

# Municipal Debt Instruments- An overview.

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## **Municipal Debt Instruments- An overview**

### **Introduction**

One of the more challenging issues in Texas municipal law is recognizing and making adequate provision for long term direct pecuniary obligations, or debt. The purpose of this presentation is to provide some insight on the nature of debt, the constitutional and legal requirements for incurring and creating debt, the alternatives and exceptions applicable to Texas cities and recent changes that may affect debt created by interlocal contracts.

### **Overview Objectives**

**The purpose of this presentation is to review the outline of Texas municipal debt instruments. This general review will review these general topics.**

1. The history of the concept of debt under Texas municipal law, as outlined in *McNeill v City of Waco*.
2. The constitutional source of debt before and after 1876.
3. The current funds exception to debt.
4. The special funds exception to debt.
5. Lease and contingent fund as debt.
8. The City of Bee Cave Amendment –Chapter 380 obligations as a form of debt.
9. The 2011 Amendments for Interlocal contracts between cities and counties and Chapter 791.

## **Municipal Debt Instruments**

### **Debts under the Constitution of 1876 and as amended.**

Prior to 1876, the Texas Constitution made no express provision for municipal debt. The 1876 Constitution added Article 11, sections 5 and 7, concerning municipal and county debt. For municipalities, the Courts have interpreted a debt instrument to be any form of pecuniary obligations. An insight to the purpose for these provisions was this description of the country and Texas in particular:

At the time the constitution was framed, the history of the country and of the state afforded examples of municipal corporations which had become bankrupt through the reckless and extravagant management of their governing bodies; and its framers doubtless had under consideration the evils which result both to

the tax-payers and the creditors of such corporation from an unlimited power to create debts.

From ... article 11, on municipal corporations, they seem to have kept prominently in view two objects, ... to protect the inhabitants of municipalities against oppressive taxation; the other ... was intended to be attained by the section last named in ... sections 5 and 7 of article 11, which limit the power of creating debts by making it proportionate to the power of taxation.

*City of Terrell v Dissaint*, 9 S.W. 593 (Tex. 1887).

Over time other political subdivisions such as conservation and reclamation districts have separate constitutional debt provisions: water districts and port authorities (Tex. Const. art. 16, Sect. 59 (1917) and Art. 3, section 52 (1904)), School districts (Tex. Const. art. VII, § 3(e)- (1962); Hospital Districts (Texas Const. Article IX, section 4 (1954)).

#### **Article 11, Section 5 and Article 11, Section 7 of the Texas Constitution - Municipal Debt**

Article 11, section 5, was amended in 1912 to permit the adoption of home rule charters, and is now generally known as the Home Rule Amendment. However, it had long provided for municipal debt.

Article 11, Section 5 provides in part:

...Said cities may levy, assess and collect such taxes as may be authorized by law or by their charters; but no tax for any purpose shall ever be lawful for any one year, which shall exceed two and one-half per cent. of the taxable property of such city, **and no debt shall ever be created by any city, unless at the same time provision be made to assess and collect annually a sufficient sum to pay the interest thereon and creating a sinking fund of at least two per cent. thereon, except as provided by Subsection (b). Furthermore, no city charter shall be altered, amended or repealed oftener than every two years.**

And the parallel provision of Article 11, section 7 which provides for two forms of debt obligations by cities and counties:

**(a) All counties and cities bordering on the coast of the Gulf of Mexico are hereby authorized upon a vote of the majority of the qualified voters voting thereon at an election called for such purpose to levy and collect such tax for construction of sea walls, breakwaters, or sanitary purposes, as may now or may hereafter be authorized by law, and may create a debt for such works and issue bonds in evidence thereof. But no debt for any purpose shall ever be**

**incurred in any manner by any city or county unless provision is made, at the time of creating the same, for levying and collecting a sufficient tax to pay the interest thereon and provide at least two per cent (2%) as a sinking fund, except as provided by Subsection (b); and the condemnation of the right of way for the erection of such works shall be fully provided for...**

These two sections of the Texas Constitution establish two forms of municipal debt:

### **Debt and debt for any purpose – differences between Sections 5 and 7.**

Article 11, section 5 refers to “debt” and section 7 refers to “debt for any purpose”. The courts have treated these references to debt, and the tax and sinking fund provisions as equivalent in municipal cases.

Section 5 requires that (1) at the time the obligation is incurred, provision must be made to assess and (2) collect annually a sufficient sum to pay the interest thereon and create a sinking fund of at least two per cent.

The second sentence of section 7 requires that if a county or city creates a debt for any purpose, provision must be made, at the time of creating the debt, for levying and collecting a sufficient tax to pay interest and provide at two per cent as a sinking fund.

The sections do have some significant differences on their face. Specifically, Section 7 applies to both counties and cities and also requires that if the tax is to be levied and collected for the construction of sea walls, breakwaters or sanitary purposes, it must first be approved by a majority of the qualified taxpayers voting in an election. Prior to 1932 it required a two-thirds of *all taxpayers* to authorize debt. Thereafter until 1973, it required a *two-thirds vote of taxpayers voting* to approve bonds for these purposes.

### **The definition of “debt” in *McNeill v. City of Waco*, 33 S.W. 322 (1895).**

In *McNeill*, the facts were that, the City entered into a contract with McNeill in 1888 to build seven underground cisterns for fire protection. Four of the cisterns were completed, tendered to the City together with a request for payment. The City refused to accept the cisterns, refused to make payment for the cisterns and refused to permit the construction of the three remaining cisterns. *McNeill* sued to enforce the contract, including lost profits on the uncompleted cisterns.

In authorizing the contract, the City had not complied with the constitutional debt requirements- no tax had been levied or a sinking fund established. Nor were any of the exceptions to the debt requirement applicable- the obligation was not payable as a current expense or from a fund in the immediate control of the City. Under these facts, the Texas

Supreme Court set forth the outline of Texas law on municipal debt, and held the obligation void.

The first issue the Court dealt with was the definition of debt as used in Article 11, sections 5 and 7. At the outset, the Court held the debt to include all possible obligations for any conceivable purpose.

These provisions in no uncertain language, without excepting any class of cases, imperatively prohibit any city's 'creating' or 'incurring' a 'debt for any purpose,' and 'in any manner,' without at the same time making the required 'provision.' Therefore, the attempted 'creation' or 'incurring' of a 'debt,' for any conceivable purpose, and in any conceivable manner, without making the 'provision,' is contrary to the express prohibition of the constitution, and void; and it is wholly immaterial whether the constaration or 'purpose' of the transaction be properly classed as an item of ordinary or current expense, or otherwise, and whether the 'debt' be evidenced by an ordinary verbal or written contract, a note, or a bond. *Id.* at 324.

The Court having thus established a broad, nearly universal definition for a "debt". The Court also acknowledged that debt has no established, fixed meaning but varies by legal context, often leading to confusion when "debt" is used in different contexts.

Since the inhibition against the 'creation' or 'incurring' of a 'debt,' without the 'provision,' is universal, it is of vital importance to determine the meaning of the word 'debt,' as used in the constitution. The word has no fixed, logical signification, as has the word 'contract,' but is used in different statutes and constitutions in senses varying from a very restricted to a very general one. Its meaning, therefore, in any particular statute or constitution, is to be determined by construction, and decisions upon one statute or constitution often tend to confuse rather than aid in ascertaining its signification in another relating to an entirely different subject. *Id.* at 323.

The Court then focused on why debt needs to be defined as an "unprovided- for" municipal pecuniary liability:

These constitutional provisions were intended as restraints upon the power of municipal corporations to contract that class of pecuniary liabilities not to be satisfied out of the current revenues, or other funds within their control lawfully applicable thereto, and which would therefore, at the date of the contract, be an

unprovided-for liability, and properly included within the general meaning of the word 'debt.' *Id.* at 324.

The Court then defines "debt" as any pecuniary obligation imposed by contract, not otherwise provided for by current revenues or an identifiable fund.

The term "debt" as used in the constitution means any pecuniary obligation imposed by contract, except such as were, at the date of the contract, within the lawful and reasonable contemplation of the parties, to be satisfied out of the current revenues for the year or out of some fund then within the immediate control of the corporation. *Id.* at 324.

### **The Exceptions to the tax and sinking fund rule.**

In addition to its broad definition of debt, the McNeill court also outlined the provisions that must be made for a valid and enforceable pecuniary obligation without the levy of a tax or sinking fund. These provisions focused on the adequacy of the non-tax provisions to satisfy the obligation at the time it is authorized or created.

The *McNeill* Court first noted that if a liability *is provided for, it is by definition, not a debt.* *Id.* at 334. Obligations payable from current revenues or another fund within the immediate control of the city are therefore provided for, and excepted from the formal constitutional requirement for the levy of a tax and establishment of a sinking fund.

They (the Constitutional debt provisions) have no application, however, to that class of pecuniary obligations in good faith intended to be, and lawfully, payable out of either the current revenues for the year of the contract or any other fund within the immediate control of the corporation. Such obligations being provided for at the time of their creation, so that in the due course of the transactions they are to be satisfied by the provisions made, it would be an unreasonable construction of the constitution to hold them debts, within its meaning, so as to require the levy of a wholly unnecessary tax upon the citizen. Thus, a warrant drawn against the current revenues of the year for one of the ordinary expenses of the corporation for such year, when all the claims for ordinary expenses for that year do not exceed such revenues, or a contract entered into for the making of any public improvement authorized by law, e. g. the building of a courthouse or jail, and obligating the corporation to pay therefor, there being funds within its immediate control lawfully applicable thereto sufficient, and in good faith contemplated by the contracting parties to be used in payment thereof when due, are not debts, within the meaning of such

constitutional provisions requiring the making of provision for the interest and sinking fund. *Id.* at 324.

### **The Current Revenue Exception**

The *McNeill* exception definition was based on earlier Texas debt cases that focused on the meaning and purpose for Article 11, Sections 5 and 7. The *McNeill* Court noted two earlier cases to illustrate the operation of the current revenue exception.

In ***City of Corpus Christi v. Woessner***, 58 Tex. 465 (Tex. 1883) the court held that no debt had been created because at the time the obligation was created there were sufficient current revenues to pay the warrants then issued to pay current city expenses.

In ***City of Terrell v. Dessaint***, 71 Tex. 770, 9 S. W. 593 (Tex. 1888) the obligation for current year expenses was payable not from current revenues but future revenues in the next succeeding year. No tax had been levied, nor was there a sinking fund. The Court held that this was not an adequate provision for payment from current funds. The obligation payable from future city revenues, beyond the current year, was therefore a debt prohibited by Article 11, Sections 5 and 7, *Id.* at 595.

In ***City of Fort Worth v Bobbitt***, an adopted Commission of Appeals opinion, the court restated the Current Funds rule as follows: “that a debt created by a city, in order to be valid without compliance with the constitutional requirements to which we have referred, must run concurrently with the current revenues” 41 S.W.2d 228, 232 (Tex. 1931).

### **The Right to Terminate and Current Revenues –Lease cases**

A pair of more recent cases focused on the current revenues rule and the making of adequate provision for lease obligation. In ***City-County Solid Waste Control Bd. v. Capital City Leasing, Inc.*** 813 S.W.2d 705 (Tex. App. – Austin 1991, writ denied) the Court invalidated a lease as prohibited debt because of the nature of the pecuniary obligation. The facts were that a joint city-county landfill board sought to terminate an earth moving equipment lease-purchase agreement.

The lease provided that the Board's “right, title and interest in and obligations under [the lease]” would terminate if the Board were unable to “obtain proper appropriation or approval of the full amount of funds necessary to make [the lease] payments.” This provision required the Board to give Capital City thirty days' notice. The lease also required the Board, “to the extent permitted by State law,” to include in its budget for each of the four years of the lease “a sufficient amount to permit [the Board] to discharge all of its obligations” under the lease. *Id.*

The Board sold the landfill in May 1987 to a private operator, terminated the lease and at the same time remitted lease payments through July 17, 1987. The Board conceded that the proceeds from the sale of the landfill to the private operator were more than sufficient to pay all of the lease payments that it would have owed had it leased the equipment for three more years.

The court noted that “[a] contract which runs for more than one year is a commitment only of current revenues, and so is not a “debt,” *if it reserves to the governing body the right to terminate at the end of each budget period.* See 1979 Tex.Gen.Laws, ch. 749, § 4(b), at 1841 [Tex.Rev.Civ.Stat. Ann. art. 2368–2 §§ 3–4, since codified at Tex. Local Gov't Code Ann. § 271.005(b) (1988) ]. *City-County Solid Waste Control Bd.*, 813 S.W.2d at 707.

However, holding that the lease was void, the Court found that the term of the lease anticipated being more than a year.

In this case, the “anticipated” term specified in the lease exceeds one fiscal year, and so the lease is a “debt” within the meaning of sections 5 and 7, unless it reserves to the Board the right to terminate at the end of each year. The lease contains a termination provision, *but that provision is not sufficient to save the lease from unconstitutionality. While the lease gives the Board the right to terminate at the end of each budget period, the Board can exercise that right only if it has not obtained an appropriation for the lease payments. By requiring the Board to pursue funding before it can terminate, the lease creates a pecuniary obligation, the exact evil sections 5 and 7 were designed to prevent. The lease it, therefore, void. Id.*

In ***City of Bonham v. Southwest Sanitation***, 871 S.W.2d 765 (Tex. App. – Texarkana, 1994) the court struck down a two year waste disposal service contract. The contract had no annual right of cancellation and the waste company claimed the City Council had authorized additional compensation, a pecuniary obligation for which the City had not made any provision.

Of significance, the court noted the effect of the service company’s election of remedies to seek only a recovery based on the express contract.

If the City had in fact agreed to pay (the additional fee), but the required formalities of the agreement were not shown, and if the agreement would in other respects have been legal, Southwest might have been able to enforce an implied contract or recover in quantum meruit if the City had accepted its services and the benefits of such an arrangement. ***Sluder v. City of San Antonio***, 2 S.W.2d 841 (Tex. Comm'n App. 1928, judgment adopted); ***Panhandle Constr. Co.***



*v. City of Spearman*, 89 S.W.2d 1053 (Tex.Civ.App. — Amarillo 1935, no writ). Because the service company did not seek to recover on an implied contract or in quantum meruit, but sued only on an express contract. It cannot now claim an implied contract or quantum meruit. *B.L. Nelson & Associates v. City of Argyle*, 535 S.W.2d 906, 910 (Tex.Civ.App.—Fort Worth 1976, writ ref'd n.r.e.). *City of Bonham*, 871 S.W.2d. at 768.

The court held the service agreement to be a debt prohibited by Article 11, Section 5 and denied any recovery to the plaintiff.

### **Section 271.093, Local Government Code**

In 1993, the Legislature enacted Section 271.093 of the Local Government Code which provides:

(a) If a contract for the acquisition, including lease, of real or personal property retains to the governing body of a local government the continuing right to terminate at the expiration of each budget period of the local government during the term of the contract, is conditioned on a best efforts attempt by the governing body to obtain and appropriate funds for payment of the contract, or contains both the continuing right to terminate and the best efforts conditions, ***the contract is a commitment of the local government's current revenues only.***

(b) In this section, "local government" means a municipality, county, school district, special purpose district or authority, or other political subdivision of this state.

This codification restated and added the common law current funds rule into the Local Government Code.

### **The Special Funds exception**

A second exception to the debt requirement is that adequate provision has been made in the form of a special fund within immediate control, lawfully applicable to the obligation, sufficient and in good faith contemplated by the parties to be used for the purpose of satisfying the obligation.

### **Revenue Bonds not payable from ad valorem taxes**

A case illustrating this broad category of special funds, that make adequate provision for a pecuniary obligation, is *City of Dayton v. Allred*, 68 S.W.2d 172, (Tex. 1934). In this original mandamus proceeding before the Texas Supreme Court, the City sought to compel the

Attorney General to approve the issuance of City of Dayton sewer revenue bonds. The Attorney General's refusal on a number of grounds including his objection that the bonds were a debt prohibited by Article 11, Sections 5 and 7 and therefore unlawful. In response the Texas Supreme Court held that the bonds were not a debt.

The contention that these bonds violate the above constitutional provisions is based on the theory that a debt against the city running for a number of years is created with no tax levy provided to pay the same. We think this objection should be overruled. These bonds are secured only by the proposed sewer system and its franchise, and the fund to be derived from the revenues from such system, and the revenues of the water system. The ordinance and the proposed bonds expressly provide that such bonds shall never be a claim against the tax funds of the city. Also the statutes authorizing such bonds make the same express provision. In other words, the holder of these bonds merely has a claim against the sewer system, its franchise, and the revenues of such system, and the water system. *He can never have any claim against tax funds. It is settled that such an obligation does not come within the term "debt" as used in the above-quoted constitutional provision.* **City of Fort Worth v. Bobbitt**, 121 Tex. 14, 36 S.W.2d 470, 473, 41 S.W.2d 228 (1931) (Obligation of City to make up any deficiency in assessment from any source is a prohibited debt); **City of Laredo v. Frishmuth**, 196 S.W. 190 (Tex. Civ. App. – San Antonio 1917, writ dismissed) (Obligation payable from a tax levy and designated fund from sales of land grant property); **McNeal v. City of Waco**, 89 Tex. 83, 33 S.W. 322 (1895); **Sowell v. Griffith** 294 S.W. 521 (Tex. Com. App., 1927) ( obligation payable solely from net water revenues, never from taxation). At this point we again refer to the fact that the statutes under which these Public policy demands that definite limitations be placed on the power of the several political subdivisions of our government to spend public money. As to counties, the limitation is to pay cash, that is, to pay out of current revenues or from funds within the immediate control of the county. Debt, with a provision at the time it is incurred to pay interest and at least two per cent of the principal each year, is the only alternative. If this provision is not made, the "debt" is a nullity. This is the requirement of Art. 11, § 7, supra. Its language is unequivocal. It voices the public policy demand so clearly that no arm or agency of government should attempt to deny it bonds are proposed to be issued completely guard against them ever becoming obligations against the tax funds of the city. *Citing Article 1114, Vernon's Annotated Civ. St., supra.*

See also; *City of Waco v. McCraw*, 93 S.W.2d 717 (Tex. 1936) (stadium bonds); *City of Houston v. Allred*, 123 Tex. 334, 71 S.W.2d 251 (1934); *Lower Colorado River Authority v. McCraw*, 83 S.W.2d 629 (Tex. 1935).

### **Contingent Provision for a pecuniary obligation**

**The debt and indemnity cases- Texas and New Orleans Railroad v. Galveston County, 169 S.W. 2d 714, (Tex. 1943), and Brown v. Jefferson County 406 S.W 2d 185 (Tex. 1966).**

A contractual promise of indemnity can involve a pecuniary obligation of an uncertain nature and unknown amount. The Texas Courts have established the outline what provisions must be made to meet the constitutional test for potentially uncertain future liability inherent in the obligation to indemnify.

In 1908 Galveston County and certain railroads entered into a contract for the construction of a causeway and draw-bridge over Galveston Bay between Galveston Island and the mainland. The railroads operated the draw-bridge and the contract provided that

**...neither the railway companies nor the interurban company shall be liable for any injury to person or damage to property which shall occur in connection with the use or attempted use of the drawbridge, or in the draw space, when the draw-bridge may be open, when the person injured or the property damaged shall be in the course of travel or transportation over the county road, and the county will indemnify and save harmless each of the other parties hereto from any such liability. *Texas and New Orleans R.R.*, 169 S.W.2d at 714.**

In 1936, two men were killed and a third injured when a car fell into Galveston Bay over a raised drawbridge. Suit was filed claiming negligence in the operation of the bridge and the county refused to indemnify the railroads. The railroads sued to enforce the indemnification provision and the Commission of Appeals held that the indemnification provision was a debt prohibited by Article 11, Section 7 of the Texas Constitution.

Public policy demands that definite limitations be placed on the power of the several political subdivisions of our government to spend public money. As to counties, the limitation is to pay cash, that is, to pay out of current revenues or from funds within the immediate control of the county. Debt, with a provision at the time it is incurred to pay interest and at least two per cent of the principal each year, is the only alternative. If this provision is not made, the "debt" is a nullity. This is the requirement of Art. 11, § 7, *supra*. Its language is unequivocal.

It voices the public policy demand so clearly that no arm or agency of government should attempt to deny it.

The Supreme Court has said that the word debt, as used in the Constitution, means any pecuniary obligation imposed by contract, except such as was, at the time of the agreement, within the lawful and reasonable contemplation of the parties, to be satisfied out of the current revenues for the year or out of some fund then within the immediate control of the county. In other words, if the obligation does not arise as an item of ordinary expenditure in the daily functioning of the county government or if it is not to be paid out of funds then in the county treasury legally applicable thereto, it is a debt and falls under the condemnation of the Constitution, unless the required provision for its payment is made at the time the obligation is incurred. *Citing McNeal v. City of Waco, 89 Tex. 83, 33 S.W. 322 (1895); Stevenson v. Blake, 131 Tex. 103, 113 S.W.2d 525 (Tex. 1935).*

The Court then focused on the unknown and potentially large nature of the county's indemnity obligation under the contract.

Manifestly, the parties making the contract could not then determine either when the county would become obligated under the clause in controversy or the extent of any such obligation. So far as they could foresee, it might accrue in a few days or not until after the lapse of centuries; it might amount to a few dollars or to many thousands. Although the obligation did not come for 28 years and amounted to only \$5,302.59, a sum which may well have been within the ability of Galveston County to pay out of current revenues for the year 1936 or from some fund then within the immediate control of the county, certainly nobody would seriously affirm that such fact was reasonably within the contemplation of the parties when they made the contract. They simply could not know when the operators of the drawbridge would become negligent or how many travelers on the causeway would suffer therefrom or what the financial condition of the county would then be. Therefore, the parties could not contemplate, from any reasonable standpoint, that the indemnity clause would not some time fix a debt on the county in violation of the Constitution. In this connection, another provision of the contract is significant. It is that any amount which may become due by one party to any other party shall bear interest at 6 per cent per annum until paid, if not paid within sixty days after written demand therefor. This clearly includes any demand that might arise against the county under the indemnity clause. In language as plain as can be used, it says that any

such indemnity demand, unsatisfied for sixty days, shall become an interest-bearing debt, yet there is not even a suggestion of any provision to pay the accrued interest and two per cent of the principal each year.

Thus, by the terms of the indemnity clause, there was attempted to be created for Galveston County for more than thirty generations a continuing hazard that its taxpayers might be confronted with an obligation growing out of the negligent operation of the drawbridge which they could not pay out of current funds or out of funds then within their immediate control. We think the indefiniteness of the clause as to what obligation may arise thereunder renders it more vicious, from the standpoint of public policy, than if it had named a sum of money to be paid at a given time but clearly beyond the power of the county to pay out of available funds. Surely the size of an obligation is a controlling factor to be considered in measuring ability to pay. ...We hold the clause under consideration is void because it violates Art. XI, § 7, of the Constitution of Texas. *Texas and New Orleans R.R.*, 169 S.W.2d at 716.

In ***Brown v Jefferson County***, 406 S.W.2d 185 (Tex. 1966), the Texas Supreme Court considered the appeal of a consolidated declaratory judgment action and bond validation suit that again included a governmental indemnity promise. The matter in dispute was a promise by Jefferson County to save and hold harmless the United States in connection with Jefferson County's sponsorship of the construction of the Sabine –Neches bridge, a project that was principally funded by the federal government

The Supreme Court affirmed the Court of Civil Appeals opinion that the indemnity or “save and hold harmless” agreement was a valid and binding obligation, on the basis that the county had made provision for the obligation through the levy of a tax and establishment of a sinking fund. In its order approving the bridge, the Jefferson County Commissioners Court had provided as follows:

During each year while there is any liability by reason of the agreement contained in this subsection of this resolution, including the calendar year 1965, the Commissioners' Court of said County shall compute and ascertain the rate and amount of ad valorem tax, based on the latest approved tax rolls of said County, with full allowances being made for tax delinquencies and costs of tax collection, which will be sufficient to raise and produce the money required to pay any sums which may be or become due during any such year, in no instance to be less than two (2%) per cent of such obligation, together with all interest thereon, because of the obligation herein assumed. Said rate and amount of ad valorem tax is hereby ordered to be levied and is hereby levied against all

taxable property in said County for each year while any liability exists by reason of the obligation undertaken by this subsection of this resolution, and said ad valorem tax shall be assessed and collected each such year until all of the obligations herein incurred shall have been discharged and all liability hereunder discharged. *All Persons Interested in or Affected by Issuance of Securities, etc. v. Jefferson County*, 397 S.W.2d 241, 247 (Tex.Civ.App. – Beaumont 1965, writ granted).

The Supreme Court distinguished the Galveston county case based upon its essential holding:

The Galveston case is to be restricted to its essential holdings, namely, that an indemnity agreement is a 'debt' within the constitutional sense, and that, as a corollary thereto, ***provision must be made for the payment of any interest that may accrue thereon and for the retirement of the obligation. This was done in the Jefferson County resolution.*** Brown, 406 S.W.2d at 188.

The Supreme Court then placed the Galveston County in context:

The (Galveston County) opinion should not, however, be construed as condemning any and all indemnity contracts which a county might enter into in carrying out its legitimate functions. In this case, it appears that under the agreement between Jefferson County and the United States government, the County is to assume all obligations of ownership, operation and maintenance of the completed replacement bridge. This is a legitimate county function. The federal government under the Act of Congress is to pay three-fourths of the cost of the bridge, but in accordance with established federal policy evidenced by House Document No. 553, the sponsoring local interest (Jefferson County) is required to 'hold and save the United States free from damage that may result from construction of the project.' This 'hold and save' clause is common to innumerable agreements between local sponsoring interests and the federal government relating to improvements of rivers and harbors and we see no valid legal objection to a county's executing such an agreement with the federal authorities as a sponsoring local interest. The bridge when completed will be part of the county's road system and under its control. The concept of an uncertain indemnity liability as a 'debt' under the usual meaning of the term is somewhat unrealistic. *Id.*

As to uncertain future contingencies, the Court pointed out that it would consider those issues if and when they arose:

Some liability in the future may arise from the construction of the bridge. Likewise, some liability may arise from the operation of the bridge after it has been turned over to county control. A presently unforeseen occurrence of the future may require extensive repairs to the bridge and the necessary expenditures therefor might exceed the available funds for current expenses during a particular year and thus require a funding of the sum necessary to repair the structure and the voting of a bond issue. The question of whether such funding or the funding of an obligation to indemnify for damages from the construction of the bridge, exceeds the permissible tax rate may arise in the future, but it is not presently before us. *Id.*

Finally, on the question of whether a specific tax has to be levied at the time the obligation is incurred, the court held that the promise to levy a sufficient future tax to pay the pecuniary obligation if and when it arose met the requirement of Section 7:

Article 11, § 7 of the Texas Constitution does not require that a definite tax rate be set for each year the 'debt' is to be outstanding. Tax rates vary with assessed valuations, governmental needs and the like and are set on a year to year basis. All the constitutional provision requires is that a 'sufficient' tax be levied. ***Bassett v. City of El Paso***, 88 Tex. 168, 30 S.W. 893, 895 (1895); ***Mitchell County v. City National Bank***, 91 Tex. 361, 43 S.W. 880 (1898); ***City of Aransas Pass v. Keeling***, 112 Tex. 339, 247 S.W. 818 (1923). Until some liability ascertainable in amount arises, no money would need be collected from the county's tax resources. In fact, as indicated in ***Arroyo Colorado Navigation District v. Kipp***, 261 S.W.2d 189 (Tex.Civ.App. 1953, no writ. hist.), no presently payable obligation can arise against a county or other local sponsoring interest under a 'hold and save' clause which is a provision for indemnity, until liability against the United States has first been fixed and established" *Id.* at 189.

**Municipal Administrative Services v City of Beaumont, 969 S.W.2d 31 (Tex. App. – Texarkana 1998, no pet.).**

Another contingent liability case is *Municipal Administrative Services v City of Beaumont* case. The City had contracted with an audit firm to review their telephone franchise gross receipt payments under their city franchise. The City refused to pay the amount claimed by the company and the trial court entered a judgment n.o.v. for the City. The contract provided that the audit firm would be paid one half of any money that would be recovered as the result of their audit of the franchisee's payment records. The City took the position that such a contingent payment contract was an invalid debt under Sections 5 and 7 of Article 11 of the Texas Constitution. In response the Court said

A 'debt' for the purposes of the above sections, means any pecuniary obligation imposed by contract. A contract does not create a debt if the parties lawfully and reasonably contemplate that the obligation will be satisfied out of current revenues or out of some fund then within the immediate control of the governing body. A contract that creates a future pecuniary obligation which depends on the contingency of future events is still a debt.

(The Auditor) argues that the constitutional provisions cited do not require a sinking fund unless and until a debt has actually been incurred. No unconstitutional "debt" ever arises under (it's) pure contingency fee contract, it claims, because until amounts are received as a result of (it's) audit findings no money is due and because collection from (the Franchisee) creates the fund out of which the (auditor) is to be paid. We agree....Because no debt was created unless and until the City actually collected from (the Franchisee), and because such collection would result in the creation of funds out of which (the auditor) would be paid, the contingency fee contract does not violate Sections 5 and 7 of Article XI." *Id.* at 37.

#### **Debt under other provisions of the Constitution**

The *Save our Springs v. City of Bee Cave* litigation resulted in an amendment to Section 52-a of Article 3 of the Texas Constitution to provide that economic development agreements were not a debt under the Texas Constitution. This 2005 Amendment resolved the question of whether a City Chapter 380 agreement for the rebate of certain sales taxes by the City in connection with a real estate development was an unconstitutional debt. By way of background, an economic development amendment to the Texas Constitution, Article 3, Section 52-a, was approved in 1987 and authorized certain economic development programs for Texas political subdivisions, including cities, originally provided:

Sec. 52-a. LOAN OR GRANT OF PUBLIC MONEY FOR ECONOMIC DEVELOPMENT. Notwithstanding any other provision of this constitution, the legislature may provide for the creation of programs and the making of loans and grants of public money, other than money otherwise dedicated by this constitution to use for a different purpose, for the public purposes of development and diversification of the economy of the state, the elimination of unemployment or underemployment in the state, the stimulation of agricultural innovation, the fostering of the growth of enterprises based on agriculture, or the development or expansion of transportation or commerce in the state. Any bonds or other obligations of a county, municipality, or other political subdivision of the state that are issued for the purpose of making loans or grants in connection with a



program authorized by the legislature under this section and that are payable from ad valorem taxes must be approved by a vote of the majority of the registered voters of the county, municipality, or political subdivision voting on the issue. An enabling law enacted by the legislature in anticipation of the adoption of this amendment is not void because of its anticipatory character.

In the *Bee Cave* litigation, the District Court had held that the Chapter 380 agreement, enacted as a program under the authority of Article 3, section 52-a was an unconstitutional debt. The Court had arrived at this conclusion despite the fact that the obligation was contingent on and payable from future sales tax revenues, as well as a “subject to appropriations” under Section 271.093 which provides that such agreements are a commitment of only the current funds of the city. In 2005, Article 3, section 52-a was amended to provide that loans or grants not payable from ad valorem taxes were not a debt. The 2005 Amendment provided as follows:

**A program created or a loan or grant made as provided by this section that is not secured by a pledge of ad valorem taxes or financed by the issuance of any bonds or other obligations payable from ad valorem taxes of the political subdivision does not constitute or create a debt for the purpose of any provision of this constitution**

The result of the *Bee Cave* litigation was that it was deemed necessary to amend Article 11, Sections 5 and 7 indirectly by this 2005 amendment to Article 3, section 52-a, by creating an exception to what is a “debt” under Texas law.

### **Municipal Obligations under Article 8, section 1-g of the Texas Constitution-Tax Increment financing.**

In 1981, the Texas Constitution was amended to add Section 1-g to Article 8 to authorize the Legislature to establish tax abatement and tax increment programs. With this amendment, cities and towns could be granted the authority to issue bonds and notes secured by a pledge of ad valorem taxes of the city and other taxing entities from properties in certain designated redevelopment areas.

**Sec. 1-g. DEVELOPMENT OR REDEVELOPMENT OF PROPERTY; AD VALOREM TAX RELIEF AND ISSUANCE OF BONDS AND NOTES. (a) The legislature by general law may authorize cities, towns, and other taxing units to grant exemptions or other relief from ad valorem taxes on property located in a reinvestment zone for the purpose of encouraging development or redevelopment and improvement of the property.(b) The legislature by general law may authorize an incorporated city or town to issue bonds or notes**

**to finance the development or redevelopment of an unproductive, underdeveloped, or blighted area within the city or town and to pledge for repayment of those bonds or notes increases in ad valorem tax revenues imposed on property in the area by the city or town and other political subdivisions. (Added Nov. 3, 1981).**

The Legislature authorized the establishment of these areas and the issuance of these obligations by Chapter 311 of the Tax Code.

### **The 2011 Amendment: pecuniary obligations created by City and County Interlocal Agreement.**

In December 2010, the Texas Senate Committee on Intergovernmental Affairs reported to the 82d Legislature on a number of issues, including a review local government consolidation of services and functions. The Committee concluded that formal, statutory consolidation had not occurred for a number of reasons, and that “functional consolidation” of government functions and services by interlocal contract was the recommended approach. *Pages 135-6 Senate Committee on Intergovernmental Relations-Interim Report to the 82nd Legislature* <http://www.senate.state.tx.us/75r/senate/commit/c520/c520.InterimReport81.pdf>.

The Report focused on issues faced by cities and other local governments in the use of Interlocal contracts for functional consolidation. These issues included the restrictions of Chapter 791, the Interlocal Cooperation Act, and the debt provisions of Article 11 of the Texas Constitution. The Issues were summarized in the Report as follows:

#### ***Issues***

**Specific provisions found in Chapter 791, Government Code and Article 11, Section 7, Texas Constitution have limited the ability of local governments to enter into agreements to jointly provide governmental services.** While the Texas Legislature has encouraged municipalities and counties to jointly provide services through adoption of the Interlocal Cooperation Act, specific provisions found in this statute have limited its use by local governments. **This is because Section 791.011(f), Government Code contains a requirement that contracts must be "renewed annually," causing consternation for many local governments that one party of the contract may back out of agreement after one-year, causing the other entity to have to solely fund the project.** Numerous local governments do not want to take any of the risks associated with short-term contracts, particularly when the construction of infrastructure of facilities is needed to jointly administer the government service or program. As a result,

many cities and counties only use this statute to provide for the financing of short-term projects and do not use it to undertake long-term projects, such as jointly constructing infrastructure and other facilities

**If a contract is executed under these limitations, it would not violate the constitutional provision found in Article 11, Section 7, but to the extent a local government enters into a contract and does not contemplate paying any financial obligations associated with the contract within the same fiscal year, this is considered to be "debt" for the purposes of the constitutional limitation. The common interpretation of these provisions is a limitation on the amount of debt a local government can assume, even if contracting with another local government for the provision of services.**

**While the need and desire to consolidate services and programs has been expressed by numerous cities and counties in Texas, existing statutory and constitutional provisions have impeded the ability of these local governments to jointly administer programs. Many of these provisions, identified as a result of interim deliberations, limit the ability of local governments to consolidate services and programs because they either limit the term of the contract to a short amount of time or limit the amount of debt a city or county can assume in order to fund the costs of projects. *Senate Committee on Intergovernmental Affairs, Interim Report to the 82d Legislature, page 87***

The Committee Report then recommended that because "...existing constitutional and statutory limitations impede the ability of local government to achieve cost savings and reduce the duplication of services through consolidation" Accordingly these changes were recommended:

- (1) Clarify that debt resulting from contracts entered into under, which is not a result of pledged bonds or other similar obligations, would not require a sinking fund and a tax levy;
- (2) Change Chapter 791 to clarify that a local government can enter into contracts with one or more local governments for a term longer than one year. *Senate Committee on Intergovernmental Affairs, Interim Report to the 82d Legislature, page 89*

In 2011, Chapter 791, the Texas Government Code was amended to provide that an Interlocal contract may have "a specified term of years." Section 791.011(d)(i), Government Code. Significantly, both Article 11, sections 5 and 7 were amended:

Section 5 was amended by adding paragraph b that provides:

**(b) To increase efficiency and effectiveness to the greatest extent possible, the legislature may by general law authorize cities to enter into interlocal contracts with other cities or counties without meeting the assessment and sinking fund requirements under Subsection (a).**

And Section 7 was amended by adding a nearly identical paragraph b that provides:

**(b) To increase efficiency and effectiveness to the greatest extent possible, the legislature may by general law authorize cities or counties to enter into interlocal contracts with other cities or counties without meeting the tax and sinking fund requirements under Subsection (a).**

Accordingly, a new form of debt was created under the Texas Constitution for which there is no requirement for the levy of tax for three general forms of Interlocal contract- a “city-city” contract, a “city-county” contract or a “county-county” contract, or any combination of these interlocal contracts.

The amendment thereby facilitates the consolidation of city and county functions and services by permitting multi-year Interlocal agreements by and between Texas cities and counties. It should be noted however that municipalities that enter into Interlocal agreements that include local governments other than a city or county, will still need to make provision for any pecuniary obligation created by the agreement in order to comply with Sections 5 and 7 of Article 11. The tax and sinking fund requirement was only eliminated for the category of city and county Interlocal contracts.

#### **Pecuniary obligations of entities on behalf of a city.**

In addition to direct municipal pecuniary obligations, another alternative is to create to create an entity to act on behalf of the city. An example is a Local Government Corporation under Subchapter D of Chapter 431 of the Transportation Code to “to aid and act on behalf of one or more local governments to accomplish any governmental purpose of those local governments.” Section 431. 101, Transportation Code. Another alternative is to establish an administrative agency by interlocal contract under the authority of Section 791.013, Government Code, to perform and provide governmental services and functions on behalf of the contracting parties.

#### **Conclusion:**

The recent history of municipal debt reveals how Texas has dealt with one of the more challenging issues in Texas municipal law. The purpose of this presentation has been to provide some insight on the nature of debt, the constitutional and legal requirements for incurring and

creating debt, the alternatives and exceptions applicable to Texas cities and recent changes that affect debt and other pecuniary obligations.