (Rehnquist, C.J., dissenting) (stating that, although taxes are designed to raise revenue, “taxes may be enacted to deter or even suppress the taxed activity”); id. at 792, 794 (O’Connor, J., dissenting) (“The power to tax illegal activity carries with it the danger that the legislature will use the tax to punish the participants for engaging in that activity,” and “a civil sanction will be considered punishment to the extent that it serves only the purposes of retribution and deterrence, as opposed to furthering any nonpunitive objective.”); id. at 803-04, 807 (Scalia, J., dissenting) (Preferring to “put the Halper genie back in the bottle” and inquire whether the “tax proceeding . . . constituted a second criminal prosecution,” but agreeing with the majority that, unlike the civil penalty involved in the Halper case, Kurth Ranch does not present “an adjudicated fine that can be judicially reduced to a lower level, but rather a tax; and so we grapple with the different, though no less peculiar, inquiry: when is a tax so high (or so something-else) that it is a punishment?”).

77. Id. at 791. (Rehnquist, C.J., dissenting). In its articulation of the constitutional standard, the Kurth Ranch Court employs an “arbitrary” or “shocking” standard that is arguably the equivalent to Carlton’s “arbitrary or irrational” and “harsh and oppressive” standards. United States v. Carlton, 512 U.S. 26 (1994); see also infra notes 84-92 and accompanying text.
regulation. The Child Labor Tax Law established that any company operating a mine or quarry that employed children under the age of fourteen or allowed children between the ages of fourteen and sixteen to work more than eight hours a day or six days a week would be taxed an equivalent of ten percent of the entire net profits for the year of such employment. Congress did not declare that employment of children was illegal, but through the tax statute it exhibited its intention to completely bar such employment.

The tax in the Child Labor Tax Case was imposed neither to collect revenue nor to reimburse the government for costs accrued; instead, it was created simply to achieve “some other purpose plainly within state power.” Not only was Congress attempting to punish those businesses that employed children, but through the tax statute it tried to regulate the labor laws of the states, an exclusive state function under the Constitution. Although the Court, “[o]ut of proper respect for the acts of a coordinate branch of Government . . . has gone far to sustain taxing acts,” in the Child Labor Tax Case, this “presumption of validity [could] not prevail, because the proof of the contrary [was] found on the very face of its provisions.”

3. Harsh and Oppressive Taxes

In addition to punitive taxes, tax law that affects individuals or groups of individuals unfairly, thereby operating in a harsh and oppressive manner, does not reflect legitimate legislative authority. Although this is true in theory, the Court has traveled some distance to uphold taxes that at first glance appear to be harsh and oppressive.

For example, a tax could be viewed as harsh and oppressive if it is retroactively applied. The Court placed the government’s power to tax retroactively in sharp focus in United States v. Carlton. In Carlton, the


79. The Revenue Act of Feb. 24, 1919, Title XII, ch. 18, § 1200, 40 Stat. 1057, 1138 (1919). This same tax was imposed whether the company employed one child or one hundred children. Child Labor Tax Case, 259 U.S. at 36.

80. Child Labor Tax Case, 259 U.S. at 43.

81. Id. at 36.

82. Id. at 37-38. The tax statute included detailed legislation attempting to proscribe the actions of mining companies which was not necessarily unconstitutional, but the tax was primarily aimed at stopping the employment of children within the age range. “Its prohibitory and regulatory effect and purpose are palpable.” Id. at 37.

83. See Carlton, 512 U.S. at 30.

84. Id. at 27.
executor of an estate engaged in a transaction resulting in over a half million dollar loss in order to take advantage of an estate tax deduction. The IRS disallowed the deduction, based on a recent tax law amendment that retroactively eliminated the deduction. The Court rejected Carlton’s claim of reliance and detriment and upheld the retroactive tax as constitutional. 85 The Court contended that because taxes are within the “sphere of economic policy,” the “harsh and oppressive” test for the validity of retroactive tax legislation is the same as the test for “arbitrary and irrational legislation” generally applicable to economic legislation. 86 The Court will uphold a retroactive tax, like any other retroactive economic legislation, if it “is supported by a legitimate legislative purpose furthered by rational means.” 87

The Carlton Court found the congressional purpose for the tax was “neither illegitimate nor arbitrary.” 88 The tax was a justifiable “curative measure” designed to correct the risk of “significant and unanticipated revenue loss” 89 created by taxpayers engaging in “purely tax-motivated stock transfers” that would drastically reduce or even eliminate their tax obligations. 90 Moreover, Congress acted promptly and the tax’s retroactivity period was “modest,” moving the Court to reject the taxpayer’s claims of

85. Id. at 28-29, 35.
86. Id. at 30. Another method courts use to review tax legislation for harsh and oppressive characteristics is to “defer to legislative judgment as to the necessity and reasonableness of [the] particular measure.” United States Trust Co. v. New Jersey, 431 U.S. 1, 22 (1977) (citing East N.Y. Sav. Bank v. Hahn, 326 U.S. 230 (1945)). United States Trust uses the “necessary and reasonable test” to look at potential Contract Clause violations when a state enacts legislation that affects previously negotiated government contracts. United States Trust, 431 U.S. at 25; see infra notes 165-172 and accompanying text.
88. Carlton, 512 U.S. at 32.
89. Id. at 31-32. Instead of a projected $300 million loss, Congress realized it would be faced with a $7 billion loss due to “essentially sham transactions” because of a congressional oversight. Id. at 32 (quoting 133 Cong. Rec. 4145, 4294 (1987) (statement of Sen. Bentsen)).
90. Id. Justice O’Connor, in her concurring opinion, emphasized that “Congress must be able to make such adjustments in an attempt to equalize actual revenue and projected budgetary requirements.” Id. at 38 (O’Connor, J., concurring).
reliance and lack of notice. Hence, the threshold for finding a retroactive tax harsh and oppressive is exceedingly high.

Attempts by taxpayers to characterize discriminatory property taxes as harsh and oppressive also have not been successful. The Supreme Court has acknowledged that there may be legitimate and rational policy reasons to deny one taxpayer a tax-connected benefit in favor of another taxpayer, including “local neighborhood preservation, continuity, and stability.” In *Nordlinger v. Hahn*, for example, after analyzing California's scheme of property taxation that explicitly favored long-time homeowners, the Court recognized that taxes may reflect the fact that the state finds one taxpayer’s expectations are “more deserving of protection” than another taxpayer’s perceptions.

As previously discussed, the *Nordlinger* Court was asked to assess the constitutionality of California’s property tax scheme under a constitutional amendment that created dramatic disparities between taxpayers owning relatively similar properties. Through this acquisition-value assessment scheme, a long-time homeowner’s property tax was based on an essentially frozen 1975-76 tax year value, with an inflationary cap not to exceed two percent. The Court noted that Nordlinger, as a 1989 purchaser of a “modest” Los Angeles home worth $170,000, had a “general tax levied against her modest home . . . only a few dollars short of that paid by a pre-1976 owner of a $2.1 million Malibu beachfront home.” In view of such disparity, Nordlinger claimed California’s tax scheme violated the Equal Protection Clause in that such a tax was arbitrary.

Remarkably, both the *Nordlinger* dissent and majority conceded explicitly that this system of taxation is discriminatory and unfair. In his dissent, Justice Stevens referred to California long-time homeowners as

91. *Id.* at 32. On the issue of reliance, the Court explained: “Taxation is neither a penalty imposed on the taxpayer nor a liability which he assumes by contract. . . . [N]o citizen enjoys immunity from [the apportioned governmental cost] burden . . . .” *Id.* at 33 (quoting Welch v. Henry, 305 U.S. 134, 146-47 (1938)). Addressing lack of notice, the Court stated that “a taxpayer ‘should be regarded as taking his chances of any increase in the tax burden which might result from carrying out the established policy of taxation.’” *Id.* at 34 (quoting Milliken v. United States, 283 U.S. 15, 23 (1931)).

92. In fact, Justice Scalia opined that “[t]he reasoning the Court applies to uphold the statute in this case guarantees that all retroactive tax laws will henceforth be valid.” *Id.* at 40 (Scalia, J., concurring).


94. *Id.* at 13.

95. *Id.* at 5-6; CAL. CONST. art. XIII A.

96. *Nordlinger*, 505 U.S. at 7.

97. *Id.* at 8.
“Squires” and said the tax law creates “a privilege of a medieval character: Two families with equal needs and equal resources are treated differently solely because of their different heritage.” But the majority refused to invalidate the tax even though it characterized it as a “grand experiment [that] appears to vest benefits in a broad, powerful, and entrenched segment of society, and . . . ordinary democratic processes may be unlikely to prompt its reconsideration or repeal.” It seems that when it comes to taxes, the Court will not “second-guess[] state tax officials.”

Even under more obvious circumstances of inequity and oppression, the Court is not easily moved to strike a tax. In Metropolitan Life v. Ward, an insurer challenged on equal protection grounds an Alabama statute that imposed dramatically different tax premiums on domestic and out-of-state insurance companies, favoring the domestic companies. This gross disparity in tax premiums, admittedly an attempt by Alabama to bolster the creation of domestic insurance companies within the state, was viewed dramatically differently by opposing members of the Court. Although a majority held the tax unconstitutional, disapproving of discrimination against foreign corporations and violations of equal protection, a strong dissent by four of the Justices criticized the majority’s decision as “astonishing” and “unsupported by precedent.” In her dissent, Justice O’Connor contradicted the majority’s opinion, asserting that “long-established jurisprudence” required the Court to defer to the judgment of the legislature.

98. Id. at 29-30 (Stevens, J., dissenting).
99. Id. at 18. With the Nordlinger Court’s allowance of a tax it admittedly but unceremoniously described as discriminatory and unfair, it seems the Court merely pays lip service to its earlier warning of dire consequences from taxes that transfer wealth from one class to another. See also Loan Ass’n v. Topeka, 87 U.S. (20 Wall.) 655, 664 (1874) (the taxation power “can easily be employed against one class of individuals and in favor of another, so as to ruin the one class and give unlimited wealth and prosperity to the other”); David L. Barlett & James B. Steele, America: Who Really Pays the Taxes? (1994) (describing the tax system as two-fold, with one set of oppressive taxes for middle-class to poor taxpayers, and another favorable set for wealthy taxpayers, which works to pit these groups of taxpayers against each other); Webber & Wildavsky, supra note 13, at 553-54 (“social democracies” are controlled by “complex hierarchies” that use the taxes “to make their policy preferences effective,” resulting in a tax system favorable to the governing “elite” and oppressive to low and middle-class taxpayers due to “prudential considerations linked to the ease of generating large amounts of revenue”). But see Crowe, supra note 70, at 26 (arguing a moral obligation to pay taxes but acknowledging, almost as an afterthought, that in the “limited cases” in which taxpayers are required to pay more than their fair share of taxes, such taxpayers have no moral obligation to pay their tax obligations).
100. Nordlinger, 505 U.S. at 25 (Thomas, J., concurring).
102. Id. at 871. The domestic companies in Metropolitan Life were paying tax premiums of only 1% on all types of insurance, whereas the foreign companies were charged a rate of 3% on gross life insurance premiums received within the state and 4% on other types of insurance. Id.
103. Id. at 883 (O’Connor, J., dissenting).
so long as the classification for the differential tax was "rationally related to a legitimate state purpose."104

The extreme reluctance to second-guess the taxing authorities, apparent in Sonzinsky, Montana, Carlton, and Nordlinger, supported by language in other cases, belies the Court’s implicit recognition of and support for the proposition that taxes play a vital role in the existence and functioning of the government. For the sake of preserving this vital power to tax and the government’s financial well-being, the Court appears willing to defer to sovereign taxation powers and to sacrifice taxpayer concepts of fairness or fair play in order to allow the government to shift its tax burdens and benefits in ways clearly discriminatory and unfair. The theme of deference to legislative power is a constant and carries through the Court’s opinions regarding the government’s inherent power to contract as well.

III. THE POWER TO CONTRACT

While it is necessary for the government to enter into contracts to exist and sustain itself, the Supreme Court, until recently, adhered to the principle that the federal government as a contracting party was subject to the same rules and must be treated the same as a private contracting party.105 Indeed, the Court said over one hundred years ago that when governments enter into contracts "[t]hey come down to the level of ordinary individuals. Their contracts have the same meaning as that of similar contracts between private persons."106

Although the Court aspired to uphold the express language of each contract in early cases, a marked change developed as the Court began to defer to the government’s sovereign power. As early as the 1935 case of Perry v. United States, and despite sweeping statements requiring the government to adhere to contractual language, the Court only provided relief that the government had originally offered prior to the litigation—a moral victory for the plaintiffs was all the Court could muster.107 Hence, roots of

104. Id. at 884 (O’Connor, J., dissenting).
105. See Perry v. United States, 294 U.S. 330, 351-54 (1935) (stating that the United States has rights and responsibilities similar to those possessed by private parties).
107. Perry, 294 U.S. at 357-58. In Perry, the government issued bonds promising to pay the principal and interest in gold. However, once the government realized that, due to a change in gold prices, repayment of $10,000 in bonds would cost $16,000 in terms of money equivalent, it sought to ignore the original obligations and pay only the face value of the bonds in legal tender. Id. Even though the Perry Court found that the government’s attempt to ignore the gold clause was a breach of contract, the Court held that the aggrieved contracting party was only entitled to the face value of
the trend of upholding the government's sovereign power in contractual situations can be seen even in the early cases.

More recent cases indicate that courts defer to the government's sovereign powers by refusing to encroach upon the government's power to contract. In reality, the government is not required to abide by the same contractual rules and limitations as private citizens. Courts allow the government not only to manipulate the terms of existing contracts to which they are a party, but also to terminate and breach the contracts. If a private citizen were to attempt to change the written language of a contract, unless obtained by modification, the attempt would quickly be labeled bad faith and the party could be subject to damages for breach of contract. Today, the government is indeed treated as a sovereign subject to separate rules. In many ways, the government has much more control over formation, enforcement, and repudiation of its contracts than the private parties on the other side of the bargaining table.

A. Reserved Contractual Powers of the Federal Government

The government's broad sovereign power to contract is well illustrated by *G.L. Christian & Associates v. United States*, from which the so-called "Christian doctrine" derives. The *Christian* doctrine holds that regulations and statutory language, which may or may not have been

the bonds, "recover[ing] no more than the loss he has suffered and of which he may rightfully complain." *Id.* at 354. "He is not entitled to be enriched." *Id.*

The dissenting opinion in *Perry* applied to four cases that were designated as the "Gold Clause Cases." *Id.* at 361. The dissenting justices believed that the government should have been held to the express terms of the contract as required by precedent. The four Justices characterized the majority's holding as "amount[ing] to a declaration that the Government may give with one hand and take away with the other." *Id.* at 377 (McReynolds, J., dissenting). "Loss of reputation [to the government] for honorable dealing will bring us unending humiliation; the impending legal and moral chaos is appalling." *Id.* at 381 (McReynolds, J., dissenting).

108. See, e.g., *G.L. Christian & Assoc. v. United States*, 312 F.2d 418, 423-24, 427 (Ct. Cl. 1963) (allowing the government to utilize language not originally written into the contract in order to terminate the contract without repercussions). Also, a "clause required by a regulation, but mistakenly omitted from a contract subject to the regulation, may be regarded as included in the contract even if the contractor has not consented to it." JOHN W. WHELAN, UNDERSTANDING FEDERAL GOVERNMENT CONTRACTS ¶ 2-10.3, at 64 (1993).


110. 312 F.2d 418 (Ct. Cl. 1963).

discussed in the bargaining process or addressed in a contract, could very well be impliedly included in the contract.\textsuperscript{112}

In \textit{Christian}, the government entered into a construction contract with the plaintiffs for the completion of a large housing project at Fort Polk, Louisiana. When the government made the decision to deactivate Fort Polk, the government also terminated the contract and the plaintiffs sought damages.\textsuperscript{113} The U.S. Court of Claims limited the plaintiffs’ recovery as if the contract contained a “termination for the convenience of the Government” clause, although such an express provision was absent from the contract itself.\textsuperscript{114} Under the \textit{Christian} doctrine, the courts must read this broad sovereign power into the government contract unless by “conscious election” it is waived by an authorized government contracting official.\textsuperscript{115}

In effect, the \textit{Christian} doctrine “saves numerous [contracting officers] from their errors” and forces parties contracting with the government to know the law in order to predict what will be inferred, included, or omitted in their contract.\textsuperscript{116} The justification for impliedly including regulations in government contracts is that all federal government regulations “have the force and effect of law so long as they flow logically from a statute and are known to the contractor by publication or actual knowledge.”\textsuperscript{117} Similarly, if a statute requires inclusion of a particular clause in a government contract, the contractor is presumed to have

\begin{itemize}
\item \textsuperscript{112} \textit{Christian}, 312 F.2d at 426-27. The \textit{Christian} doctrine has been limited to cases in which the “regulations that implement fundamental procurement policy” require the term to be added to or withdrawn from a contract. \textsc{Ralph C. Nash, Jr. & Steven L. Schooner, The Government Contracts Reference Book} 71 (1992). “However,” it is explained, “a surprising number of clauses ... fall within its scope.” Nash & Cibinic, \textit{supra} note 111, at 27.
\item \textsuperscript{113} \textit{Christian}, 312 F.2d at 419.
\item \textsuperscript{114} \textit{Id.} at 427; \textit{see also} Nash & Cibinic, \textit{supra} note 111, at 27. Theoretically, at least, the government “has rights and it ordinarily incurs responsibilities similar to those of a private person.” \textit{Christian}, 312 F.2d at 423 (citing Lynch \textit{v. United States}, 292 U.S. 571 (1934)). Under this line of reasoning, the government’s termination should have resulted in its liability for all ensuing damages so as to “put the injured party in as good a position pecuniarily as he would have been if the contract had been performed.” \textit{Id.} (citing Miller \textit{v. Robertson}, 266 U.S. 243 (1924)). However, the right to recovery for these profits was dependent on the government breaching the contract. \textit{Id.}
\item If the government had reserved the right to terminate the contract at its convenience, which it was required to do under federal regulations, then there was no breach and therefore limited recovery. \textit{Id.}
\item \textsuperscript{115} Note that contracting officers may remove or modify standard contract clauses if permitted under regulations. In fact, the clause in \textit{Christian} could have been removed by an appropriate government official; however, the contracting officer who made the contract did not have the proper deviation authority. Nash & Cibinic, \textit{supra} note 111, at 27.
\item \textsuperscript{116} \textit{Id.} at 30. This idea of institutional knowledge is reflected in \textit{United States \textit{v. LaSalle National Bank}, 437 U.S. 298 (1978} (attributing governmental good faith to I.R.S. agents who might otherwise have been seen to act in bad faith).
\item \textsuperscript{117} Nash & Cibinic, \textit{supra} note 111, at 27 (citations omitted).
\end{itemize}
"constructive knowledge of all statutes" and the clause is impliedly included in that contract.\textsuperscript{118} If a contractor bargains for a clause different than what is required by a regulation or statute, the contractor must make sure that the contracting officer was authorized to include or waive such terms in order to avoid "fruitless" negotiation.\textsuperscript{119} Recent cases affirm the \textit{Christian} doctrine's grant of broad sovereign powers in a contract setting.\textsuperscript{120}

The significance of the \textit{Christian} doctrine and the trend of recent cases demonstrate that traditional contract theories applicable to private parties offer little protection to parties dealing with the government in a contract setting. Because the sovereign's contractual powers are presumed to be retained unless specifically abandoned, it is little wonder that a court may find "there is no breach and normally there can be no recovery" for lost profits when the government exercises its discretionary contractual powers that have been reserved through statute or regulation.\textsuperscript{121}

The "Court-enforced" limitations on the authority of federal government agents when contracting is another instance where the Supreme Court protects the government's reserved powers. Generally speaking, an agent of a private company acting within the scope of her authority, or within her "apparent or ostensible authority," can bind her principal to a contract.\textsuperscript{122} Government agents are also said to have broad contracting power unless Congress has limited the agent's power by statute.\textsuperscript{123} Yet the same set of rules do not apply to government agents and their private counterparts, for "anyone entering into an arrangement with the Government takes the risk of having accurately ascertained that he who purports to act for the Government stays within the bounds of his authority." . . . [T]his is so

\textsuperscript{118} \textit{Id.}
\textsuperscript{119} \textit{Id.} at 30. Government contractors are not always the party penalized by the \textit{Christian} doctrine. The \textit{Christian} doctrine may be used to add a mandatory clause to benefit a contractor if the government contracting officer forgets to include the clause or waives a clause without proper authority. \textit{See id.} The doctrine's message is "both parties beware." \textit{Id.}
\textsuperscript{120} \textit{See} ETSI Pipeline Project v. Missouri, 484 U.S. 495 (1988); Western Fuels-Utah, Inc. v. Lujan, 895 F.2d 780 (1990).
\textsuperscript{121} \textit{Christian}, 312 F.2d at 423.
\textsuperscript{122} \textit{Whelan}, supra note 108, ¶ 2-10.4, at 65.
\textsuperscript{123} G.L. Christian & Assoc. v. United States, 320 F.2d 345, 348 (Ct. Cl. 1963) (opinion denying motion for rehearing and reargument of original \textit{Christian} decision, discussed \textit{supra} text accompanying notes 110-15); \textit{see also} Paul v. United States, 371 U.S. 245, 251-55, 261-63 (1963) (holding that state regulations that conflict with federal procurement regulations cannot be applied constitutionally at U.S. military enclaves); Kern-Limerick, Inc. v. Scurlock, 347 U.S. 110, 114 (1954) (holding that state tax law does not apply to contractors acting as purchasing agents under federal procurement regulations).
even though . . . the agent himself may have been unaware of the limitations upon his authority." 124

An example of the repercussions of this limitation on the contracting authority of government agents appears in ETSI Pipeline Project v. Missouri. 125 ETSI entered into a forty-year contract with the Secretary of the Interior to withdraw water from Lake Oahe, Missouri. 126 Unfortunately for ETSI, the approval of the Secretary of the Army was required for this contract because the Army Corps of Engineers operated the reservoir pursuant to the Flood Control Act of 1944. 127 In accord with the language in Christian and the limitations on unauthorized government agents, the Court denied the enforceability of the contract because the actions by the Secretary of the Interior were "directly inconsistent" with the Flood Control Act. 128 Pursuant to Christian, one can assume that ETSI should have known the law in order to ensure that the contract being negotiated was in fact valid.

B. Fairness Limitations

The notion of fairness underlies rules of business as well as principles of law. As noted above, fairness remains fundamental to the formulation and administration of federal tax policy. 129 Fairness is also significant to any contractual relationship, whether it be between private citizens or with the government. This is reflected in both the Uniform Commercial Code's and the Restatement (Second) of Contracts' requirements of good faith and fair dealings. 130 One of the first cases to recognize the good faith requirement employed the following language:

126. Id. at 497.
127. Id. at 505-06.
128. Id. at 506-17.
129. See supra notes 37-48 and accompanying text. Professor (now Judge) Sneed theorized that the two dominant criteria of federal tax policy are equity and practicality. Joseph T. Sneed, The Criteria of Federal Income Tax Policy, 17 Stan. L. Rev. 567, 601 (1965). The primacy of both fairness and utility is underscored by a recent Internal Revenue Service study on reform of the penalty system. EXECUTIVE TASK FORCE, supra note 43, ch. III, at 3-4. The IRS labels the two components "fairness" and "effectiveness," but the ideas are similar.
130. The Uniform Commercial Code requires that each contractual relationship be grounded in notions of good faith and fair dealing. U.C.C. §§ 1-203, 2-103(b) (1978). Good faith is further defined in Section 1-201 as "honesty in fact in the conduct or transaction concerned." Id. § 1-201(19). The Restatement (Second) of Contracts provides that every contract imposes an obligation of good faith in its performance or enforcement. RESTATEMENT (SECOND) OF CONTRACTS § 205 (1979); see also Burton, supra note 109, at 404 (listing cases recognizing the contractual duty of good faith).
“[N]either party shall do anything which will have the effect of destroying or injuring the right of the other party to receive the fruits of the contract.”

1. Fairness in Contracts

In general contract law, fairness is examined by considering the behavior and actions of the parties. As long as the parties to a contract behave honestly and in good faith toward each other under the contract, fairness is not an issue. However, if a dispute arises under a contract, courts use the good faith doctrine in an effort to "effectuate intentions of the parties, or to protect their reasonable expectations."

In the context of the contractual relationship itself, the good faith doctrine protects weaker parties by limiting discretion-wielding or stronger parties' ability to control contract terms. A discretion-wielding party who controls price, time, or quantity essentially controls and shapes the other party's anticipated benefits under the contract. During the performance of the contract, a discretion-wielding party's attempt to regain benefits that have been previously contracted away during formation violates the principles of fairness inherent in all contracts. It will be held an act of bad faith, thus a breach of the implied duty of good faith and potentially a breach of the contract itself, if there is an attempt by one party "to recapture opportunities foregone upon contracting."

It is bad faith if the purpose for which this discretionary power is exercised is not "reasonably within the contemplation of the parties" and is "beyond the risks assumed" by the aggrieved party at the time of contract formation. One evaluates the discretion-wielding contracting party's purpose subjectively by examining her purpose in exercising this power, and objectively by surveying the "contemplated range . . . of events that the parties expect or should expect at the time of contract formation, and with reference to which they implicitly contract."

133. Burton, supra note 109, at 383-84.
134. Id. at 373.
135. Id. at 385-86.
136. Id. at 386. A so-called mixed-motive purpose, exercising discretion both to regain foregone opportunities and for legitimate reasons, is not enough to constitute bad faith. Id. at 390-91.
The duty of good faith is defined not by the actions necessary to maintain honesty and fair dealings during performance of a contract but by deciding what constitutes bad faith in a dispute. Some courts have become frustrated with the loosely-defined concept of good faith and reject tort remedies for breach of good faith and fair dealings.\textsuperscript{137} However, academics argue theoretical bases for the good faith doctrine. Professor Burton explains that there are legal justifications (increased security of contracts) and economic benefits (decreased contract costs) underlying the doctrine, but “[i]t is costly for the legal system to present the parties with the less costly alternative of relying on the good faith of their contractual partners rather than on more information concerning their partners’ reputations or on more detailed contracts.”\textsuperscript{138}

2. Bad Faith in Federal Government Contracts

It is tempting to assume that the government is subject to the same limits on good faith behavior that are imposed upon private contracting parties. If this were true, the government would be acting in bad faith if it used its sovereign powers of taxation to modify a contract by invoking a price increase, thereby recapturing an advantage or benefit it had bargained away or lost upon entering the contract.\textsuperscript{139} After all, one could argue that comparable contractual maneuvers by private parties would undoubtedly be deemed bad faith in depriving a contracting party the benefits it contracted

\textsuperscript{137} See Oki Am., Inc. v. Microtech Int'l, Inc., 872 F.2d 312 (9th Cir. 1989) (per curiam). In Oki, the plaintiff denied it had entered into a contract and the defendant counterclaimed for the tort of bad faith denial of a contract, demanding millions of dollars in punitive damages. \textit{Id.} at 313. These claims were summarily rejected by the court. \textit{Id.} at 314. Judge Kozinski wrote a scathing concurrence criticizing corporations which claim the tort of bad faith in every contract action. “Nowhere but in the Cloud Cuckooland of modern tort theory could a case like this have been concocted.” \textit{Id.} at 314 (Kozinski, J., concurring). He explained that the “tortification of contract law—the tendency of contract disputes to \textit{metastasize} into torts—gives rise to a new form of entrepreneurship: investment in tort causes of action.” \textit{Id.} at 315 (emphasis added). Judge Kozinski emphasized that what he found “most troubling” about the tort of contractual bad faith is the fact that because this is a soft area of the law, the courts can and will impose “their own sense of public policy and proper business decorum [which] deprives individuals of an important measure of freedom.” \textit{Id.} at 316. However, the judge ended his concurrence by expressing his relief over the tendency of the courts to be “moving in the right direction” again in recognizing that “[n]ot every slight, nor even every wrong, ought to have a tort remedy.” \textit{Id.} at 315-17.

\textsuperscript{138} Burton, \textit{supra} note 109, at 394 n.108.

\textsuperscript{139} Professor Whelan categorizes government taxation of contracts as either imposed at the time the contract was made, imposed during the life of the contract (after-imposed), or reduced during the life of the contract (after-relieved). \textit{WHelan, supra} note 108, ¶ 5-2.4, at 178. This article focuses on taxes imposed during the life of the contract. In his work, Whelan does not claim that the government acts in bad faith by imposing these taxes. \textit{Id.} at ¶ 2-10.4, at 65-68.
In order for an attempt by a private party to recoup what was originally bargained away to be valid, “unforeseen commercial exigencies” must exist that “would prompt an ordinary merchant to seek a modification to avoid a loss on the contract.”

If taxation is a primary “instrument for regulating individual behavior,” then the government’s taxing of its contracts would seem to grant the government too much control over the contractual relationship and its contracting partner. This amount of control violates the long-honored and enforced doctrine of freedom of contract and the notion of free will. Government contracts are fundamentally different from purely private contracts. Professor Whelan asserts that government contracts are normally adhesion contracts and should be treated accordingly. However, unlike private party adhesion contracts, government contracts seemingly are not limited by that doctrine. Professor Whelan explains the anomaly as a product of the fact that “the standard of good faith can be given only limited scope in government contracts” and as a symptom of the resulting few governmental contractual bad faith cases. This lack of cases “is not surprising, however, because of the long-accepted presumption that public officials act in good faith, and with integrity in the performance of their

140. See T & S Brass and Bronze Works, Inc. v. Pic-Air, Inc., 790 F.2d 1098 (4th Cir. 1986). In that case, the plaintiff contracted with the defendant to purchase faucet handles. The defendant subsequently informed the plaintiff that production would not begin unless the plaintiff agreed to a price increase. The defendant later required the plaintiff to pay the cost of air freight, which was originally to be paid by the defendant. Id. at 1101. The court held that “[a]lthough a contract modification need not be supported by consideration . . . [there is] an obligation of good faith upon all efforts to modify a contract.” Id. at 1105 (citation omitted). The defendant was found to have no “legitimate commercial reason for modifying the contract” and, therefore, acted in bad faith. Id. at 1106.


142. WEBBER & WILDAVSKY, supra note 13, at 553.

143. See Burton, supra note 109, at 387 (stressing the importance of voluntary assumption of rights and duties by contractual partners).

144. WHelan, supra note 108, ¶ 2-10.5.1, at 68-69.

145. Professor Whelan notes that, in the same vein, the unconscionability doctrine has had little application in the context of government contracts. Id., ¶ 2-10.5.2, at 70-71. Courts have evinced a strong distaste for adhesion contracts that conclusively result in unequal bargaining power between the contract drafter and the weaker party, who must accept the terms of the standardized contract. See 3 LAWRENCE A. CUNNINGHAM & ARTHUR J. JACOBSON, CORBIN ON CONTRACTS § 559A (Supp. 1997). However, courts are forced to uphold many provisions in these contracts because the majority of business is conducted with these tools. Id. Terms of these contracts will be upheld when it is clear that both parties were aware of the language and when there was no attempt by the stronger party to deceive the party with little bargaining power or stick the weaker party with all of the burdens. See id. at § 559F.

146. WHelan, supra note 108, ¶ 2-10.5.1, at 69.
duties." The presumption of good faith is based on the Court's need to protect the treasury from innumerable indiscriminate claims and the doctrine of sovereign immunity prescribing narrow rights to sue the government.

As a result of this presumption, the courts have set an extremely difficult standard to prove that the government committed contractual bad faith. The aggrieved "must present 'irrefragable' proof" such as 'conspiracy to get rid of the plaintiff,' or that the actions were 'motivated alone by malice,' or were 'designedly oppressive.' Because bad faith is a form of fraud and "implies intentional conduct," an aggrieved contracting party has the enormous task of showing "some trick or contrivance [on the part of the government] intended to exclude suspicion and prevent inquiry."

Various court decisions support the notion that government contracts are somehow inherently different from private contracts. The few bad faith cases and the judicial protection of the government's exercise of its tax and contractual powers both demonstrate the perception that the government is incapable of bad faith. The protectiveness of the courts may not only signal a willingness to defer to the government's discretion, but could also be a sign that the judiciary is moving toward the recognition that, in the land of government contracts and the marketplace, actions amounting to traditional notions of bad faith are presumed the norm and, as such, are to be tolerated. This idea is consistent with the reality that the courts have given the government immense control over their contracts by allowing the contracts to become the subject of taxation.

147. Gregory Lumber Co. v. United States, 11 Ct. 489, 501 (1986), aff'd, 831 F.2d 305 (Fed. Cir. 1987). Almost two hundred years ago, Justice Johnson gave pragmatic reasons to explain why the government is presumed incapable of bad faith: "The acts of the supreme power of a country must be considered pure for the same reason that all sovereign acts must be considered just; because there is no power that can declare them otherwise." Fletcher v. Peck, 10 U.S. (6 Cranch) 87, 144 (1810) (Johnson, J., dissenting).


149. Webster's defines "irrefragable" as "incapable of being refuted; unanswerable; incontestable; undeniable." WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY 1196 (1993).

150. Gregory Lumber Co., 11 Ct. at 501 (quoting Def.'s Supp. Resp., which cites Knotts v. United States, 121 F. Supp. 630, 631, 636 (Ct. Cl. 1954); Gadsen v. United States, 78 F. Supp. 126, 127 (Ct. Cl. 1948); Struck Constr. Co. v. United States, 96 Ct. Cl. 186, 222 (1942)). But see Toomey, supra note 148, at 118-24 (arguing that more recent case law suggests that courts are moving towards eliminating the heightened standards to prove governmental bad faith behavior and suggesting that the government should be subject to the same standards as a private party).

151. Gregory Lumber Co., 11 Ct. at 502 (quoting Lamphere v. United States, 9 Ct. Cl. 562, 570 (1986)).

152. Id. (quoting Wood v. Carpenter, 101 U.S. 135, 143 (1879)).
C. Limitations of the Contract Clause

At first glance, the Contract Clause of the U.S. Constitution appears to prevent state governments from repudiating or even modifying their own contracts.\textsuperscript{153} However, a literal reading of the clause would deprive the government of its sovereign right to pass legislation that is in the public interest.\textsuperscript{154} What restrictions should be placed on state government interference with contract rights by the Contract Clause? When contracting with the government, it is fair to assume that future legislation may affect the contract. The state ought to be free to legislate in the public interest without breaching its contracts. Throughout history, the Supreme Court has struggled to find an interpretation of the Contract Clause which allows state governments to enact beneficial legislation while limiting legislation that unfairly impacts its contracts.

The first and most expansive interpretation of the Contract Clause was advanced by Chief Justice John Marshall. He advocated a broad reading of the clause to afford protection against state interference with both private and public obligations.\textsuperscript{155} In \textit{Fletcher v. Peck}, the Court held that the Contract Clause applied to contracts between a state and private citizens.\textsuperscript{156} Further, writing for the majority in \textit{Sturges v. Crowninshield}, Marshall opined that legislation in effect at formation of a contract becomes a part of the contract and cannot be changed without impairing the obligation of the contract.\textsuperscript{157} Marshall's ideas expanded the reach of the Contract Clause during the nineteenth century, where it primarily was used to restrict governmental regulation of corporations.\textsuperscript{158}

\textsuperscript{153} "No State shall . . . pass any . . . Law impairing the Obligation of Contracts." U.S. CONST. art. I, § 10, cl. 1. Note that the restrictions of the Contract Clause only apply to the states and not the federal government. Although no express language in the Constitution protects contracts against federal legislation, the Due Process Clause of the Fifth Amendment has been used to the same effect. TRIBE, supra note 6, § 9-5, at 465 n.1; see also Lynch v. United States, 292 U.S. 571 (1934) (discussed infra Part IV.A.).


\textsuperscript{156} 10 U.S. (6 Cranch) 87, 139 (1810).

\textsuperscript{157} 17 U.S. (4 Wheat.) 122, 197-200 (1819).

\textsuperscript{158} See generally BENJAMIN F. WRIGHT, JR., \textit{THE CONTRACT CLAUSE OF THE CONSTITUTION} 28 (1938) (asserting that Chief Justice Marshall wished to give the broadest possible protection to contracts under the Contract Clause); Robert L. Hale, \textit{The Supreme Court and the Contract Clause} (pts. 1-3), 57 HARV. L. REV. 512, 526 (1944) (stating that Marshall maintained that "individuals do not derive from government their right to contract" but inherently have the right to contract (quoting Ogden v. Saunders, 25 U.S. (12 Wheat.) 213, 345-46 (1827))). Marshall
Beginning in 1880 with the decision in Stone v. Mississippi, the Supreme Court began to slowly restrict the significance of the Contract Clause. In Stone, Mississippi had entered into a contract giving a corporation a twenty-five year charter to operate a lottery. A few years later, the state tried to revoke the charter by enacting a prohibition on lotteries in the state’s new constitution. Chief Justice Waite held that the new constitution did not violate the Contract Clause based on the government’s reserved police powers. Under his reasoning, the state never bargains away its basic powers of sovereignty, and every contract is subject to the proper exercise of the state’s police power necessary for the general good of the public. The charter to operate the lottery was held to be a mere license until the legislature determined that this charter should be revoked to protect the public morals. Subsequent decisions by the Court have expanded the police power doctrine to allow governments to enact legislation that protects the “vital interests of the community” while impairing government contracts. The police power doctrine established in Stone is still alive and well today.

If the state can use its police powers to legislate in the public interest even if the legislation impairs contracts, how is the legitimate use of these powers separated from situations where the state uses these powers to

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was in the minority in only one important Contract Clause case—Ogden v. Saunders. In Ogden, the Court held that, although the Contract Clause prohibited legislation that retrospectively interfered with contracts incurred under prior law, states were free to enact legislation that prospectively affected contracts—i.e. interfered with future contractual opportunities. Id. at 260. Marshall believed that any law that interfered with the right to contract violated the Contract Clause, whether retrospective or prospective. Id. at 346-47 (Marshall, C.J., dissenting).

159. 101 U.S. 814 (1879).

160. Id. at 817-18. Police powers are defined by one commentator as “the government’s power to protect the public health, safety, and morals.” Leo Clarke, The Contract Clause: A Basis for Limited Judicial Review of State Economic Regulation, 39 U. MIAMI L. REV. 183, 191 n.44 (1985).


162. See, e.g., Home Bldg. & Loan Ass’n v. Blaisdell, 290 U.S. 398, 416 (1934). In Blaisdell, Minnesota passed legislation during the Depression designed to assist mortgagees by deferring their payments and avoiding foreclosure, all without permission of the lenders. This undoubtedly varied the terms of the existing mortgage arrangements between the mortgagees and the lenders. Chief Justice Hughes held that the legislation did not violate the Contract Clause because it was an appropriate use of police powers “addressed to a legitimate end and the measures taken [were] reasonable and appropriate to that end.” Id. at 438; see also City of El Paso v. Simmons, 379 U.S. 497 (1965) (holding that legislation modifying public land sales contracts to allow easier forfeiture did not violate the Contract Clause based on the police power doctrine).

improperly benefit the state? In *United States Trust Co. v. New Jersey*, the Court tried to develop a test that balances these competing ideas. In 1962, the New York Port Authority sold bonds to private investors that contained covenants promising the revenues would not be used for mass transit. Facing a need for revenue to expand mass transit in 1974, New York and New Jersey attempted to repudiate the covenant with these bondholders. In *United States Trust*, the Supreme Court held that this was not a valid exercise of state police powers because the state had unlawfully impaired the obligation of the bondholders by completely repealing the covenant and alternative means for raising revenues could have been designed to achieve the state’s goals. Justice Blackmun devised a new test to determine if the state may constitutionally impair its contracts: whether the impairment is “reasonable and necessary to serve an important public purpose.” Cases decided after *United States Trust* have given the state more discretion to enact legislation that possibly affects private contracts. However, government contracts are still subject to stricter scrutiny by the Court under the “reasonable and necessary” test. This test is used to

165. *Id.* at 29-30. “[A] State is not free to impose a drastic impairment when an evident and more moderate course would serve its purposes equally well.” *Id.* at 30.
166. *Id.* at 25. An impairment is necessary if the state’s purpose cannot be accomplished in a less drastic fashion and alternative means of achieving the state’s goals are not feasible. *Id.* at 29-30. An impairment is reasonable if it was foreseeable at the time the contract was made. *Id.* at 31-32. One article suggests that Justice Blackmun’s balancing test in *United States Trust* is inappropriate because it "ignores the plain language of the Contract Clause." Douglas W. Kmiec & John O. McGinnis, *The Contract Clause: A Return to the Original Understanding*, 14 HASTINGS CONST. L.Q. 525, 546-47 (1987). The authors claim that a balancing test is particularly unsuitable for construing the Contract Clause because of the absolute language of the clause which was formulated to provide certainty to contracting parties and to avoid unpredictability. *Id.* at 559.
167. See, e.g., Exxon Corp. v. Eagerton, 462 U.S. 176 (1983) (holding the statute prohibiting oil companies from passing through severance tax increases to consumers does not unconstitutionally impair private industry contracts because it was designed to advance society’s interest in protecting consumers from excessive prices); Energy Reserves Group Inc. v. Kansas Power & Light, 459 U.S. 400 (1983) (holding that if state legislation impairs a private contract, the state must show only a significant and legitimate public purpose behind the impairment rather than the more strict *United States Trust* standards).
168. *Energy Reserves*, 459 U.S. at 412 n.14. See generally Merrill, *supra* note 155, at 597-99 (arguing that this dual standard between private and government contracts should be eliminated). Scholars claim that decisions after *United States Trust* signal that the Contract Clause has been retired as a prohibition on state interference with private contract rights. See Clarke, *supra* note 160, at 185; Kmiec & McGinnis, *supra* note 166, at 552. However, since *United States Trust*, the Court has not yet decided another Contract Clause case involving state interference with government contracts. Thus, the *United States Trust* test continues to govern situations where the state repudiates or modifies its own contracts.
differentiate permissible impairments\textsuperscript{169} of government contracts from situations where the state is merely trying to shirk its financial responsibilities. When dealing with government contracts, "complete deference to a legislative assessment of reasonableness and necessity is not appropriate because the State's self-interest is at stake. . . . If a State could reduce its financial obligations whenever it wanted to spend the money for what it regarded as an important public purpose, the Contract Clause would provide no protection at all."\textsuperscript{170}

Although the outcome in \textit{United States Trust} appears to contradict the earlier Contract Clause cases, the language in the opinion suggests that the clause will not impair the government's sovereign power to enact valid legislation. Deference to the clause was required in \textit{United States Trust}, but the clause "does not require a state to adhere to a contract that surrenders an essential attribute of its sovereignty."\textsuperscript{171} Are taxation powers an essential attribute of sovereignty that require the Court to uphold a state's right to enact taxes that impair its own contracts? The Court has not answered this question. \textit{United States Trust} indicates that a state may not reduce its contractual financial obligations whenever it wishes. However, the police power doctrine and principles of sovereignty may force the Court to uphold taxes that impair government contracts.

\section*{IV. INTERSECTION OF POWERS TO TAX AND CONTRACT}

Few cases have dealt with situations where the sovereign's powers to contract and to tax have intersected. The decided cases primarily deal with situations where the government has contracted with a private entity and later attempted to tax either the contract or the entity. The earliest Supreme Court cases dealing with the intersection of the power to tax and the power to contract show that the Court was initially wary of expanding the government's taxation powers. These decisions embody the idea that contracts are somehow superior to sovereign taxation powers and that once

\textsuperscript{169} The Supreme Court has not given direction on what could be permissible impairments of government contracts under the Contract Clause. In \textit{United States Trust}, the Court defined what is not permissible. However, since that case, the Court has had no occasion to uphold an impairment of a contract, and thus has not defined what the Contract Clause might allow.

\textsuperscript{170} \textit{United States Trust}, 431 U.S. at 26.

\textsuperscript{171} \textit{Id.} at 23. Note that \textit{United States Trust} is a four-three decision. The dissent interpreted the Court's prior decisions as "constr[ing] the Contract Clause largely to be powerless in binding a State to contracts limiting the authority of successor legislatures[,] . . . [and that] those decisions established the principle that lawful exercises of a State's police powers stand paramount to private rights held under contract." \textit{Id.} at 33 (Brennan, J., dissenting).
the government enters a contract it is bound to the contract and cannot easily evade its obligations.

Over time, the Court found that this approach was far too restrictive of the government and that it limited the sovereign from enacting legitimate and necessary legislative controls. Modernly, the Court narrowly scrutinizes allegations that the government has waived or surrendered its inherent sovereign powers by entering into a contract.\textsuperscript{172} These sovereign powers are not to be bound or relinquished by contract. The application of this principle means that the Court has given governments great advantage by allowing them to recoup through taxation some of the benefits they have bargained away in contract. Government now has great latitude to act in ways private citizens, when contracting, could not.

\textit{A. Historical Cases}

The following discussion illustrates the control the early Court sought to exercise over the government's ability to tax in a contract setting. \textit{Loan Ass'n v. Topeka}\textsuperscript{173} and \textit{Murray v. Charleston}\textsuperscript{174} exemplify the Court's initial fear of allowing the government broad authority when contracting, whereas \textit{Sinking-Fund Cases}\textsuperscript{175} signify the beginning of the end of these restrictions. The Court retains the ability to strike the government's power to tax its contracts, as in \textit{Lynch v. United States},\textsuperscript{176} but has not expressed any clear rule to differentiate between permissible and impermissible taxes.

The Court's initial restraint of the government's taxation power had its genesis in \textit{Loan Ass'n v. Topeka}. In \textit{Topeka}, the Court angrily struck a tax imposed to pay for bonds "donated" to private industry without corresponding public benefit, characterizing such taxation as tantamount to "robbery."\textsuperscript{177} The Court held that one of the limitations on taxation powers is that taxes must be levied for public benefit rather than designed merely to funnel tax dollars to corporations.\textsuperscript{178} The \textit{Topeka} Court seemed aware of and genuinely afraid of the taxation power and the resulting ability of

\textsuperscript{172} See Merrion v. Jicarilla Apache Tribe, 455 U.S. 130, 148 (1982); \textit{see also United States Trust}, 431 U.S. at 23 (holding that "the Contract Clause does not require a State to adhere to a contract that surrenders an essential attribute of its sovereignty").

\textsuperscript{173} 87 U.S. (20 Wall.) 655 (1874).

\textsuperscript{174} 96 U.S. 432 (1877).

\textsuperscript{175} 99 U.S. 700 (1878).

\textsuperscript{176} 292 U.S. 571 (1934).

\textsuperscript{177} \textit{Topeka}, 87 U.S. at 664.

\textsuperscript{178} \textit{Id.} at 663-64.
government to wreak havoc within the system and upon citizens.\textsuperscript{179} As the Court explained, the power to tax "can as easily be employed against one class of individuals and in favor of another, so as to ruin the one class and give unlimited wealth and prosperity to the other, if there is no implied limitation for the uses for which the power may be exercised."\textsuperscript{180}

In spite of this pronouncement, the \textit{Topeka} Court acknowledged that the power to tax for legitimate purposes should be unlimited.\textsuperscript{181} Such unrestrained power to tax is justifiable according to the Court, for "in most instances . . . [such as for] the support of the government, the prosecution of war, the National defense, any limitation is unsafe. The entire resources of the people should in some instances be at the disposal of the government."\textsuperscript{182} This qualification of the limits imposed on the government’s taxation powers is arguably a recognition of the government’s need for tax revenues to function and to sustain itself.

With these seemingly unbridled taxation powers in mind, the \textit{Topeka} Court’s warning about the potential for misuse is particularly chilling: "Of all the powers conferred upon the Government that of taxation is most liable to abuse. Given a purpose or object for which taxation may be lawfully used and the extent of its exercise is in its very nature unlimited [sic]."\textsuperscript{183} In \textit{Topeka}, the Supreme Court was the arbiter of whether the tax was designed to benefit the public or whether it was enacted for an unlawful purpose.\textsuperscript{184} Later cases show that the Court has retreated from this view to become more deferential to local governments, allowing them greater liberty to design taxes that might benefit their individual community.\textsuperscript{185}

\textsuperscript{179} "A government . . . which held the lives, the liberty, and the property of its citizens subject at all times to the absolute disposition and unlimited control of even the most democratic depository of power, is after all but a despotism." \textit{Id.} at 662.

\textsuperscript{180} \textit{Id.} at 664. The \textit{Topeka} Court recognized that a legitimate tax must strike the uneasy balance between providing the needed financial support for the government and being "sanctioned by time and the acquiescence of the people." \textit{Id.} at 665. For a discussion of the role of taxpayer compliance in matters of tax legislation and enforcement, see Martinez, \textit{supra} note 3, at 540-47.

\textsuperscript{181} \textit{Topeka}, 87 U.S. at 663.

\textsuperscript{182} \textit{Id.}

\textsuperscript{183} \textit{Id.}

\textsuperscript{184} Professor Edward H. Levi explains that \textit{Topeka} was not based on a specific constitutional provision, but on inherent limits on government in what is described as "the age of faith" where courts upheld property rights and the "power of the reigning establishment." Edward H. Levi, \textit{The Sovereignty of the Courts}, 50 U. Chi. L. REV. 679, 684-90 (1983). This "age of faith" is described as "the law’s black night . . . . Never had lawyers and judges been so confident, so self-assured, so convinced beyond the shadow of a doubt, that they were serving not only righteousness but truth." Grant Gilmore, \textit{The Ages of American Law} 41 (1977).

\textsuperscript{185} \textit{Topeka} appears to have been effectively overruled or at least "substantially undermined by later Supreme Court decisions making clear that the Court will defer to the states in the area of taxation so as to permit local economic experimentation." \textit{Common Cause v. Maine}, 455 A.2d 1,
Soon after the *Topeka* decision, the Court dealt directly with the issue of whether the government could tax its own contracts in *Murray v. Charleston*, striking a tax imposed upon a contracting party as an unconstitutional attempt by the government to relieve itself from debt. The Court recognized that a “promise to pay, with a reserved right to deny or change the effect of the promise, is an absurdity.” Given the strong holding against the tax in *Murray*, it may surprise the reader to find that, in dicta, the Court provided a method by which a government could legally tax a contract. The government can “raise contributions” or tax a contractual property right of a creditor after payment has been made by the government and received by the creditor. Thus, in the case of a government bondholder or other creditor, the government may “pay[] the interest with one hand, and tak[e] back the amount of the tax with the other. But . . . the tax must be upon all the money of the community . . . . The creditor should be no otherwise acted upon than as every other possessor of money . . . [the contractor’s] money he receives from the public can then only be a fit subject of taxation when it is entirely separated [from the contract], and thrown undistinguished into the common mass.”

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26 (Me. 1983) (citing Carmichael v. Southern Coal Co., 301 U.S. 495 (1937); Green v. Frazier, 253 U.S. 233 (1920); Jones v. City of Portland, 245 U.S. 217 (1917)).

In *Jones*, the Court explained its deference to local taxing officials’ discretion as recognizing that “local conditions are of such varying character that what is or is not a public use in a particular state is manifestly a matter respecting which local authority . . . has peculiar facilities for securing accurate information.” *Jones*, 245 U.S. at 221. Also, in a later case with facts similar to *Topeka*, the Court dismissed an appeal regarding a statute allowing taxes to be raised to fund municipal bonds to finance a private corporation’s facility costs “for want of a substantial federal question.” Albright v. City of Winona, 303 U.S. 627 (1938), aff’d 178 So. 799 (Miss. 1938).

Similarly, *Everson v. Board of Education* appears to reflect the Court’s subsequent deference to the sovereign’s exercise of taxation powers and its willingness to re-examine the earlier *Topeka* decision. 330 U.S. 1 (1947). The *Everson* Court explained that *Topeka* was simply one of the “rare instances” in which the Court struck a tax on such grounds, a “far reaching authority [which] must be exercised with the most extreme caution. Otherwise, a state’s power to legislate for the public welfare might be seriously curtailed . . . . Changing local conditions . . . may lead a state . . . to believe that laws . . . are necessary to promote the general well-being of the people.” *Id.* at 6-7; *see also* Regan v. Taxation With Representation, 461 U.S. 540, 547 (1983) (asserting that legislatures “have especially broad latitude in creating classifications and distinctions in tax statutes”).

186. 96 U.S. 432 (1877).

187. The tax essentially would have lessened the government’s obligation to pay interest on its bonds. Therefore, it was in reality a contractual price increase.

188. *Murray*, 96 U.S. at 445. The Court was clear in declaring that contract obligations are limitations, even to the government’s power of taxation, primarily because of the Contract Clause. *Id.* at 444; *see discussion supra* Part III.C.

189. *Id.* at 445.

190. *Id.* at 446 (quoting 3 MARYLAND WORKS OF ALEXANDER HAMILTON 514 (1st ed. 1885)).
However, the Court's distinction between a tax imposed on the contracting party, which will be struck, and a tax upon the debt itself, which will pass constitutional muster, may not impress some taxpayers who may question the difference between such methods of taxation. When the dust settles, the creditor or party contracting with the government is still the one left with less than she bargained for.\textsuperscript{191}

Subsequent historical cases illustrate that the Supreme Court slowly began to allow the government's sovereign contract and tax powers to intrude and take precedence over previously negotiated contract rights. Four years after \textit{Topeka}, in \textit{Sinking-Fund Cases},\textsuperscript{192} the Court used the notion that the government needs to be free to function without strict limitations to justify the government's arguably broad use of its tax and contract powers. In \textit{Sinking-Fund Cases}, the federal government loaned bonds to a government corporation to provide the necessary capital for the corporation to build a railroad from the Missouri River to the Pacific Ocean. Under the terms of the contract, the bonds were to be repaid at the end of thirty years and the railroad would provide transportation for the government at reasonable rates. Concerned about the potential for default, Congress later passed a law that "taxed" twenty-five percent of the railroad's earnings and withheld the government payments for railroad transportation, placing this money into a sinking fund for the ultimate redemption of the bonds.\textsuperscript{193}

The \textit{Sinking-Fund Cases} majority did not characterize the legislation as a tax and belittled the argument that it impaired the obligation of the original contract. The Court explained that the legislation "takes nothing from the corporation or the stockholders which actually belongs to them. It oppresses no one, and inflicts no wrong."\textsuperscript{194} It was of "no consequence" that the Treasury Secretary controlled the fund into which its contractual partner's profit was deposited because "in law" such deposits are considered

\textsuperscript{191} Modernly, government contractors have reacted to these conditions by shifting the burden of taxes either back to the government or to other parties. See \textit{Whelan, supra} note 108, ¶ 3-4.3.5, at 110 (holding that state and local governments can tax a federal government contractor unless such tax discriminates against the United States, and that the contractor may then seek a "cost-reimbursement" from the federal government for state and local tax payments incurred); see also \textit{Exxon Corp. v. Eagerton}, 426 U.S. 176, 187-96 (1983) (holding that a statute increasing tax on oil and gas extractions but specifically exempting royalty owners did not violate the Contract Clause because the increased taxation under pre-existing contracts "does not directly fall on royalty owners" and the statute "nowhere states that producers may not shift the burden of the tax in whole or in part to royalty owners") (emphasis added).

\textsuperscript{192} 99 U.S. 700 (1878).

\textsuperscript{193} \textit{Id.} at 706-16. The government's original contract stated that only half of what the government owed the railroad for transportation plus a mere five percent tax on its partner's net earnings were required to be withheld as security for bonds. \textit{Id.} at 709.

\textsuperscript{194} \textit{Id.} at 725.
payments to, though not under the control of, the government’s contractual partner. The dissent placed more emphasis on the fact that the money was directly taken from the corporation and placed in the federal treasury, calling it a “distinction without a difference” that the money was technically not applied to repay the debt until the end of the thirty-year period.

Unlike the Court’s terse examination of a contract and its conclusion that “[s]uch was the contract, and such was the whole contract” in *Murray v. Charleston*, the *Sinking-Fund Cases* Court justified the contract change as “simply giv[ing] further assurance” of and “add[ing] another guaranty” that the railroad “in which the public [is] so largely interested” will remain solvent and its securities valuable. The Court viewed the contract changes and heavier tax merely as a means for the government to “prevent[] to some extent [its contractual partners] from depleting the treasury for their own benefit” and to compel its contractual partners “to do what they ought to do voluntarily.” Thus, *Sinking-Fund Cases* begins the long line of cases which establish that the government may use its tax and contract powers to gain considerable contractual advantage unheard of in the realm of private contracts. In fact, many historical decisions following *Sinking-Fund Cases* stress that, unless the government specifically contracts to bar subsequent taxation, the government is free to later enact a tax that adversely affects a contract.

*Lynch v. United States*, decided during the Great Depression, does not address the government’s power to tax its contracts, but rather, deals

195. *Id.* at 725-26.
196. *Id.* at 735 (Strong, J., dissenting).
197. 96 U.S. 432, 443 (1877).
198. *Sinking-Fund Cases*, 99 U.S. at 726. Note the similarity between this language and the language used by the court in *Transahio Savings Bank v. Director, Office of Thrift Supervision*, 967 F.2d 598 (D.C. Cir. 1992), to justify its upholding the government’s change in contract terms. The legislation in question in *Transahio*, the Financial Institutions Reform, Recovery and Enforcement Act (“FIRREA”), is described as a means to impose “self-restraint” upon the government’s contractual partner and to provide a “cushion” at the expense of its partner to guard against governmental loss. *Id.* at 603.
199. *Sinking-Fund Cases*, 99 U.S. at 725. For a discussion of the coercive nature of taxation, see Martinez, supra note 3, at 542-44.
200. It appears the court in *Madera Irrigation District v. Hancock* is justified in stating that it must construe government contracts with a more “liberal” hand than private contracts. 985 F.2d 1397, 1401 (9th Cir. 1993).
201. See, e.g., *New Orleans City & Lake R.R. v. City of New Orleans*, 143 U.S. 192 (1892) (holding that a legislature has not surrendered the taxing power unless its intention is expressed in unmistakable terms); *Vicksburg, Shreveport & Pac. R.R. v. Dennis*, 116 U.S. 665 (1886) (holding that a state is never presumed to have relinquished its power of taxation unless its intention is clearly expressed); see also the discussion of the unmistakability doctrine, infra notes 217-22 and accompanying text.
with the limits of governmental power to repudiate legislatively those contracts.\textsuperscript{202} Nonetheless, \textit{Lynch} is relevant to the discussion because it shows that the subject matter of the contract may have some influence on the amount of restraint the Court will exercise over the government. In \textit{Lynch}, the Court, at first glance, appears to retreat to its earlier position that contracts cannot be legislatively altered or terminated. \textit{Lynch} involved contracts created during World War I with veterans for term life insurance policies. Finding that these policies would eventually cost the government $1 billion,\textsuperscript{203} Congress terminated them in 1933 with the Economy Act.\textsuperscript{204} Though the Court agreed that there was “great need of economy” and that “Congress was free to reduce gratuities deemed excessive” like pensions and hospital coverage, the Court held that “Congress was without power to reduce expenditures by abrogating contractual obligations of the United States.”\textsuperscript{205} As the Court put it:

\begin{quote}
To abrogate contracts, in an attempt to lessen government expenditure, would not be the practice of economy, but an act of repudiation. “The United States are as much bound by their contracts as are individuals. If they repudiate their obligations, it is as much repudiation, with all the wrong and reproach that term implies, as it would be if the repudiator had been a State or a citizen.”\textsuperscript{206}
\end{quote}

Although \textit{Lynch} seems to contradict the earlier \textit{Sinking-Fund Cases} giving the legislature great discretion to alter contracts, the decision is distinguishable in two ways. First, Congress sought to repudiate totally the contract rather than alter it to meet a necessary public purpose. In \textit{Lynch}, the legislation’s sole purpose was to avoid totally the financial obligation of the insurance contracts.\textsuperscript{207} Second, the term insurance in \textit{Lynch} was contracted with sympathetic plaintiffs for a beneficial purpose. Although the Court found the contracts “legal obligations of the same dignity,” the insurance contracts “unlike [other contracts], were not entered into by the United States for a business purpose [but for a ] . . . benevolent purpose.”\textsuperscript{208} Arguably, the status of the contract beneficiaries—the \textit{Lynch} veterans and

\textsuperscript{202} 292 U.S. 571 (1934).
\textsuperscript{203} Id. at 576 n.2.
\textsuperscript{204} Id. at 575.
\textsuperscript{205} Id. at 580.
\textsuperscript{206} Id. (quoting \textit{Sinking-Fund Cases}, 99 U.S. at 719).
\textsuperscript{207} Id.
\textsuperscript{208} Id. at 576.
their families versus the *Sinking-Fund Cases* corporations whose managers had the potential to abuse profits—may also have been a factor influencing the *Lynch* Court to side with the aggrieved veterans and the *Sinking-Fund Cases* Court to enforce the contracts on their unilaterally revised terms. After all, allowing the government to use its taxing and contractual powers to curb its contractual partner’s ability to gain a potential underhanded contract advantage may be more justified as an act “within the federal police power or some other paramount power” than denying veterans their insurance benefits.\(^\text{209}\)

The general theme of deference by the Court is implicit even in historical cases involving the intersection of the power to tax with the power to contract. The need for the government to remain flexible in order to protect itself and its citizens forces the Court to view free governmental rein as necessary. This free rein is not unlimited, however. The Court has demonstrated that it will restrain the government’s power if it becomes, what the Court believes to be, too destructive.\(^\text{210}\) Nonetheless, even in cases where the Court has restrained the government action in question, the government’s sovereign powers are evidenced in other ways.\(^\text{211}\)

**B. Modern Cases**

Modern cases addressing situations where the government attempts to modify its contracts through taxation illustrate that the Court continues to defer to sovereign powers. *Merrion v. Jicarilla Apache Tribe* emphasizes the control that the Court has given to the sovereign.\(^\text{212}\) In *Merrion*, the Jicarilla Apache Tribe, as a sovereign power, leased mineral rights in exchange for cash, royalties, and rents. The Tribe later enacted legislation to tax all such removed minerals under the contract. When the lessees claimed that the Tribe’s tax on minerals extracted under the contract violated their contractual rights, the Court likened the Tribe’s contract stance and its sovereign powers of taxation to that of a state. Using ideas analogous to the

\(^{209}\) *Id.* at 579.

\(^{210}\) See id.

\(^{211}\) Recognizing the doctrine of sovereign immunity, the Court stated in *Lynch* that “[t]he contracts between a Nation and an individual are only binding on the conscience of the sovereign and have no pretensions to compulsive force. They confer no right of action independent of the sovereign will.” *Id.* at 580-81 (quoting *The Federalist No. 81* (Alexander Hamilton)). Although the doctrine of sovereign immunity is not addressed in the scope of this article, it is another example in which the government wields its sovereign powers to gain advantages over its partners in contract.

\(^{212}\) 455 U.S. 130 (1982).
Christian doctrine, the Court held that for a sovereign to surrender its power to tax, which in the context of Merrion is effectively the power to invoke a contractual price increase, such a surrender must be explicit and "specifically surrendered in terms which admit no other reasonable interpretation."\textsuperscript{213} That the contract was manipulated by the Tribe was of no moment; the Court focused not on the contract terms but on protecting the idea that sovereign power is inherent and perpetual and on the principle that all contracts are subject to subsequent legislation by the sovereign.\textsuperscript{214}

In Merrion, the Court rejected the argument that the sovereign impliedly promises not to tax its contracts and upheld the Tribe's taxation of its contract partner's products.\textsuperscript{215} In the realm of contracts, the Merrion decision means a sovereign is allowed to impose a price increase, disguised as a tax, to recoup contract rights that were bargained away by the sovereign as initial inducement for the other party during the contract negotiation. The Merrion Court supported its decision by invoking the unmistakability doctrine, which commands courts to find that the "sovereign power, even when unexercised, is an enduring presence that governs all contracts . . . and will remain intact unless surrendered in unmistakable terms."\textsuperscript{216} Under Merrion, a sovereign need not expressly retain its power to tax by either statutory or contract language, for to require such action "turns the concept of sovereignty on its head."\textsuperscript{217}

The paucity of modern cases dealing with the intersection of the power to tax and the power to contract requires an inquiry into cases that deal exclusively with limitations set on governmental power to alter government contracts legislatively. While these cases do not specifically address the issue of taxation, their reach implicates the exercise of sovereign

\textsuperscript{213} Id. at 147-48 (quoting City of St. Louis v. United Rys., 210 U.S. 266, 280 (1908)). The Merrion Court upheld the tax by the Jicarilla Apache Tribe even though it was enacted subsequent to and not mentioned within the contract to which the Tribe was a party. Id. For a discussion of the Christian doctrine, see supra notes 110-21 and accompanying text.

\textsuperscript{214} The Court stressed this proposition by finding that the government, as both a party to the contract and a sovereign power controlling the contract, retains the power to enact subsequent legislation affecting any contract right unless that power is specifically abandoned in the contract. The Court held that a government contract should always be construed as retaining, not abandoning, the government's right to exercise its sovereign power. Merrion, 455 U.S. at 147-48.

\textsuperscript{215} Id. at 148.


\textsuperscript{217} Merrion, 455 U.S. at 148.
powers, and they are thus appropriately included at this point of the discussion.

The Court affirmed this broad sovereign contractual power in *Bowen v. Public Agencies Opposed to Social Security Entrapment*. 218 In *Bowen*, the issue was whether Congress could enact a law barring the states from withdrawing participation in the federal Social Security program, even though the original Social Security Act provided that states could terminate their participation at any time. The Court held that Congress could constitutionally enact the legislation withdrawing participation based on a section of the original Act that reserved the “right to alter, amend, or repeal any provision,” thus preventing the state from exercising a bargained-for termination clause. 219 Because of this express reservation to amend the Act, the Court found that the contract could be ignored by Congress and that the courts should construe such contracts as retaining, not restricting, sovereign power. 220 *Bowen* affirmed the *Merrion* unmistakability doctrine, which requires that, in executive “commercial contracts,” Congress as a lawmaker is an “enduring presence” whose lawmaking powers must be “surrendered in unmistakable terms” in order to be abrogated. 221

Perhaps more importantly for this article, *Bowen* exemplifies the Court’s reaction when the contracting party or the circumstances surrounding the contract threaten the sovereign’s stability and economic well-being. 222 Under such circumstances, the Court upholds the sovereign’s power to tax for pragmatic reasons to ensure the sovereign’s survival and ability to function. 223 The sovereign can conceivably alter or repeal any contract without retribution if its survival is threatened. The *Bowen* Court recognized that the survival, or at least the economic health, of the Social Security system hinged on the decision. The Court characterized the Social Security system as a “comprehensive social welfare program affecting millions of individuals throughout our Nation,” and it expressed its reluctance to


219. *Id.* at 51-52. The *Bowen* Court pointed out that the termination provision “simply was part of a regulatory program over which Congress retained authority to amend,” as distinguished from “property” within the Just Compensation Clause of the Fifth Amendment, which would require compensation as a result of the “taking.” *Id.* at 55.

220. *Id.* at 52-53. This express reservation goes to the ideas of notice and that the contracting party takes its chances when it makes a deal with the sovereign. *Id.* at 54.

221. *Id.* at 52 (citation omitted).

222. The *Bowen* Court described the contractual provision allowing states to withdraw their employees from the Social Security system as a threat to the “integrity of the System” because, inter alia, states exercising their contractual power to withdraw cost up to $1 billion per year, and withdrawn workers who were entitled to benefits sparked resentment in workers mandatorily in the system. *Id.* at 47.

223. *Id.*
construe the contract as limiting sovereign authority. Perhaps these practical concerns outweighed the legal niceties of the state’s arguments based on the Just Compensation Clause of the Fifth Amendment.

The Court’s recent pronouncement in United States v. Winstar leaves the sovereign’s powers intact even though the government was held liable for damages in a breach of contract suit. Winstar was one of many cases spawned by the savings and loan crisis. Three savings institutions sued the federal government, claiming that the enactment of the Financial Institutions Reform, Recovery, and Enforcement Act (“FIRREA”) constituted a breach of contracts between the savings institutions and bank regulators. FIRREA disallowed certain accounting practices that had been encouraged by the regulators in these previous contracts as an incentive for the thrifts to acquire other failing thrifts. As a result of FIRREA’s ban on these accounting practices, many institutions were seized and liquidated or suffered huge financial losses. In Winstar, the Supreme Court held that FIRREA’s enactment was a breach of contract, and, therefore, the thrifts could obtain damages from the government.

At first glance, the Winstar decision seems to undercut this article’s proposition that the government may enact tax legislation that impairs contracts without suffering damages. However, closer scrutiny reveals that the case does not significantly curtail the government’s sovereign powers. First, Winstar holds that the unmistakability doctrine used in Merrion and Bowen is still a valid constitutional doctrine. The government in Winstar tried to assert the unmistakability doctrine to claim that, because the original

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224. Id. at 53.
227. The Federal Savings and Loan Insurance Corporation (“FSLIC”) sought to head off the savings and loan crisis by encouraging healthy institutions to take over ailing institutions in a series of “supervisory mergers.” See LAWRENCE J. WHITE, THE S & L DEBACLE: PUBLIC POLICY LESSONS FOR BANK AND THRIFT REGULATION 157 (1991). The acquiring thrifts were allowed to count the excess of the purchase price over the fair value of all assets acquired as an intangible asset called “supervisory goodwill,” and the acquiring thrift could then leverage those loans based on this goodwill. Winstar, 116 S. Ct. at 2437. These transactions were accomplished through express agreements between the FSLIC and the acquiring thrifts. Id. at 2438. When Congress and the President realized that supervisory goodwill was “severely counterproductive . . . [and] actually aggravate[d] the decline,” Congress enacted FIRREA in an attempt to “restore public confidence” and “ensure a safe, stable, and viable system.” Transohio Sav. Bank v. Director, Office of Thrift Supervision, 967 F.2d 598, 602-03. (D.C. Cir. 1992).
228. Two of the thrifts instituting the Winstar action were later seized and liquidated by federal regulators. The third, Glendale Federal Bank, avoided seizure only through a private recapitalization. Winstar, 116 S. Ct. at 2437, 2447.
229. Id. at 2438.
contracts did not surrender the power to enact future legislation in "unmistakable terms," the thrills could not collect damages for breach of contract. The Winstar majority held that the unmistakability doctrine did not apply to the contract at issue because the enforcement of the contracts would not "block the exercise of a sovereign power of the Government." 230

Winstar does alter the unmistakability doctrine by forcing courts to examine the effects of enforcing the original government contract. If enforcement of the contract does not block any sovereign power, as in the contracts at issue in Winstar, then the unmistakability doctrine does not apply and the original contract must be enforced. 231 However, if enforcing the contract would block the exercise of a sovereign power, then the unmistakability doctrine can be used to preclude enforcement of the original contract. Moreover, the Court mentioned at least twice that the power to tax is a sovereign power and that the unmistakability doctrine would, therefore, apply to situations where the legislature enacted a tax that adversely impacted an existing contract. 232 Winstar, therefore, clearly affirms that the unmistakability doctrine can be used by courts to defer to the sovereign power of taxation.

Winstar also is important to the government's power to tax its contracts because it refines the sovereign acts doctrine. 233 Under the doctrine, the sovereign can enact, for "public and general" purposes, legislation that interferes with a contractor's rights to performance under a government contract. 234 Although the Winstar Court held that the sovereign acts doctrine did not apply to the contract at hand, the Court set out to define

230. Id. at 2457. Rather, the original contract was designed merely to "indemnify its contracting partners against financial losses arising from regulatory change." Id. at 2461.

231. Id. at 2457-58.

232. The Court defined sovereign powers as "e.g., to tax or control navigation." Id. at 2457. Later, the Court describes a hypothetical situation where blocking the exercise of the taxing power by attempting to enforce a contract would be an unacceptable limit on sovereign authority. Id.


The sovereign acts doctrine is different from the broad ideas of sovereignty in tax and contract examined in this article. The sovereign acts doctrine is limited to governmental contract actions and has never been implicated in situations involving both the sovereign powers of taxation and contract.

234. Winstar, 116 S. Ct. at 2463. Note the similarity between "public and general" purposes that can interfere with a contractor's rights to performance and the concept of police powers discussed in the Contract Clause cases. See supra notes 159-63 and accompanying text.
what constitutes a sovereign act of public and general purpose. The Court stated that the legislature can enact laws that are "relatively free of government self-interest" but not "statutes which are tainted by a governmental object of self-relief." The Court defined government self-interest as "instances in which the Government seeks to shift the costs of meeting its legitimate public responsibilities to private parties."

What will happen now if the Court is confronted with a situation where the government attempts to tax its contractual partners and invokes the sovereign acts doctrine? As the Winstar dissent suggests, the tax could potentially be labeled an act of self-relief on the government's part. However, the government can use legislative intent to invoke the sovereign acts doctrine, claiming that it is enacting the tax for the benefit of its citizens and not in pure self-interest. Even if the government is barred from using the sovereign acts doctrine, presumably it still may use the unmistakability doctrine to prove that it never surrendered the power to tax in the original contract and, therefore, can enact the tax without paying damages. The unmistakability doctrine involved in Merrion and Bowen is still sound and unaffected by the Winstar decision. Winstar, therefore, does not adversely affect the government's sovereign powers in tax and contract.

Winstar's reservation of sovereign powers is nothing new or surprising. Professor Eule has argued that the executive and legislative branches lack the power to "entrench" their contracts against alteration by their successors because the elected individuals who enact the contracts are merely agents of the people and their authority is limited by time. Whether for temporal or other reasons, the Court has consistently adhered to the principle that contracts cannot limit future actions by the state in its sovereign capacity.

236. Id. at 2465. This new definition compares favorably with the decision in Lynch v. United States, where the government sought to repudiate life insurance contracts with veterans through legislation. 292 U.S. 571 (1934); see discussion supra Part IV A. Lynch involved a situation where the government's actions were completely motivated by self-interest and self-relief.
238. Chief Justice Rehnquist suggests in his dissent that any tax reform bill potentially could be directed to governmental self-relief because it is "designed to put more money into the public coffers." Id. at 2483 (Rehnquist, C.J., dissenting).
239. Eule, supra note 8, at 384.
240. Dillingham v. McLaughlin, 264 U.S. 370, 374 (1924) ("The operation of reasonable laws for the protection of the public cannot be headed off by making contracts reaching far into the future."); Hudson Water Co. v. McCarter, 209 U.S. 349, 357 (1908) ("One whose rights, such as they are, are subject to state restriction, cannot remove them from the power of the State by making a contract about them. The contract will carry with it the infirmity of the subject-matter.").
C. Fairness

It may be tempting to conclude that contractors dealing with the government take the risk of unfairness. Certainly, some measure of unfairness is presumed in matters of discretion and economic policy. The Nordlinger Court, for example, showed us that fairness is not a main concern in the context of taxation. In sanctioning a tax it conceded was discriminatory and unfair, the Nordlinger Court appears to have ignored the fairness issue when it comes to the government’s actions. Furthermore, decisions like Nordlinger, Sinking-Fund Cases, Merrion, and Bowen suggest that traditional notions of bad faith or breach of contract will not restrict the government when, whether by taxation or by contract, it acts in ways that are discriminatory and unfair.

Thus, it appears that, with governmental contracts, it is the party contracting with the government who must truly take her chances. This article suggests that, in most situations, the government may tax its contractual partners seemingly at will without suffering damages for breach of contract. Although this may seem unfair, the Court is protecting basic aspects of sovereignty by upholding these taxes.

241. See Barclays Bank PLC v. Franchise Tax Bd., 511 U.S. 2268, 2278 (1994) (dismissing as inconsequential the fact that certain tax legislation subjects taxpayers to multiple taxation); WEBBER & WILDAVSKY, supra note 13, at 553 (noting the long and often “unrecognized” history of the tax power used by the governing “elites” as a means to provide “incentives for behavior deemed desirable” and to “regulate” that which is undesirable).

Former President Jimmy Carter has criticized this inherent unfairness in government actions, arguing that efficiency should be secondary to more human concerns. “Nowhere in the Constitution of the United States, or the Declaration of Independence, or the Bill of Rights, or the Emancipation Proclamation, or the Old Testament or the New Testament do you find the words ‘economy’ or ‘efficiency.’ Not that these words are unimportant. But you find words like . . . fairness . . . and many others which describe what a government of human beings ought to be.” Lawrence J. Haas, Mixing Missions, 21 NAT’L J. 1114, 1116 (May 6, 1989) (quoting JIMMY CARTER, WHY NOT THE BEST? (1976)).

242. Nordlinger v. Hahn, 505 U.S. 1, 25 (1992) (“But not since the coming of modern equal protection jurisprudence has this Court supplemented the rational judgments of state representatives with its own notions of ‘rough equality,’ ‘undervaluation,’ or ‘fairness.’”). But see Bird, supra note 7, at 214 (noting that fairness and reliability are the essential aspects of an ideal tax, one that “should be stable and predictable over time . . . [and] should be perceived to be reasonably fair by taxpayers”).

243. See United States v. Carlton, 511 U.S. 2018 (1994) (stating that a taxpayer must take his chances that the government will retroactively terminate the sought-after tax benefit or advantage); Madera Irrigation Dist. v. Hancock, 985 F.2d 1397 (9th Cir. 1993) (asserting that a party contracting with the government must take its chances that, in a renewal contract, the government will impose a retroactive price increase to recoup its past contractual losses); see also Cheek v. United States, 498 U.S. 192 (1991) (noting that a taxpayer takes his chances that his good-faith belief that tax laws are unconstitutional will be interpreted as willful tax evasion and therefore criminal).
V. CONCLUSION: TAX COLLECTION AND PRAGMATISM

The Court appears to destroy any implication that it is unconstitutional for the government to impose taxes upon its contractual partners. This, in essence, enables the government to recapture advantages it had previously bargained away during contract negotiations. As the Court stated long ago, “the United States . . . cannot be held liable for . . . its public and general acts as sovereign.” So long as the Court finds the government imposed the tax to perform essential government services or to fulfill a necessary government function, the Court can justify upholding the tax as necessary and not simply a bad faith reneging of governmental debt or breach of governmental obligation. This extreme deference to government authority supports the view that the high standard set by the Court can “be used to validate any action . . . [by the government] that is not demonstrably lunatic.”

Setting such a high threshold for striking a tax or rendering the government’s contractual stance unconstitutional seems to be the Court’s pragmatic method of protecting government’s attempts to prevent or to alleviate serious economic consequences. Taxes are primarily prospective and would not deprive a contract party of a vested contract benefit. In fact, the benefit will be received by the private party, yet some unexpected cost

244. See discussion supra Part IV.B.
245. This idea is implicit in the Nordlinger opinion because the Court upheld the discriminatory and unfair property tax, even though it theoretically was subjected to the “harsh and oppressive” standard. Nordlinger, 505 U.S. at 11 (holding that, as long as a plausible policy reason exists, a discriminatory classification can be upheld).
246. Horowitz v. United States, 267 U.S. 458, 461 (1925) (citations omitted) (holding that the government can impede the performance of its own contracts by sovereign acts).
247. Congress is using such an excuse in a case now before the U.S. District Court in the Eastern District of California, Wetlands Water District v. United States, No. CV-F 93-5327 OWW/SHH (E.D. Cal. 1996) (seeking to justify the “annual mitigation and restoration payments” to be collected from the beneficiaries of water service contracts as necessary to, among other things, restore endangered species habitats damaged under the original Act from which the contracts ensued); see also United States Trust Co. v. New Jersey, 431 U.S. 1, 21-25 (1977) (upholding a contract deemed “purely financial” in limiting states’ powers to subsidize transportation through revenues already set aside as security for issued bonds and deemed not to involve an abandonment of its “essential attribute of its sovereignty”—its reserve powers to “safeguard the welfare of its citizens”).
248. Walter Guzzardi, Jr., What the Supreme Court is Really Telling Business, FORTUNE, Jan. 1977, at 146, 149. Considering the wide latitude the Court granted the taxing officials in its recent Nordlinger, Carlton, and Barclays decisions, as well as the assertion that the Court defers to the sovereign’s exercise of "experimental" taxation powers, one may wonder just how far the sovereign may go when imposing taxes before reaching the threshold of harsh and oppressive behavior. See United States v. Carlton, 511 U.S. 208 (1994); Barclays Bank PLC v. Franchise Tax Bd., 511 U.S. 298 (1994); Nordlinger v. Hahn, 505 U.S. 1 (1992).
may result from the additional tax. In taxing its contracts, the government is neither taking property nor repudiating a debt. Consequently, these limits do not apply in the context of taxes imposed on sovereign contracts. Moreover, the sovereign could also rationalize the tax as necessary to perform essential government functions or services and silence any claim that it is reneging on its debt. Preserving these sovereign powers does result in some unfair advantage for the government in its contracts, but this must be balanced with the obvious need for the government to contract with private parties.

Judging from the Court’s interpretation of governmental sovereign powers, it appears that the Court grants the government a free rein in the areas of both taxation and contracts. Since the government’s right to exercise its sovereign powers is an “enduring presence” over all of its contracts, requiring an express reservation of the right to tax or to drastically affect its contracts in recouping an advantage bargained away would seem to be redundant.

Although the Court’s consistent support of “free governmental rein” gives the government great power in contracting and taxing, private parties in government contracts have countered by contracting for price escalation clauses should tax legislation increase the parties’ burdens. Although the parties’ reactions are merely responses to the Court’s broad view of


250. See id. at 52 (holding that, since the Act under which the contracts were created “was designed to protect future, as well as present, generations of workers,” the sovereign, as a party to that contract, may amend the contract to conform to “evolving social and economic conditions”).

251. See the discussion of the Christian doctrine, supra notes 110-21 and accompanying text, holding that statutes and regulations are included as implied terms in government contracts unless expressly waived by an authorized government official.

252. See Montana v. United States, 440 U.S. 147, 149, 152 (1979) (holding that when a state imposed a one percent gross receipts tax on contractors, the contractors could then credit the amounts against other taxes or otherwise pass on the tax to the state). Private contractors may also submit bids with an increase in price, anticipating the future imposition of taxes. The result is that if taxes are imposed on the contracts, the government is simply paying the contractor with one hand, and taking the money back with the other.

Tax escalation clauses are often added by contractors in long-term lease agreements with the federal government to compensate for state and local tax increases. See Kimbrell v. Fischer, 15 F.3d 175 (Fed. Cir. 1994) (accepting an agreement whereby lessors contracting with the federal government include tax escalation clauses requiring government to pay additional rent for increases in local property taxes). Left open is the question of whether tax escalation clauses can be used by government contractors to recover costs from taxes imposed by their own contracting partners. Certainly this article suggests that such a clause would not be constitutionally enforceable.
government powers, the government is eventually hurt by the increased cost of doing business.\textsuperscript{253}

The increased costs have forced some to question whether the government should even contract with private parties to get its work done.\textsuperscript{254} The growing "phenomenon" of public and private sector contracts has prompted some to call such arrangements the creation of a "third-party government," or "government by proxy."\textsuperscript{255} The important issue becomes accountability, and when "the federal government shares a responsibility with another entity, accountability is muddled."\textsuperscript{256} When the government delegates some of its duties to private entities, it may be difficult to guarantee that a contractor will deliver as originally intended.\textsuperscript{257} Furthermore, the private entities are given "quasi-government powers" through the contracts without actually having the same status as other public authorities. In reality, the complaint is that such an approach implicates separation of powers concerns.

Finally, the problem of the executive binding Congress through contract, or one Congress binding a future Congress, is at the heart of the separation of powers debate.\textsuperscript{258} Supreme Court decisions giving the sovereign broad power to correct its contractual mistakes and to protect itself have alleviated some of this concern. The strict scrutiny the Court has placed on any release of taxing power in government contracts has greatly limited the debate as it appears that the sovereign can escape its bad bargains.\textsuperscript{259} The Court realizes the government's need to remain flexible in

\textsuperscript{253} See Harold J. Krent, Reconceptualizing Sovereign Immunity, 45 VAND. L. REV. 1529, 1560-61 (1992) (reasoning that, in light of the government's ability to exercise its sovereign powers to breach and terminate its contracts, private contractors respond by charging more for services to insure themselves).

\textsuperscript{254} Haas, supra note 241, at 1118. Haas suggests that giving private parties the role of quasi-government agencies complicates the system.

\textsuperscript{255} Id. at 1116-17 (commenting on the assertion that "direct government . . . [is] the exception to the rule"). Following his assessment of "various semi-public, semi-private entities, such as . . . the Corporation for Public Broadcasting," Harold Seidman, who coined the phrase "government by proxy," stated, "If necessary steps to deregulate the government are not taken and present trends are not reversed, we are likely to end up with two governments: one subject to the rule of law and the Constitution, and the other an outlaw government, composed of quasi-private institutions that can utilize public authorities and funds for their own purposes." Id. at 1118.

\textsuperscript{256} Id.

\textsuperscript{257} Id.

\textsuperscript{258} United States Trust Co. v. New Jersey, 431 U.S. 1, 24 (1977) (noting that tax exemption contracts, through which the sovereign abandons its power to tax, have not received sympathetic reading).

\textsuperscript{259} These ideas have been cited to limit the authority of government officials to contract away sovereign powers, as well as to assume that government powers (and future legislation) are not contracted away (and are applicable) unless done so specifically and expressly in the contracts. See
order to react to unforeseen situations. In reality the cases discussed above not only affirm broad contracting and taxing powers, they also demonstrate that the sovereign enjoys an even more important power to protect itself by relieving itself from contracts.

However, at some point the government must yield if it is to remain an attractive party with which to contract. Government’s ability to survive and function is as dependent on its ability to contract as it is on its taxing power. Arguably the government must act to restrain itself in a contractual setting in order to maintain private party interest in its contracts. Justice Brennan opined that this idea is an effective check on the government’s power to manipulate its contracts, for the government would unlikely “kill a goose that lays golden eggs for them.”

The recent Winstar decision stresses the importance of maintaining the government as an attractive contracting partner. It remains to be seen whether the Court’s paternalistic attitude toward sovereign contracting powers will be sustained in future decisions. The Court’s new focus will probably be on determining which sovereign powers are fundamental to the survival of the sovereign and protected, and how to differentiate them from situations where the government “seeks to shift the costs of meeting its legitimate public responsibilities to private parties.” Certainly the Winstar decision and this article suggest that taxation is one such sovereign power to which ordinary contract principles must defer.

Whether the government should be required to abide by the same contract rules as private parties is an unfair question. Although the notion of equality in bargaining power and contract performance is a noble theme, the

G.L. Christian & Assoc. v. United States, 312 F.2d 418 (1963); see also supra notes 110-28 and accompanying text.

260. See Bowen v. Public Agencies Opposed to Soc. Sec. Entrapment, 477 U.S. 41 (1986); Merrion v. Jicarilla Apache Tribe, 455 U.S. 130 (1982). Both cases exemplify the idea that sovereign powers remain with the sovereign even in contractual settings. Deferring to the sovereign and its powers of taxation and term modification even in these situations has allowed the sovereign to make contracts, bargain for terms, and later change the bargain to fit its needs.


263. Winstar, 116 S. Ct. at 2459 (stating that allowing the government free rein to abrogate contracts would undercut its “long-run interest as a reliable contracting partner in the myriad workday transaction of its agencies”); see also Kyle D. Logue, Tax Transitions, Opportunistic Retroactivity, and the Benefits of Government Precommitment, 94 Mich. L. Rev. 1229, 1146 (1996) (“If we allowed the government to break its contractual promises without having to pay compensation, such a policy would come at a high cost in terms of increased default premiums in future government contracts and increased disenchantment with the government generally.”).


265. See supra note 234 and accompanying text.
reality is that the government is a far more complicated entity with different internal and external pressures than a private party. To some extent, these pressures demand that the government act as a sovereign in order to effectively represent and care for its citizens.

It might be tempting to view the government’s exercise of its inherent power to tax as nothing more than skullduggery—an attempt to recapture what was already bargained away. Certainly the idea is an intuitively unattractive one, if for no reason other than that the government’s need to tax its contracts is not compelling. However, as a practical matter, apart from the legal niceties, the power to tax must be upheld. The sovereign, at least in the eyes of the Court, must not be challenged when it uses its constitutionally enumerated power to tax, unless such use is clearly erroneous. Therefore, the Court protects the government’s power to tax by setting extremely high thresholds for striking a tax as unconstitutional and by narrowly construing any claims that its power of taxation over its contracts has been abandoned. The government is thereby allowed to act as a sovereign when using its sovereign powers.