IN THE COURTS

Deliberate N.C. Supreme Court Accelerates Pace on Matters of Taxation and Education

by Katherine White

In 1994 in North Carolina Insight, *Raleigh attorney Katherine White assessed the North Carolina Supreme Court on the occasion of its 175th anniversary. A longtime observer of the North Carolina legal scene, White had this to say: "Unlike the General Assembly, which often makes sudden or sweeping legal changes in the give-and-take of politics, the Court makes law slowly, by interpreting the constitution, the legislature's statutes, and its own past decisions." Ten years later in 2004, White revisits the state's highest court and finds the pace of changing policy has quickened—with considerable fiscal impact.*

North Carolina citizens are turning to the courts to challenge legislative and executive branch decisions—and winning. In total, the state has been forced to surrender $1.5 billion in realized revenue—in today's terms almost 10 percent of the state's $15.9 billion General Fund budget—and forgo as much as $9.3 billion in revenue that would have been realized without the court decisions. And, thanks to a ruling that every child in North Carolina is entitled to a "sound basic education," the state also will have to reshape its relationship with local school systems. Other suits still pending could have a large financial impact.

It is not unusual for state courts to make decisions that have an impact on public policy as the third branch of government. The courts are the final arbiters of the North Carolina Constitution, they must interpret statutes passed by the North Carolina General Assembly, and they must review executive branch decisions. The courts also reinterpret the common law, the body of law that has grown from custom and usage, as opposed to legislative acts. However, the fiscal impact of these recent decisions is unusually large at a time when state government revenue shortfalls have become the norm.

In this article, White examines rulings in three lawsuits that have had—and will continue to have—a huge fiscal impact on state government. Bailey v. North Carolina *resulted in a settlement of some $800 million for state and federal government retirees.* Smith v. State *forced the abandonment of the state's intangibles tax and a settlement with taxpayers approaching $600 million. And,* Leandro v. State of North Carolina *resulted in a ruling that every child in North Carolina is entitled to a "sound basic education," which will alter the fiscal relationship between state and local government concerning funding of public education.*

Over the last decade, North Carolina citizens have turned to the courts to challenge the state's methods of taxation as well as the distribution of its revenues. The state Supreme Court has responded, emptying the state's coffers of more than $1.5 billion—in today's terms almost 10 percent of North Carolina's General Fund budget (see Table 1, p. 93) and forcing the state to revise its educational commitments to local governments. The value of the tax benefits awarded by the court to citizens, over time, is estimated at $9.3 billion. Other suits that could have a large fiscal impact are pending.[1]

In its first 175 years of existence (1819–1994), the North Carolina Supreme Court moved slowly in its legal interpretations, not making wholesale changes as other states' courts had, and taking few steps that altered the way business is done.[2]

Katherine White is an attorney in Raleigh, North Carolina.

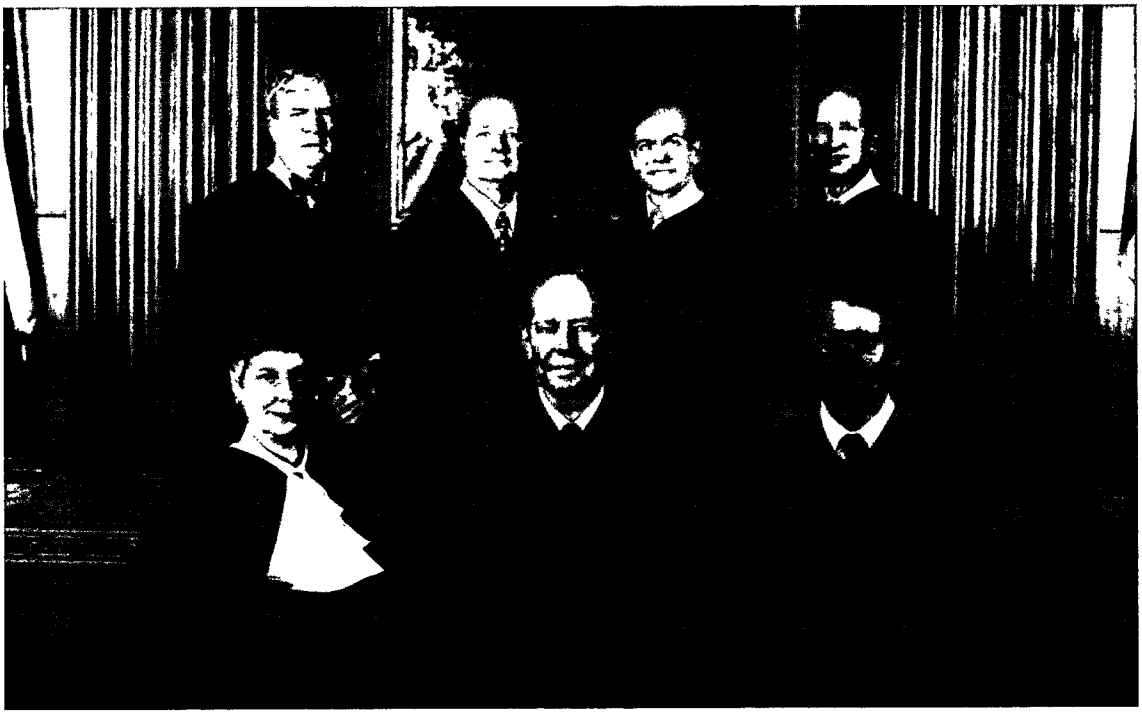


Photo courtesy of N.C. Supreme Court

North Carolina Supreme Court Justices:
(front row) Sarah Parker, Chief Justice I. Beverley Lake, Jr., Mark Martin,
(back row) Edward Thomas Brady, George C. Wainwright, Jr., Robert H. Edmunds, Jr., Paul M. Newby

What a difference a decade makes. In the last 10 years, the Supreme Court has reversed a 100-year string of its own cases,[3] has revamped how the state's public schools operate,[4] and has ordered the refund of taxes to tens of thousands of citizens.[5]

It is not unusual for state courts to decide matters of public policy. As the third branch of government, courts are the final arbiters of the North Carolina Constitution. They interpret the laws enacted by the General Assembly and review executive branch decisions. The courts also reinterpret the common law, the body of law that has grown from custom and usage, as opposed to legislative acts.

What is unusual is the breadth of recent decisions and their impact on citizens and industry. The fiscal impacts of the decisions are long-lasting during a period when North Carolina government's revenues have faltered. And in broad terms, although grounded in constitutional interpretation, the cases appear to focus on fundamental fairness, as opposed to the narrow legal construction that is the Court's wont.

Beyond the legal arguments, the constitutional issues with which the Court has wrestled have affected areas usually addressed by the executive branch and the General Assembly—taxes and education. This incursion into areas traditionally left to the two other branches of government is not an ordinary occurrence.

The Power To Impose Taxes on Citizens

> ***The power of taxation ... shall never be surrendered, suspended, or contracted away.***
>
> —N.C. CONSTITUTION, ARTICLE V, SECTION 2(1)

This constitutional provision, originally adopted in 1936,[6] arose after years of court battles over whether tax exemptions adopted by one General Assembly could be changed by a future General Assembly. The battles began in 1871, when the United States Supreme Court held that the North Carolina General Assembly could not tax a railroad after granting the railroad a charter that exempted it from taxation. The U.S. Supreme Court directed the state to withdraw its tax because the tax would unconstitutionally impair the obligation of contract.[7] The North Carolina Supreme Court lamented the higher court's interpretation, expressing "regret ... that the right of one general assembly to surrender

In the last 10 years, the Supreme Court has reversed a 100-year string of its own cases, has revamped how the state's public schools operate, and has ordered the refund of taxes to tens of thousands of citizens.

a portion of the sovereign power to tax, so as to disable itself or its successor to resume it, has been recognized."[8] The General Assembly began its campaign to amend the state constitution to allow tax laws to change when public policy dictated. It took 65 years to get the public approval required.[9]

In 1939, three years after establishing a constitutional provision that allowed the state to change its tax policy, the General Assembly decided that pensions for state retirees should be free from taxation. The tax-free status changed on August 12, 1989, when the North Carolina General Assembly passed a law requiring the taxation of retired state and local employees' pensions, with a $4,000 cap on annual benefits that would be exempt from state taxation. The new tax arose after the United States Supreme Court held that if a state taxes state and local government employees differently than federal employees, the state violates both federal statutory law and the constitutional doctrine of intergovernmental tax immunity.[10]

With the adoption of the 1989 tax measure, a group of former judges, teachers, and other state employees began what would become a 12-year court battle over the taxation of their pensions. The litigation, in various forms, addressed the taxation of federal and state pensions, as well as those of local retirees.

Until the U.S. Supreme Court decision, federal retirees in North Carolina paid taxes on their retirement. Their state and local counterparts did not. The General Assembly attempted to remedy the situation, changing the tax exemption of government pensions to (1) include federal retirees; and (2) exempt the first $4,000 of retirement income from taxation for all government retirees—federal, state and local. For the first time in decades, all government retirees were taxed on their retirement income.[11] The impact of the legislation meant state and local retirees had to pay $100 million a year in additional state taxes. The recurring costs to the state if the tax was found to be illegal were staggering—$45 million annually for the portion of the tax paid by state retirees and some $84 million annually for the federal retiree portion.[12]

The 78 named plaintiffs who opposed the new law were retired state employees and included James H. Pou Bailey, a retired judge of the Superior Court; A. Pilston Godwin, a retired judge of the Superior Court, and later his widow; Henry L. Bridges, the State Auditor from 1947 to 1981; Col. James Speed, a retired Highway Patrol officer who served as commander of the patrol from 1966 to 1969; and Col. Edwin Guy, a retired Highway Patrol officer who served as commander of the patrol from 1969 to 1973. More than 85,000 retired state employees would be affected by the case, which challenged the state's system of taxing their pensions.

The class action was filed in October 1992.[13] The retirees contended that the state's program to provide tax–free pensions to state employees was part of their contract for employment and that they had entered public service with the understanding that their pensions would not be taxed. They told the Supreme Court: "To condone the defendant's breach [of contract], were it not for the [state constitution's] contract clause, would be to entrap citizens in a classic 'bait and switch' scheme. Make promises, get what you can. Break the promise and change the deal. Natural law, moral law, ethics, state law, federal law, constitution law, or parental law—anyway you look at it—it's not right. It is wrong to make a promise, take advantage of the other person's performance and then go back on your word," they argued.[14] The argument, in sum, was based in simple contract law.

The Attorney General argued that the tax exemption to which the retirees claimed they were entitled was a violation by the state itself of the state's constitution, which states that the taxing power cannot be contracted away. For that reason, even if there were contract rights that arose after state employees worked for a certain number of years, "those contractual rights do not include the former tax exemptions."[15] Rather, the Attorney General argued, the tax exemptions constituted public policy that the General Assembly could change at any time.

After losing at a trial lasting intermittently from March to September 1995 and in seeking review by the Supreme Court, the Attorney General advanced its own public policy reasons for upholding the 1989 law and allowing the change of tax status. The matter "is of interest to all North Carolina's citizens and taxpayers. It will determine whether the State can retain, and collect in the future, hundreds

of millions of dollars of taxes from all government retirees, and it will determine whether the State will have access to these hundreds of millions of dollars to provide a better education for its children in the public schools, to provide secure prisons to protect its citizens from criminal offenders, and to deliver all the myriad services performed by the State. Beyond these immediate, enormous fiscal considerations, resolution of this case will determine whether the General Assembly will have the power to alter the present exemptions in the future to account for the changing legal, demographic and economic needs."[16] The Court granted the Attorney General's request to review the case, but the public policy arguments advanced by the Attorney General fell on deaf ears.

In a 5–2[17] decision in *Bailey v. North Carolina* written by Justice I. Beverly Lake Jr. (now Chief Justice), the North Carolina Supreme Court agreed with the retirees. "[T]he state acted unconstitutionally by impairing the contracts and taking without just compensation the property of state and local government employees whose retirement benefits vested on or before 12 August 1989."[18]

Table 1. Major Lawsuits Against N.C. With Fiscal Impact on State Government and Actual Payouts and/or Appropriations by the State, 1997–Present*

Name of Lawsuit and Description of Case	Actual Payout or Expenditure by State, 1997–Present	Future Funding Required?
1. *Bailey v. North Carolina,* on taxing government pensions of state, local, federal, and military retirees	$825 million	No
2. *Smith v. State* on legality of application of intangibles tax	$596 million	No
3. *Leandro v. State* on public school finance and the right to a sound, basic education	$ 22 million	Yes—in excess of $200 million annually
4(a). *Ford Motor Credit Company v. N.C. Department of Revenue* on taxation of installment debt papers issued by out-of-state company through in-state auto dealers	$ 38 million	No
4(b). *Chrysler Financial Service v. N.C. Department of Revenue* on taxation of installment debt papers issued by out-of-state company through in-state auto dealers	$ 21 million	No
Total	**$ 1.5 billion**	**$200 million-plus**

* Other cases yet to be decided with large potential fiscal impact include (1) *Harrington and Goldston v. N.C. Secretary of Revenue* on the diversion of funds from the N.C. Highway Trust Fund to other uses, Wake County Superior Court, seeking the return of $80 million; (2) *Cabarrus County v. State* on Governor Mike Easley's decision in 2001 to withhold tax revenues from local governments collected on behalf of local government during the economic downturn in order to balance the state's 2001 budget, $315 million; and (3) *Coley et al. v. Easley* challenging a retroactive tax on high-income taxpayers passed in 2001 and covering the first seven months of the year before the General Assembly adopted the tax, $73 million.

Source of cases with actual payouts and/or expenditures: N.C. Office of the State Controller.

By approaching the retirement tax issue as an employment contract case, the Supreme Court's decision essentially reversed a line of its own cases from the 1880s that the state's power to tax cannot be contracted away. North Carolina legislatures pursued state constitutional amendments beginning in 1913 to restrict the contracting away of sovereign power. During that period, one expert witness testified that a proposed constitutional provision "merely guards against the danger that the State Legislature may at some unguarded moment surrender to some interest its right of taxation and guarantee it perpetual exemption."[19]

In addition to addressing the constitutional question in the *Bailey* case, the Supreme Court had to decide whether retirees who had not protested the taxation of their pensions would be entitled to refunds. State law then required that taxpayers make written demands within 30 days of a tax payment if they believed a tax were illegal. Here the court did not hesitate: "It would be unjust to limit recovery only to those taxpayers with the advantage of technical knowledge and foresight to have filed a formal protest and demand for refund. Such a result would clearly elevate form over substance. This is especially untenable in a case such as this, where the matter is of constitutional import and where, in practical consequence, the purpose of the statute was realized."[20]

Justices Henry Frye and John Webb dissented on the majority's dispatch of the statute requiring a protest within 30 days of paying the tax. "The General Assembly has determined that in order to contest the imposition of a tax, there must be a payment under protest. We should not repeal this action of the General Assembly,"[21] they said.

As noted above, the decision was based in fundamental fairness. One legal commentator observed, the "decision's interpretation [of the state constitution] is ... questionable at best. But why did the court so clearly reject the constitutional interpretation adopted by other state courts and instead strain to create its own unique interpretation? The answer may well lie in the court's overriding feeling that the state's repeal of the tax exemption on the retirement benefits of public employees was simply unfair."[22] The Court found that the retirees had labored for years for state government, which was their end of the bargain for a tax-free retirement.

Fairness aside, the *Bailey* decision's impact may go beyond the taxing of retirees' benefits. Dana Simpson writes in the *North Carolina Law Review,* "Today, economic development tax breaks have expanded beyond granting tax exemptions to railroads and now include tax incentives for a wide array of private businesses. Following *Bailey*, state and local governments may find themselves locked into agreements for perpetual tax exemptions that they never intended to make permanent. Although many may have assumed that the North Carolina Constitution prevented the creation of such permanent tax breaks, the state supreme court's unique interpretation of Article V, section 2(1) opens the floodgates to such claims by private businesses."[23]

Whether the North Carolina Supreme Court will expand its holding to other areas when confronted with the question remains unknown. But, after 10 years of waiting, in 1999, retired Judge James Pou *Bailey* received a check for $13,243.99 from the state.[24] He said, "The check is made payable to me and my wife, which means she gets it."[25]

Eliminating a Tax on Wealth

> ***Only the General Assembly shall have the power to classify property for taxation, which power shall be exercised only on a statewide basis and shall not be delegated. No class of property shall be taxed*** **except by uniform rule....** ***[Emphasis added].***
>
> —N.C. CONSTITUTION, ARTICLE V, SECTION 2(2)

In 1996, the United States Supreme Court concluded that North Carolina's intangibles tax scheme, which favored in-state corporations' shareholders and discriminated against out-of-state corporations, was in violation of the U.S. Constitution's Commerce Clause.[26] The tax at issue excluded assets invested in North Carolina from the state intangibles tax, which realized about $100 million in revenue each year. Under the law, the state imposed an intangibles tax of 25 cents of each $100 of market value of stock and shares in mutual funds. The state exempted from taxation the share of income that was earned in North Carolina. If a company earned all of its income in North Carolina, the stock was exempted from the intangibles tax. If the company earned 25 percent of its income in North Carolina, 25 percent of the stock's value was exempted from tax.

But in 1992, the Fulton Corporation, a hardware manufacturer in Fulton, Illinois, challenged the constitutionality of the intangibles tax, alleging that the statute violated the Commerce Clause of the United

States Constitution because it placed a heavier tax burden on the stock of corporations not doing business in North Carolina. After the North Carolina Supreme Court upheld the tax, the U.S. Supreme Court reversed, concluding that "North Carolina's intangibles tax facially discriminates against interstate commerce."[27] As the *Fulton* case proceeded, a group of taxpayers, who also objected to the tax method, filed a class action case on similar grounds to protect their rights should the *Fulton* case be successful.[28] That case, *Smith v. Offerman,*[29] by agreement, was held in abeyance until the U.S. Supreme Court decided *Fulton*. The plaintiffs sought certification as a class action, meaning that all individuals who had paid the taxes for the years 1991 through 1994 would be entitled to a refund. A trial court certified two classes of taxpayers totaling about 220,000 for each tax year. Class A members were those who had paid the tax and who had protested that payment within 30 days, as required by law; Class B members were those had paid the tax and not filed a protest.

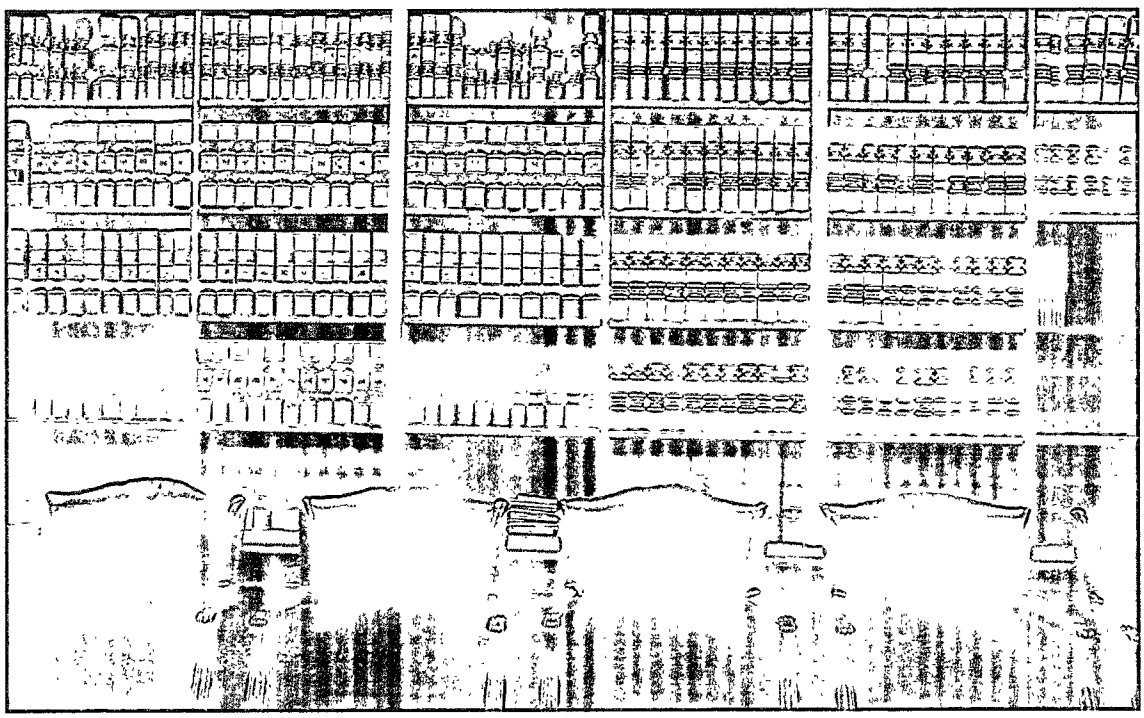
The *Fulton* decision meant, simply, that the intangibles tax had to be fairly applied, with no preference for in-state corporate investments. It did not mandate the repeal of the tax, merely the severance of the unconstitutional exclusion favoring in-state investors.

While the case was pending, the General Assembly passed legislation that made the state liable for refunds to protesters for tax years 1991–1994[30] and also directed the N.C. Secretary of Revenue to take no action to assess or collect retroactive intangibles on stock from those taxpayers who had been entitled to use the deduction.[31] The legislative action meant that some North Carolina residents would save hundreds of thousands of dollars in taxes.[32]

The General Assembly's action to eliminate the tax was but one approach that could have been taken. It gave refunds only to those individuals who had filed a timely protest with the N.C. Department of Revenue.

Thus, the issue left for the Supreme Court of North Carolina was whether Class B non-protestors would be entitled to a refund. The case was running in tandem with *Bailey*[33] in the sense that similar issues were being raised in the courts in the two cases. In the *Smith* case, the Attorney General issued an opinion in April 1997 stating, "It would be unconstitutional for the General Assembly to make any payments to those taxpayers who did not file a timely protest to the payment of the [intangibles] tax" on stock. The argument is founded in another state constitutional provision.[34] "Our Supreme Court has ... made it crystal clear that absent a legal obligation or a public service purpose, the legislature may not appropriate funds to a select few, even if the legislature believes it has a moral or equitable obligation to do so," the opinion said.[35]

The North Carolina Supreme Court's decision



Karen Tam

was founded on the principle of uniformity in the application of taxes outlined in Article V of the State Constitution. "[T]he General Assembly made a policy decision ... mandating that the State not assess taxes against those who had previously avoided paying the intangibles tax. Having made that decision, the General Assembly was required as a constitutional matter to 'forgive' the taxes of those taxpayers who had paid the tax or else run afoul again of the United States Supreme Court's decision in *Fulton,*" wrote Justice Bob Orr for the majority.[36] Justice Henry Frye concurred with the result but reached his conclusion on different grounds. Although dissenting on the same issue in *Bailey*, he wrote that the notice requirements were not required because of the notice provided by the litigation.[37] Regardless of the reasoning, the decision resulted in a refund of $40 million in illegal taxes.

According to Dan Gerlach, now senior policy adviser on fiscal affairs for Governor Michael Easley, the intangibles exemption was one of North Carolina's initial economic incentives. "It was an attempt to use the tax code to increase investment and jobs in North Carolina by making our companies more competitive."[38] The public policy may have been established to improve the state's economic posture, but the tax also meant that some wealthy North Carolina residents left the state so they would not have to pay it.[39]

Before the Supreme Court's decision, however, the General Assembly eliminated the entire intangibles tax.[40] "The legislature could do this because the state was enjoying good economic times and because the intangibles tax was a small enough percentage of total tax money that it could be afforded."[41]

A 1994 legislative analysis concluded that the wealthiest 6.6 percent of the state's citizens paid a little more than half of the total intangibles tax collected. Each paid an average of $2,900 in tax and had at least $400,000 in investments.[42]

The political reaction was swift. "The decision was not a surprise.... Most of us were thinking that the Supreme Court would come down in favor of these people who did not protest, as a matter of fairness," said then-Senate Majority Leader Roy Cooper (D-Nash).[43] Frank S. Goodrum, the former director of the N.C. Department of Revenue's Intangibles Tax Division, said, "The law could have been amended to eliminate the use of taxable percentages of stocks based on income earned in and out of North Carolina and to tax the market value of all stocks at the same percentage rate.... Well, why wasn't this done? Primarily (in my opinion) because too many members of the legislature wanted to satisfy the desires of their wealthy and/or powerful constituents."[44] In the General Assembly there was not one dissenting vote.[45]

N.C. Constitution Guarantees Every Child a Sound Basic Education[46]

> ***The people have a right to the privilege of education, and it is the duty of the State to guard and maintain that right.***
>
> —N.C. CONSTITUTION, ARTICLE I, SECTION 15

> ***The General Assembly shall provide by taxation and otherwise for a general and uniform system of free public schools, which shall be maintained at least nine months in every year, and wherein equal opportunities shall be provided for all students.***
>
> —N.C. CONSTITUTION, ARTICLE IX, SECTION 2(1)

On May 25, 1994, Robert A. Leandro was 15 when he and his mother joined school boards and students from five low-wealth school districts, including his home school district in Hoke County,[47] in a lawsuit challenging the state's funding of education in poor counties. At the time, he was a gifted high school student (who has since graduated from Duke University and in 2005 is in his second year at Vanderbilt University Law School). His high school lacked the lab equipment he needed to take an advanced placement biology test. His older brother's class lacked Bunsen burners.[48] The poorer counties, including his own, spent approximately $3,700 per student each year. The wealthier counties spent an average of $5,200 or more.[49]

Because of this disparity and the resulting academic deficiencies in certain schools, the plaintiffs sought a court determination that North Carolina's public education system, including its funding scheme, violates the North Carolina Constitution and various state statutes by failing to provide "equal educational opportunities," as the state constitution requires, for all public school children. Specifically, the plaintiffs argued that the educational funding system is not constitutionally "general and uniform" because "the quality of the education programs and amounts of funding vary substantially between plaintiff school districts and wealthy school districts."

Karen Tam / Winston-Salem Journal

Robert Leandro

Six urban school districts[50] and students from those districts then intervened in the low-wealth schools' action. Their claims were similar but were based upon a different theory. They argued that state funding "fails properly to take account of the significant differences in the educational and resource needs of students and school districts throughout the state."[51] Basically, they said the state did not account for the unique needs of urban areas where there exists a higher proportion of students with disabilities, students for whom English is a second language, and poverty. "The right the urban plaintiffs seek to enforce, therefore, is not a right to equal *funding,* but a right to equal *opportunity,*" they argued. A trial court denied the Attorney General's motion to dismiss the case, and the case was appealed to the N.C. Court of Appeals, which granted the Attorney General's motion.

On appeal, the Attorney General argued that the uniformity required is *system* uniformity, not spending or programming uniformity. The Attorney General further argued that the structure of the state's educational system is general and uniform, as required by the Constitution. And, the Attorney General advanced the argument that the trial court should have dismissed the plaintiffs' claims because the North Carolina Constitution and existing case law had consistently held that the Constitution "is silent on the issue of 'adequate education,' and that there is no such constitutional right."[52] In the Court of Appeals, the state's arguments prevailed.[53]

A year later, in 1997, the North Carolina Supreme Court reversed a key holding of the lower appellate court. The Court, in an unanimous decision[54] written by then-Chief Justice Burley Mitchell, asked itself whether the state is constitutionally required to provide children with an education that meets some minimum standard of quality. "We answer that question in the affirmative and conclude that the right to education provided in the state constitution is a right to a sound basic education. An education that does not serve the purpose of preparing students to participate and compete in the society in which they live and work is devoid of substance and is constitutionally inadequate."[55]

The state Supreme Court said the constitutionally protected sound basic education "is one that will provide the student with at least: (1) sufficient ability to read, write, and speak the English language and a sufficient knowledge of fundamental mathematics and physical science to enable the student to function in a complex and rapidly changing society; (2) sufficient fundamental knowledge of geography, history, and basic economic and political systems to enable the student to make informed choices with regard to issues that affect the student personally or affect the student's community, state, and nation; (3) sufficient academic and vocational skills to enable the student to successfully engage in post-secondary education or vocational training; and, (4) sufficient academic and vocational skills to enable the student to compete on an equal basis with others in further formal education or gainful employment in contemporary society."[56]

The Court's holding went beyond existing case law, which, until that time, had generally held that students had a right of equal access to schools.[57] It relied in part on a 1917 case, which stated that "it is manifest that these constitutional provisions were intended to establish a system of public education adequate to the needs of a great and progressive people, affording school facilities of recognized and ever-increasing merit to all children of the State, and to the full extent that our means could afford and intelligent direction accomplish."[58] The constitutional provisions at issue in that case declared "that schools and the means of education should be forever en-

"An education that does not serve the purpose of preparing students to participate and compete in the society in which they live and work is devoid of substance and is constitutionally inadequate."

—LEANDRO DECISION
STATE SUPREME COURT

couraged" and that the General Assembly "shall provide by taxation and otherwise for a general and uniform system of public schools, wherein tuition shall be free of charge to all the children of the state, between the ages of six and 21 years." The case did not mandate equal schools across the state. Indeed, the 1917 court expressly stated, simply, that high schools may be established and, when they are, they are part of the uniform system of public schools and shall be funded by the county. The court observed: "The term 'uniform' here clearly does not relate to 'schools,' requiring that each and every school in the same or other districts throughout the State be of the same fixed grade, regardless of the age or attainments of the pupils, but the term has reference to and qualifies the word 'system' and is sufficiently complied with where, by statute or authorized regulation of the public school authorities, provision is made for the establishment of schools of like kind throughout all sections of the State and available to all of the school population of the territories contributing to their support."[59]

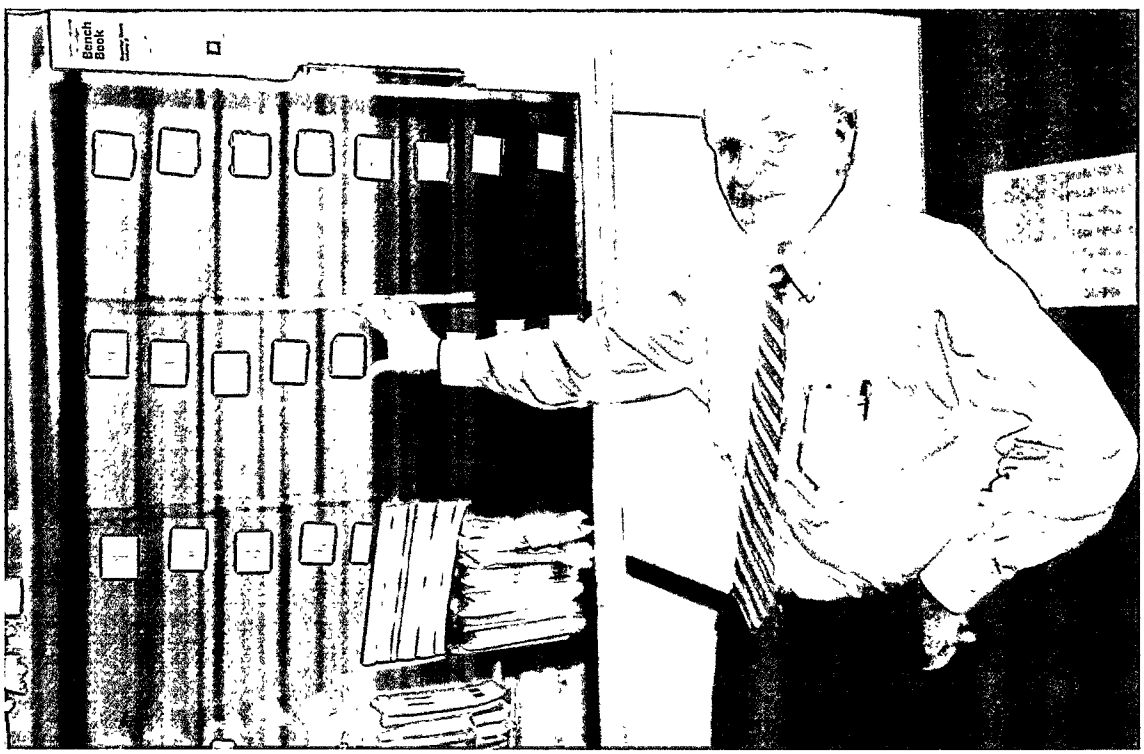
Robert Spearman, an attorney representing the low-wealth school systems in *Leandro*, says the 1917 case had to be taken into account but was not the legal underpinning for the *Leandro* decision. "The 1917 case was not really the key support for the supreme court decision," says Spearman. "Rather, it had to interpret broad constitutional language and did so as other supreme courts (e.g. in the *Rose* case in Kentucky) have done."

Left unsaid in the Supreme Court's *Leandro* decision was how to pay for the sound basic education if, in fact, students were not receiving it. The court did not need to address this issue because it sent the case back to the trial court for a full-blown trial to determine whether students were receiving the constitutionally mandated sound basic education.

Justice Mitchell designated Superior Court Judge Howard E. Manning, Jr. of Raleigh to hear the case on remand. Before the trial began, Judge Manning asked the county school boards to amend their original complaints "to assert claims on behalf of children of pre-kindergarten age to educational rights under the North Carolina Constitution."[60]

Judge Manning's hands-on expansion of the case thrust the court into direct management of the state's educational system, a role traditionally left to the executive branch and the General Assembly.[61] After weeks of testimony, Judge Manning issued a series of orders. The orders were far reaching and reflected some frustration on the part of Judge Manning, who began his fourth and last order with the following:

Superior Court Judge Howard Manning, pictured with paperwork generated in the *Leandro* case.



Karen Tam

It should never be forgotten that the State of North Carolina, represented by its Attorney General, while acknowledging the State's constitutional responsibility has consistently fought "tooth and nail" to prevent any finding that (1) the State of North Carolina is not providing the equal opportunity for each child to obtain a sound basic education through its educational programs, systems and offerings and (2) that the State of North Carolina is not providing sufficient funding to its school districts to provide each and every child with the equal opportunity to obtain a sound basic education within its funding delivery system.[62]

Clearly, Judge Manning was upset with the status quo. He took his message on the hustings, telling an audience at the University of North Carolina at Pembroke: "They went nuts and told me I was crazy. They basically told me to go to hell. They said they are educators and politicians, and they didn't have to do what some judge from Wake County told them to do. I didn't get mad. I got even. I stepped on some toes, and I will do it again. This case is not over."[63]

Manning, in a subsequent interview, did not deny that he made the remark, which was reported by the UNC-Pembroke news bureau. However, he says the writer left out key context. The legislators and educators were upset because Manning ordered them to reallocate funds to provide programs for under-performing, disadvantaged students and to report to the court as to how this was going to be done. The state appealed, and Manning says he "got even" by withdrawing the order, enabling him to continue evidentiary hearings as to what works and come up with a plan of his own. Manning says his reasoning was, "You don't want to do it? Fine, I'll do it myself. It's my responsibility anyway. I took the thorn out of the lion's foot. I amended my order so they didn't have to do anything."

But the gloves were off. Manning's key findings—that the state must provide pre-kindergarten for children at risk and that the state has failed to provide a sound basic education for public school students—were appealed to the N.C. Supreme Court. As that case was pending, Judge Manning actively sought to have his findings implemented by the state. Although the case didn't expressly dictate that funds be spent, the reforms sought by Judge Manning would cost money. In the spring of 2004, after prodding from Judge Manning, the State Board of Education proposed the establishment of a Disadvantaged Student Supplemental Fund, with an annual allocation of $223 million. The first annual installment was to be $22 million to pilot the program in 16 school systems.[64] On July 2, 2004, as the General Assembly was ending its legislative session, Judge Manning wrote Michael E. Ward, then-State Superintendent of Public Instruction, and Howard N. Lee, Chairman of the State Board of Education, that there "was no mention of the Disadvantaged Student Supplemental Funding being included" in the state budget. "The bottom line is that *Leandro* requires that the foregoing resources [$22 million] must be available to every child first and foremost before other dollars are spent on educational resources not necessary to provide the opportunity for a sound basic education." In another letter to the lawyers involved in the case, also on July 2, 2004, Judge Manning wrote:

I know that all of you remember the computer lab example about where the money must be spent when you have a situation where there is a constitutional deficiency and you only have $5,000,000 left to spend. All agreed that the money must be spent on the constitutional deficiency.... This is what the law requires. I do not see what is so hard to understand about this requirement.

On July 6, 2004, Superintendent Ward reported that he had shared the letter with legislative leaders and that he would encourage the General Assembly to include the funds in its budget. The General Assembly adjourned without providing the requested funds. Subsequent hearings resulted in Governor Easley's signing an executive order to provide $12 million for the Disadvantaged Student Supplemental Fund. "It's not $22 [million], but it's not chump change, by any means," Judge Manning said.[65]

A day after Governor Easley's order, the second *Leandro* opinion was issued by the North Carolina Supreme Court, affirming most of Judge Manning's findings. It did not uphold Judge Manning's ruling that the state must provide pre-kindergarten education for at-risk children, but it left the door open for future litigation.

We read *Leandro* and our state Constitution, as argued by plaintiffs, as according the right at issue to all children of North Carolina, regardless of their respective ages or needs. Whether it be the infant Zoë, the toddler Riley, the preschooler Nathaniel, the "at-risk" middle-schooler Jerome, or the not 'at-risk' seventh grader Louise, the constitutional right articulated in *Leandro* is vested in them all. As a consequence, we note that the

initial question before us is not whether that right exists but whether that right was shown to have been violated.[66]

This language affirms Judge Manning's ruling that the state must take affirmative steps to identify and assist at-risk children. Pre-kindergarten children, therefore, are included in those children who have a right to a sound and basic education.[67] With regard to Judge Manning's conclusion that the State had failed to provide a sound, basic education, the Supreme Court agreed. "[T]his Court affirms the trial court's conclusion that plaintiffs have made a clear showing than an inordinate number of students in Hoke County are failing to obtain a sound basic education and that defendants have failed in their constitutional duty to provide such students with the opportunity to obtain a sound basic education."[68]

The finding seems narrow: The Court limits its discussion only to Hoke County, not to the other school systems—the poor and the urban—who were parties to the lawsuit. The parties, however, agree that the decision is broader, that the basic facts that apply to Hoke County essentially apply to the other low-wealth schools.[69] "Assuring that our children are afforded the chance to become contributing, constructive members of society is paramount. Whether the State meets this challenge remains to be determined,"[70] the court said.

With the state Supreme Court backing Manning, Governor Easley found the additional $10 million from other sources to reach the agreed-upon $22 million. As to why the legislature had adjourned for the summer without providing the additional $10 million for the Disadvantaged Student Supplemental Fund, Manning believes the leadership was confident that his ruling would be overturned by the state's highest court. Instead, it was affirmed. "The judicial system in North Carolina—the third branch—has basically been laid back and compliant with everything government does," Manning told Wake County Citizens for Effective Government in a speech in November 2004. *Leandro* represented a new tack with the determination that every North Carolina child is constitutionally entitled to a sound basic education. Manning gives the credit to former Chief Justice Burley Mitchell, who wrote the 1997 *Leandro* decision. "It's the best, most important decision he ever wrote," says Manning. "It's a tribute to the judiciary—the hated, underfunded third branch of government that can flex the power that it has under the constitution."

Conclusion

And the moral of these stories? The third branch of government, the judiciary, can influence public policy in North Carolina on large issues as well as small. These decisions already have forced the state to surrender $1.5 billion in revenue. These decisions also show that the third branch of government, the judiciary, is a forum in which citizens can gain redress of grievances. And, the fiscal impact of decisions in such cases can be substantial.

FOOTNOTES

[1] As this article is being written, additional challenges are pending that question: (1) the diversion of funds from the N.C. Highway Trust Fund to other uses (*Harrington and Goldston v. N.C. Secretary of Revenue,* Wake County Superior Court, seeking the return of $80 million to the fund that was diverted to the state's general account to balance the state's 2001 budget. The state prevailed, and the case has been appealed.); and (2) the Governor's decision in 2001 to withhold tax revenues from local governments collected on behalf of local governments during the economic downturn (*Cabarrus County v. State,* Wake County Superior Court, seeking $315 million in collections for distribution to counties and municipalities, which Governor Michael Easley withheld to balance the state's 2001 budget). Another pending taxpayer suit challenges a retroactive tax on incomes greater than $120,000 if single, $160,000 if a head of households, and $200,000 if married (*Coley et al. v. Easley,* Wake County Superior Court, seeking $73 million in taxes that were collected for the first seven months of the year in 2001 before the General Assembly adopted the tax).

[2] See Katherine White, "The N.C. Supreme Court at 175: Slow on Civil Rights But Fast on Free Speech?" *North Carolina Insight,* Vol. 15, Nos. 2–3 (September 1994), pp. 106–111.

[3] *Bailey v. North Carolina,* 348 N.C. 130, 500 S.E.2d 54 (1998).

[4] *Leandro v. State,* 346 N.C. 336, 488 S.E.2d 249 (1997).

[5] *Bailey, supra* and *Smith v. State,* 349 N.C. 332, 507 S.E. 2d 28 (1998).

[6] The North Carolina General Assembly first proposed the constitutional provision in 1913 only to have it rejected by the voters in 1914. See Dana Edward Simpson, "Survey of Developments in North Carolina Law and the Fourth Circuit, 1998 .... How *Bailey v. North Carolina* Undermines the Constitutional Prohibition Against the State Contracting Away Its Power of Taxation," 77 *North Carolina Law Review* 2217, 2231, September 1999.

[7] *Raleigh & Gaston Railroad Co. v. Reid,* 80 U.S. (13 Wall.) 269 (1871).

[8] *Worth v. Wilmington & Weldon Railroad,* 89 N.C. 291, 299-300 (1883).

[9] Simpson, note 6 above.

[10] *Davis v. Michigan Department of Treasury,* 489 U.S. 803, 103 L.Ed. 2d 891, 109 S.Ct. 1500 (1989).

[11] The retirees would be taxed at different rates, depending on their adjusted gross income, which is applied evenly to all taxpayers.

[12] Marvin K. Dorman, Jr., State Budget Officer, wrote in a memorandum to Governor James B. Hunt, Jr., dated May 15, 1998, that his office estimated that the refunds and interest for state and local retirees from August 12, 1989 through June 30,

1997 would be $352.7 million. On a recurring basis, he estimated that the reduction to the General Fund revenue would be $45 million a year. With regard to the federal retirees, he estimated the cost in refunds and interest for the same time period would total $702.4 million, with an annual reduction in General Fund revenue of $83.6 million.

[13] Many of the plaintiffs had filed a virtually identical case in 1989, opposing the collection of $19.3 million for the 1989 tax year. The North Carolina Supreme Court held that in that case the plaintiffs had failed to comply with mandatory protest or demand requirements of N.C.G.S. §105-267, which the Court held was the exclusive method for challenging taxes in North Carolina. *Bailey v. North Carolina,* 330 N.C. 227, 412 S.E.2d 295 (1991), *cert. denied,* 504 U.S. 911, 118 L.Ed. 2d 547, 112 S.Ct. 1942 (1992). The plaintiffs took a voluntary dismissal of that case on October 6, 1992 and, after complying with the statutory requirements, refiled the case seeking additional relief for 1990 ($22.07 million) and 1991 ($23.59 million). The trial on the issues began March 13 and ended March 24, 1995.

[14] Plaintiffs' Brief on Appeal to the Supreme Court, No. 53PA96, June 4, 1996, pp. 66 and 140.

[15] Defendants' Brief on Appeal to the Supreme Court, No. 53PA96, April 15, 1996, p. 37.

[16] Defendants' Petition for Discretionary Review, No. 53PA96, February 5, 1996.

[17] All seven justices agreed with the holding that the state acted unconstitutionally by impairing the contracts.

[18] *Bailey,* 348 N.C. at 166, 500 S.E. 2d at 75.

[19] State of N.C. Commission on Constitutional Amendments, Minutes of the Committee on Article V, Revenue and Taxation 33, S. 1884 (1913), cited in Simpson, note 6 above.

[20] *Bailey,* 348 N.C. at 166-167, 500 S.E. 2d at 75. The statute exists to put the state on notice that its taxing efforts are being challenged. The "practical consequence" was the fact that the litigation had been pending in one form or another since 1989 and that, therefore, the state was on notice.

[21] *Bailey,* 348 N.C. at 169, 500 S.E. 2d at 77.

[22] Simpson, note 6 above, p. 2240. The state of Montana faced a lawsuit similar to *Bailey* after the U.S. Supreme Court's decision in *Davis.* In that case, the court concluded that the statute that established the tax exemption on state retirees' pensions did not create a contract because the state constitution prohibited, like North Carolina's constitution, the state from contracting away its power to tax. *Sheehy v. Public Employees Retirement Division,* 864 P.2d 762 (1993).

[23] Simpson, note 6 above, p. 2245.

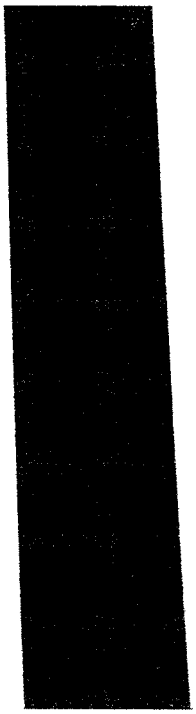
[24] In the end, the total amount due was $1.056 billion. While the case was ongoing, the plaintiffs would continue to pay the taxes under the 1989 law and would continue to protest their payment, says Eugene Boyce, a lead attorney for the retirees. Every three years, a new lawsuit would have to be filed to make certain that the three-year statute of limitations did not bar recovery. The Attorney General's Office took the position that the ultimate result of the cases were of no import because the doctrine of sovereign immunity protected the state from this kind of adverse judgment. In other words, the state argued, that even if a judgment were imposed, the state would never have to pay it. The plaintiffs ultimately agreed to settle for $800,000,000. "In September 1995 [Governor James B.] Hunt wanted it settled...." Boyce says. The clients agreed to $799,000,000, leaving $1 million on the table. Boyce carries a phony $1 million bill in his wallet to this day. The federal retirees agreed to settle for less than their apportioned share, on the theory that the state retirees' pensions were less than theirs. In the end, after interest was earned on the settlement amount, the state and local retirees received almost 100 percent of the amount claimed, he said.

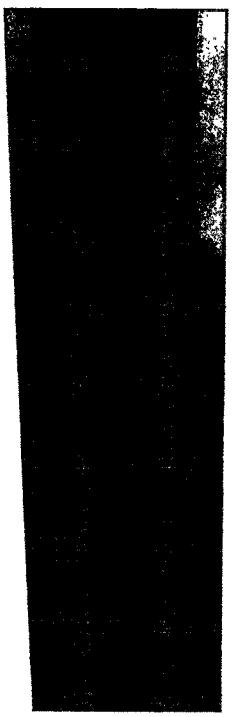
[25] David Rice, "Retirees start to receive refunds," *Winston-Salem Journal,* Winston-Salem, N.C., April 7, 1999, p. B1.

[26] Article 1, Section 8, Clause 3 of the United States Constitution empowers the United States Congress "To regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes."

[27] *Fulton Corp. v. Faulkner,* 516 U.S. 325, 346, 133 L.Ed. 2d 796, 815, 116 S.Ct. 848 (1996).

[28] Eugene Boyce, one of the lawyers for the *Smith*/Shaver plaintiffs, says he contacted Fulton Corp. to see whether his





Karen Tam

clients could join that lawsuit. His request was denied.

[29] *Smith v. State,* 349 N.C. 332, 507 S.E. 2d 28 (1998).

[30] Session Law 1997-318. The legislation also allowed taxpayers for 1990 to receive refunds. This extension was gratuitous. Under the law, there is a three-year statute of limitations for suing over a challenged tax, which had expired for the 1990 taxpayers. About 125 taxpayers had filed a protest in 1990, according to Boyce. As the cases were pending, more and more taxpayers (and their CPAs) knew to file a protest. The numbers of Class A plaintiffs, therefore, increased over time.

[31] Session Law 1997-17.

[32] Ruth Sheehan and Bill Krueger, "Most get tax cuts; few get big savings," *The News & Observer,* Raleigh, N.C., March 19, 1995, p. A1.

[33] The *Bailey* decision was decided May 8, 1998.

[34] Article 1, Section 32: "Exclusive emoluments. No person or set of persons is entitled to exclusive or separate emoluments or privileges from the community but in consideration of public services."

[35] Attorney General Advisory Opinion, "Authority of the General Assembly To Provide Credits or Refunds to Individuals Who Paid Intangibles Taxes But Did Not Comply with N.C.G.S. §105-267; The Exclusive Emoluments Provison *[sic]* of the North Carolina Constitution, Article I, Section 32" April 9, 1997.

[36] *Smith,* note 29 above, 349 N.C. at 340, 507 S.E. 2d at 32.

[37] Justice Willis Whichard joined in Justice Frye's concurring opinion.

[38] Dan Gerlach, N.C. Justice Budget & Tax Center, "Please Dim the Halo," October 2000.

[39] Indeed, in 1996, *The Salisbury Post* wrote an editorial with the headline: "Archie, Come Home." The editorial went on to say "The North Carolina intangibles tax that you hated so much is dead and buried, and all nine members of the U.S. Supreme Court are merrily stomping on its grave." Archie Rufty, a prominent Salisbury lawyer and judge, moved to Nevada in the late 1980s so he wouldn't have to pay the tax. He never returned to Salisbury to live. See Rose Post, "Archie Rufty Jr.—a North Carolinian Through It All," *Salisbury Post,* Salisbury, N.C., March 7, 2002, p. 1A.

[40] Chapter 41 of the 1995 N.C. Session Laws (Senate Bill 8).

[41] Gerlach, note 38 above.

[42] Tim Gray and Joe Neff, "High Court upholds intangibles tax," *The News & Observer,* Raleigh, N.C., December 10, 1994, p. D1.

[43] Jena Heath, "Ruling Expands Refunds," *The News & Observer,* Raleigh, N.C., December 5, 1998, p. A1. Cooper is now the Attorney General of North Carolina.

[44] "A loss of vital revenue," Letter to the Editor, *The News & Observer,* Raleigh, N.C., March 3, 2002, p. A29.

[45] Bob Geary, "Government, Giving it to the rich—till it hurts," *The Independent,* Durham, N.C., April 16, 2003.

[46] Fifty-six percent of the state's budget in 2002–2003 went for education, most of it for primary and secondary schools. The State Department of Public Instruction received $5.9 billion of the $8.36 billion ... Current Operations and Capital Improvements Appropriations Act of 2001, ch. 242, pt. I, 2.1, 2000 N.C. Sess. Laws 1670, 1671-72 (2001).

[47] The other poor school systems were Cumberland, Halifax, Robeson, and Vance counties.

[48] David Rice, "Lead plaintiff in school suit says he's just lucky," *The Winston-Salem Journal,* Winston-Salem, N.C., July 5, 2004, p. A1.

[49] See *Brief for Plaintiff-Appellees* at 3, *Leandro v. State,* 122 N.C. App. 1, 468 S.E. 2d 543 (1996). (No. COA950321), reversed in part, 346 N.C. 336, 488 S.E. 2d 249 (1997).

[50] The school systems were the city of Asheville and the counties of Buncombe, Wake, Forsyth, Mecklenburg, and Durham.

[51] *Leandro* v. State, 112 N.C. App. 1, 468 S.E. 2d 543 (1996).

[52] *Ibid.*

[53] *Ibid.*

[54] Justice Robert Orr dissented on the issue of equality but agreed with the basic holding.

[55] *Leandro v. State,* 346 N.C. 336, 345, 488 S.E. 2d, 254 (1997).

[56] *Ibid.*, 346 N.C. at 347, 488 S.E. 2d at 255.

[57] *Sneed v. Board of Education,* 299 N.C. 609, 264 S.E. 2d 106 (1980), where the Supreme Court, examining the two constitutional provisions, concluded: "It is clear, then, that equal access to participation in our public school system is a fundamental right, guaranteed by our state constitution and protected by considerations of procedural due process." *Id.* at 618, 264 S.E. 2d at 113. *Britt v. N.C. Board of Education,* 86 N.C. App. 282, 289, 357 S.E. 2d 432, 436, *disc. review denied and appeal dismissed,* 320 N.C. 790, 361 S.E. 2d 71 (1987). Britt was the first appellate decision to address the constitutionality of the state's school funding system.

[58] *Board of Education v. Board of Commissioners of Granville County,* 174 N.C. 469, 472, 98 S.E. 1001, 1002 (1917).

[59] *Ibid.*, 174 N.C. at 472, 98 S.E. at 1002.

[60] Tico A. Almeida, "Symposium—School Finance Litigation: Refocusing School Finance Litigation on At-Risk Children: *Leandro v. State of North Carolina,*" 22 *Yale Law & Policy Review* 525, Spring 2004, quoting an interview with Judge Howard Manning in which he said "Early education was an issue that wasn't on the table, so I had them amend their complaints." He wanted pre-kindergarten included in the case because: "I would see every day as a judge all of these kids—most of them black and most of them poor—all selling drugs and all going to jail. And for all of them, highest grade completed in school? Eighth. You see this constant barrage as a judge. I made up my mind that something is not right and you've got to do something early." At page 535, footnote 74.

[61] The Supreme Court rejected plaintiffs' arguments that equal funding was required to meet the educational needs of students. "We are convinced that the equal opportunities clause of Article IX, section 2(1) does not require substantially equal funding or educational advantages in all school districts.... [W]e conclude that provisions of the current state system for funding schools which require or allow counties to help finance their school systems and result in unequal funding among the school districts of the state do not violate constitutional principles." *Leandro* at 346 N.C. at 349, 488 S.E. 2d at 256.

[62] *Hoke County Board of Education et al. v. State of North Carolina,* 95 CVS 1158, Wake County Superior Court.

[63] Scott Bigelow, "*Leandro* case 'not over' Manning tells UNCP audience," University Newswire, University of North Carolina-Pembroke, Pembroke, N.C., June 2, 2003.

[64] For eight years, the state said that no additional funds were needed to meet the *Leandro* requirements. Judge Manning then required the State Board of Education to send an assistance team to Hoke County. They then submitted reports that additional funds were necessary.

[65] Todd Silberman, "Needy schools to get millions," *The News & Observer,* Raleigh, N.C., July 30, 2004, p. B1.

[66] *Hoke County Board of Education v. State,* 599 S.E. 2d 365, 397 (2004).

[67] This coincides with Governor Michael F. Easley's "More at Four" education plan, a plan to provide at risk 4-year-old children preparation for kindergarten.

[68] *Hoke,* note 66 above, 599 S.E. 2d 365, 396.

[69] This determination is reflected in the State Board of Education's proposal to establish the Disadvantaged Students Supplemental Fund, which covers a number of counties.

[70] *Hoke,* note 66 above, 599 S.E. 2d 365, 397.