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Supreme Court Watch

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SUPREME COURT WATCH

By Reginald C. Oh

The U.S. Supreme Court wrapped up its 2002–03 Term by handing down several key Fourteenth Amendment equal protection decisions. In *Grutter v. Bollinger,* 123 S. Ct. 2325 (2003), and in the companion case *Gratz v. Bollinger,* 123 S. Ct. 2411 (2003), the Court established that narrowly tailored race conscious affirmative action programs can indeed survive heightened judicial scrutiny. In *Grutter,* the Court upheld the University of Michigan Law School's affirmative action policy as a narrowly tailored use of race, but in *Gratz,* the Court struck down the University of Michigan's undergraduate affirmative action admissions policy because the Court concluded that the policy in effect acted as a rigid quota and hence was not narrowly tailored.

In *Grutter,* a white student applied for admissions to the University of Michigan Law School and had her application denied. The student then filed a lawsuit against the law school in federal district court, alleging that the law school's policy of considering race as a factor in its admissions criteria violated her rights under the Fourteenth Amendment Equal Protection Clause. The district court in *Grutter* struck down the law school's admissions policy, as it determined that the law school's interest in using race to attain a racially diverse student body was not a compelling state interest and that even if it were, that the law school's policy was not narrowly tailored to further that interest.

The Sixth Circuit reversed the district court's decision, holding that based on the *Bakke* precedent, the interest in racial diversity is a compelling state interest, and further, that the law school's use of race was narrowly tailored because it was only a factor in the school's admission decision and did not operate as a rigid quota mandating that certain seats be reserved for racial minority students.

The Supreme Court granted certiorari to plaintiff's appeal, and in an opinion written by Justice O'Connor, the Court voted 5–4 to uphold the law school's affirmative action program. (Justices Ginsburg, Breyer, Stevens, and Souter joined the majority decision. Chief Justice Rehnquist and Justices Kennedy, Scalia, and Thomas dissented.)

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Justice O'Connor acted as the swing vote in the close decision, as she voted to uphold the affirmative action program in *Grutter,* even though in two previous affirmative action decisions, Justice O'Connor had written the majority decision in which the Court struck down race conscious affirmative action programs. In *Adarand v. Pena,* 515 U.S. 200 (1995), O'Connor voted to strike down a federal government minority business set-aside, and in *City of Richmond v. Croson,* 488 U.S. 469 (1989), she voted to strike down a local government minority business set-aside. Perhaps an explanation for O'Connor's change in positions can be attributed to the fact that in *Adarand* and *Croson,* the Court was dealing with race conscious remedies in government contracting, whereas *Grutter* involved the use of race in higher public education admissions practices.

Grutter is an important decision, as it clarified several issues left open by the Court's earlier affirmative action decisions. For the first time, a majority of the Justices agreed that the goal of having a racially diverse student body is a compelling state interest under equal protection strict scrutiny. Under equal protection doctrine, any racial classification enacted by the government must be subject to the two-prong strict scrutiny test. First, the court must determine if the state has a compelling state interest, and if so, whether the policy or statute is narrowly tailored to further that compelling state interest. What was contested in this case was whether the promotion of diversity in higher education should be considered a compelling state interest.

The racial diversity rationale was first developed and discussed in *Bakke v. University of California,* 438 U.S. 265 (1978), in which Justice Powell, in a plurality opinion that failed to command a majority of the Justices, held that a state may constitutionally use race conscious affirmative action programs to ensure a diverse student body. In *Grutter,* Justice O'Connor quoted extensively from Powell's *Bakke* opinion and reaffirmed Powell's assertion that diversity is a compelling state interest firmly grounded in the First Amendment principle that a paramount goal of educational institutions is to select students who will contribute to a "robust exchange of ideas." Accordingly, Justice O'Connor concluded that the Court must give some deference to an educational institution when it declares that a racially diverse student body is necessary for it to effectively advance its First Amendment-based pedagogical mission.

Once Justice O'Connor established that institutions of public higher education may give preferences to racial minority applicants in order to further the compelling state interest in attaining a diverse student body, she then applied the second prong of the strict scrutiny test, and determined that the law school's admissions policy was narrowly tailored to

further its interest in a diverse student body. The key point for O'Connor was that the law school's admissions policy assessed each applicant in a highly individualized, flexible, "holistic" manner, in which "race" was but one factor among several considerations that the law school took into account in making its admissions decisions.

Moreover, Justice O'Connor emphasized that the law school's policy makes clear that when it states that its goal is to have a diverse student body, it uses the term "diversity" in the broadest sense, and that the law school gives "substantial weight to diversity factors besides race." The law school's policy, noted O'Connor, "makes clear that there are many possible bases for diversity admissions, and provides examples of admittees who have lived or traveled widely abroad, are fluent in several languages, have overcome personal adversity and family hardship, have exceptional records of extensive community service, and have had successful careers in other fields." That the law school frequently admitted nonminority candidates with lower grades and test scores over qualified underrepresented racial minorities helped to convince O'Connor that the law school truly applied its admissions policy in a flexible manner and did not operate as a de facto "quota system."

While upholding the government's ability to enact race conscious affirmative action programs, Justice O'Connor ended her opinion by emphasizing that "any race conscious admissions policies must be limited in time." She admonished the law school to keep its word to "terminate its race-conscious admissions programs as soon as possible" and concluded by predicting that "in 25 years from now, the use of racial preferences will no longer be necessary to further the interest approved today." Justice O'Connor seemed to be sending the message that affirmative action has a twenty-five year time limit, and that if the law school or any other public education institution is still relying on race conscious admissions policies, then the Court would more likely than not strike such programs down as unnecessary reliance on race.

Although the *Grutter* decision reaffirmed the government's ability and authority to use race conscious measures as a way to open up educational opportunities for underrepresented racial minorities in higher education, it did so in a way to minimize and deflect attention away from the primary goal of affirmative action programs: the promotion of equality of opportunity for disadvantaged racial groups in the United States. The Court emphasized the important pedagogical benefits that a diverse student body provides for students of all races and emphasized the importance of a diverse student body as a way to further the First Amendment value of academic freedom. Yet, it failed to explicitly recognize the systemic factors that make affirmative action programs necessary—the continuing socioeconomic inequalities experienced by African-Americans, Latino-Americans, and Native Americans.

Such an omission did not escape the attention of Justice Ruth Bader Ginsburg, who, in a concurring opinion joined by Justice Breyer, made sure to emphasize what Justice O'Connor did not in her majority opinion: that "conscious and unconscious race bias, even rank discrimination on the basis of race, remain alive in our land, impeding realization of our highest values and ideals." Justice Ginsburg cited to statistics showing that African-American and Hispanic students continue to experience racial segregation in elementary and secondary public schools, and that such students in many states are lacking in educational resources. Although Justice O'Connor seemed to place the responsibility on the law school to ensure that it will not have to use race conscious measures in twenty-five years, Justice Ginsburg made sure to emphasize that whether the law school and other institutions need to use affirmative action programs in twenty-five years will depend on circumstances beyond their control, and that, depending on whether equal educational opportunity in America's primary and secondary public schools is achieved, the law school may still need to rely on race conscious measures even twenty-five years from now.

However, even though Justice O'Connor's opinion could have more explicitly recognized the central role that continuing socioeconomic inequality continues to hamper the educational opportunities of underrepresented racial minorities, her opinion does leave an opening for legal advocates to develop new theories to justify the use of race conscious measures in the education and government procurement context.

For example, the Court clarified an important question regarding the equal protection strict scrutiny test. An issue that had split the circuit courts was whether the *only* interest a state could put forth to justify its use of a racial classification is the interest in remedying the effects of its own past racial discrimination. The Court clearly rejected this narrow interpretation of the Court's equal protection doctrine and held that the government may be able to articulate other interests that may meet the "compelling interest" standard besides the interest in remedying one's own past discrimination. Hence, in *Grutter,* the Court held that the attainment of a diverse student body is a "compelling interest" for purposes of equal protection.

Grutter therefore opens up the possibility that, in addition to the remedying past discrimination and promoting diversity rationales, the Court may accept other rationales for affirmative action as "compelling state interests," in addition to diversity interest and remedying past discrimination interest. For legal advocates seeking to develop alternative compelling interests to justify affirmative action, the *Grutter* decision strongly suggests that the Court is more likely to accept an interest as *compelling* if that interest is rooted in a constitutional principle, just as the diversity rationale is rooted in the First Amendment. Thus, using similar reasoning, the government may rely on *Grutter* to use other constitutional amendments as the basis for articulating a compelling state interest for equal protection strict scrutiny purposes.

For example, government institutions, instead of using the First Amendment based student body diversity rationale, could instead justify their affirmative action programs as a way to further the compelling state interest in attaining a racially *integrated* student body, an interest that is rooted in both the Thirteenth Amendment prohibition against slavery and the badges and incidents of slavery and the Fourteenth Amendment prohibition against *de jure* segregation. *See* Elizabeth S. Anderson, *Integration, Affirmative Action,*

and Strict Scrutiny, 77 N.Y.U. L. REV. 1195 (2002) (articulating racial integration as a compelling state interest under equal protection strict scrutiny analysis).

Although it is beyond the scope of this article to fully lay out how the Thirteenth Amendment can be used as the basis for justifying racial integration as a compelling state interest, a few tentative points can be made. Under the Thirteenth Amendment, the federal and state governments have a duty to eliminate the existence of slavery or the badges and incidents of slavery, regardless of whether or not "state action" has caused or contributed to the existence of such. It could be argued that racial groups that suffer from the badges and incidents of slavery are those groups who continue to be saddled with indicia of inferiority and second-class citizenship status. Thus, the Thirteenth Amendment could provide the rationale for an affirmative action program focused on eliminating the indicia of racial inferiority and second-class status that saddle certain historically disadvantaged racial groups.

There are several advantages to justifying affirmative action on racial integration grounds rather than racial diversity grounds. First, an affirmative action program seeking to promote racial integration in the student body and society as a whole would put attention directly on the continuing existence of socioeconomic racial inequality in the United States. Such a rationale would be truer to the spirit and purpose of the Reconstruction Amendments than the First Amendment based racial diversity rationale. Second, when an affirmative action program is justified on grounds that it is seeking to eliminate the badges and incidents of slavery, it cannot be forced to be "sunset" or ended prematurely, because the duty to eliminate the badges and incidents of slavery ends only when such treatment of racial groups is thoroughly eradicated from society. To be sure, Justice O'Connor's concerns that race conscious policies will turn into a permanent racial spoils system are valid, and any attempt to argue for the continuing necessity of race conscious measures must adequately address such concerns.

Third, the Thirteenth Amendment interest in racial integration as a way to eliminate the badges and incidents of slavery also could justify the use of race conscious measures to remedy continuing societal racial inequality. While the Court has held that the government may use a racial classification to remedy past identified discrimination, it has suggested that it may not enact affirmative action programs to remedy the effects of "*societal discrimination.*" In other words, the Court has been reluctant to uphold affirmative action programs seeking to address the effects of continuing socioeconomic racial inequality in the United States. The Court has never had to decide, however, whether the government has the authority to remedy societal racial inequality as a way to pursue

the goals of the Thirteenth Amendment. Because the central purpose of the Thirteenth Amendment is to prohibit and eliminate the badges and incidents of slavery in society, it would seem logical that it could provide the legal justification for enacting affirmative action programs that specifically seek to remedy "societal discrimination."

By no means does the *Grutter* case signal that the Court is now more open to arguments seeking to expand the scope of affirmative action. At the very least, however, *Grutter* has given legal advocates and government institutions at least a twenty-five year time frame to develop new programs to ensure adequate representation of racial minorities in higher education.

Finally, in the companion case, *Gratz v. Bollinger,* the Court reaffirmed *Grutter's* holding that the government has a compelling state interest in furthering racial diversity. In *Gratz,* however, a case involving an equal protection challenge to the University of Michigan undergraduate admissions policy, the Court, in a 6–3 decision written by Justice William Rehnquist, struck down the undergraduate admissions policy, holding that the practice of giving certain underrepresented racial minorities 20 points of the 100 points needed to gain admissions was not narrowly tailored to further its compelling interest in racial diversity. The primary difference between the law school policy and the undergraduate policy was while the law school policy was administered in a highly individualized, holistic manner, in which racial minorities were not guaranteed a slot by virtue of their racial minority status, the undergraduate policy, by automatically giving 20 points to underrepresented racial minorities in effect guaranteed their admissions to the school, and thus, for the Court, the policy operated as an unconstitutional "de facto" racial quota.

The SEC Sends a Message

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investment risks of the particular bonds and accounting practices of municipal issuers in both primary disclosure documents (the basic bond offering materials) and also secondary disclosures—after the bonds have been sold to investors and are being traded in the market.

The SEC has been active in taking actions against municipalities that did not disclose bad financial news in bond documents. The SEC took action against Maricopa County, Arizona, for failing to disclose a decline in its financial position and the necessity for it to use bond proceeds to balance its budget. Maricopa County, Arizona, Securities Act of 1933 Rel. No. 33–7354 (Oct. 3, 1996). Likewise, the SEC took action against the City of Syracuse for misstating in bond documents a budget surplus when a deficit actually existed and for characterizing unaudited financial statements as having been audited. City of Syracuse, New York, Securities Act of 1933 Rel. No. No. 33–7460 (Sept. 30, 1997).

In perhaps the most significant enforcement action in recent years, the SEC took aim at Miami's disclosures during times of financial difficulty. In the early 1990s, the City of Miami began experiencing fiscal difficulties. City of Miami, *supra.* The city's financial advisers and auditors warned that it would run out of operating cash. *Id.* At a meeting of senior city staff, one elected commissioner, and mid-level staff, to discuss the potential and (under Florida law, illegal) operating deficit for FY 1994, the participants determined that based on past experience, the city council would not raise taxes or increase fees. *Id.* The only way they believed they could balance the budget was to issue bonds and use the bond proceeds to finance city operations. *Id.* The city began a program to eliminate waste and redundancy within the municipal government, but this program would not seriously impact the operating deficit confronting the city. *Id.* The city's financial condition continued to deteriorate and the city eventually declared a fiscal emergency, prompting the governor to appoint a fiscal oversight board to take control of the city's finances. *Id.*

Before the appointment of the state oversight board, the city faced enough of an operating deficit that it could not pay its bills and employees through legal means. *Id.* Nevertheless, despite the deterioration of its financial condition from bad to worse, in the official statements for three bond issues during this time, the city represented its budget to be balanced. *Id.* The disconnect between the city's financial position as described in the official statements for the bond issues and the city's financial position as described in its audits and comprehensive annual financial reports was problematic for the SEC. As the SEC dryly observed, "A reasonable investor would have considered it important to know that Miami could not generate sufficient revenues to pay its bills or employees. The fact that Miami needed to use bond proceeds to satisfy operational expenses demonstrated the gravity of its cash flow deficit, and, thus, the City's need to disclose this fact to public investors and the market place." *Id.*

Miami countered by arguing that its auditors had not issued a "going concern" qualification to its financial report. *Id.* A "going concern" qualification indicates that the subject will not be able to meet its obligations in the next twelve months. The SEC found, however, that only the infusion of bond proceeds prevented the auditors from giving a going concern qualification. In other words, only the illegal use of bond proceeds enabled Miami to argue that it did not merit a going concern qualification.

Miami also argued that it had relied on its auditors and other professionals for information on what to disclose in its official statements. *Id.* The SEC rejected this argument on two grounds. First, "Primary responsibility for the accuracy of information filed with the Commission and disseminated among investors rests upon the municipality." *Id.* Second, the SEC noted, "the record is unclear as to whether and to what extent Miami consulted with or relied on professionals." *Id.* The SEC also found that Miami had acted with scienter, based on circumstantial evidence concerning what its officials knew, but also upon the city's dismissal of the importance of the bond documents, as evidenced by the testimony of its

then city manager quoted at the beginning of this essay. *Id.*

What then, are elected laypeople to make of these actions? On the one hand, trying to ascertain whether a municipality relies too much on interest income seems a little much to ask of politicians. On the other hand, the failure to mention in bond documents that the municipality has trouble meeting payroll seems akin to lying on a mortgage application. Moreover, blaming the finance professionals does not seem to be a productive strategy. To the extent that the SEC has to bother with a municipal debt issue, it is a safe bet that the SEC will be examining the conduct of all the professionals connected with the transaction.

The dangers inherent in the blame the professionals approach are obvious in the Miami litigation. First, the SEC reiterated that professionals notwithstanding, the primary responsibility for accuracy of information in an official statement lies with the issuer. Second, the SEC questioned the record evidence concerning how much the city had, in fact, relied on professional advice. One may well question the degree of finger pointing and backside covering going on from the financing professionals back toward the city. The third consequence is found in statements in the SEC opinion: "The fact that Miami has pointed its finger at Deloitte, and other bond professionals, without taking any responsibility for its own conduct, suggests that Miami has not accepted fully its responsibility for the City's financial disclosures. . . . The City must be given the clear message. . . that Miami is responsible for the adequacy of its financial disclosures when seeking money from the investing public." City of Miami, *supra.* Notionally, it is a bad thing when a federal regulatory agency feels compelled to "send a message" to a municipality.

There are, however, general steps and specific steps that, if taken, could prevent municipalities from having to receive messages from federal regulators. At the general level, lay elected officials must have some awareness of the financial condition of their municipality. They must pay attention to what is going on around them. They must also respect the bond documents. It is no longer acceptable to have a "who reads these documents?" attitude.

As a specific guide, there are certain questions that elected officials should ask and to which they should receive answers. The questions are found in a brochure the SEC published in 1996, entitled "Questions to Ask Before You Approve a Bond Issue." This brochure contains ten questions elected officials should ask themselves and their staffs and five questions that they should ask their outside professionals. The questions are set forth below. If these questions are asked, and accurately answered, and the elected officials make their decisions based on these answers, elected officials can avoid the need for the SEC to have to send them a message.

Questions Officials Should Ask Themselves and Their Staffs

1. How have we allocated responsibilities for the preparation of the official statement? Have we clearly defined the responsibilities of all participants in the transaction?
2. What processes or procedures have been established to select qualified outside professionals? How are we relying on them and is our reliance appropriate? How are they being compensated?
3. What have we done to establish the accuracy of financial and operating information and its disclosure in the official statement? Has anything happened since the date of the financial statements that needs to be disclosed?
4. What policies and procedures have we developed to determine whether material conflicts of interest exist that need to be disclosed?
5. What procedures have we established to accurately describe the project, the bond terms, the sources of repayment, and the risks associated with the project? What procedures have we established for the investment and disbursement of the bond proceeds?
6. Do our procedures permit the underwriters to carry out their "due diligence" and other responsibilities?
7. Have we fully considered any questions asked by the rating agencies?
8. What continuing disclosure responsibilities have we assumed and what procedures have we established to meet them? Who will determine and file the annual financial and material event disclosure information? Have we designated an individual to speak to the market on our behalf?
9. If we are relying on the bond counsel, financial advisor, or trustee to evaluate and meet our continuing disclosure requirements, what procedures are in place to keep them apprised of our financial condition and other material information?
10. Have our procedures produced an official statement that we feel accurately presents our financial condition and discloses the information a reasonable investor needs to know? Have all the right people reviewed it?

Questions Officials Should Ask Outside Professionals

1. What is the nature or scope of the written opinion or certification, if any, that you are giving in this transaction and relating to the disclosure document? Have we given you access to the information you need?
2. Have you explained to us all aspects of the structure or nature of this transaction so that you are confident we fully understand all critical aspects? Does our official statement adequately address any concerns you have about this transaction that a reasonable investor would consider important?
3. Are there any matters regarding your participation in this transaction about which you should make us aware, including potential conflicts of interest?
4. Has your review of the relevant financial documents and other materials, including the official statement, raised any concerns regarding this borrowing? Do these concerns need to be disclosed?
5. Are you aware of any circumstances in which we, our staff, or others have not complied with our procedures so that we can make sure that our official statement adequately and accurately describes this transaction?