

# Municipal Debt Instruments

## An Overview

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## Review Objectives

- The history of Debt under Texas law.
- Constitutional Sources for Debt from 1876.
- The Current Funds Exception.
- The Special Funds Exception.
- Lease and contingent funding of debt.
- The Bee Cave litigation amendment.
- The 2011 amendment for interlocal contracts.

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## Debts under the 1876 Constitution

- Prior to 1876, no express provision for debt.
- 1876 Constitution adds Sections 5 and 7 of Article 11 to the Texas Constitution.
- Both sections generally require that provision be made to levy and collect a tax and to establish a sinking fund of at least two per cent to repay the principal amount of the obligation.

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### Article 11, Section 5



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.

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## Article 11, Section 7 – part one

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.

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## Article 11, Section 7 –part two

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.

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## "Debt" and "Debt for any purpose."

- Debt and debt for any purpose have been read to be identical. Debt has been construed to mean any pecuniary obligations, which is indistinguishable from a debt for any purpose.



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## The Seawall Provision

- The first part of section 7 relates only to counties and cities bordering on the Gulf of Mexico and authorizes debt and bonds for "seawall, breakwater and sanitary purposes.'
- First required 2/3ds vote of all taxpayers, then reduced to 2/3ds of all taxpayers voting in an election and then in 1973 changed to the present majority vote of qualified voters.

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## McNeill v City of Waco- Debt defined by the Texas Supreme court.

- 1888 -the City and McNeill contract for the construction of seven cisterns for fire protection. No tax levied, no sinking fund and no other provision was made for the obligation.
- Four cisterns built, but no acceptance and payment refused by the City.
- McNeill sues under contract for completed construction and the lost profits on the 3 unconstructed cisterns.



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## Debt Broadly Defined- McNeill

- 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.***

33 S.W. at 324

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## Debt can be in any Form- Written or Verbal

"(I)t is wholly immaterial whether the ... '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."

33 S.W at 324.

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## The Public Purpose for the Debt Provision Requirement

- 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.'***

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## Debt as defined in McNeill v. City of Waco

"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." 33 S.W. at 324

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## Exceptions to the Tax and Sinking Fund Rule

- McNeill not only established the definition of Debt, it also outlined some exceptions to the requirement that a tax be levied and sinking fund established.
  
- These exceptions are
  - Current funds for the year.
  - Special funds within immediate control of the City

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## The Exceptions-Mc Neil

- 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.
- 33 S.W. at 324

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## The McNeill Exceptions Rule

Examples:

- 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.
- a **contract** entered into for the making of any public improvement 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.

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## Current Revenues Exception

- McNeill relied on two earlier cases on current revenues.
  - 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.

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## Current Revenues Defined

- McNeil also relied on :
  - *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. This was not an adequate provision for payment from current funds. The obligation was payable from future city revenues, beyond the current year, was therefore a debt . 9 S.W. at 595.

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## City of Fort Worth v. Bobbitt-Concurrency

- Restates the Current Revenue Rule
- “... 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. Comm. App, Opinion adopted. 1931)

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## The Right to Terminate and Current Revenues- the Lease Cases.

- *City-County Solid Waste Control Bd. v. Capital City Leasing, Inc., 813 S.W. 2d. 705 Ct.App-Austin*
- **The equipment lease is held to be a prohibited debt because of the nature of the pecuniary obligation established by the lease.**

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## The City-County lease problem

- 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."
- 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.

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## The general lease rule

- 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.

813 S.W.2d at 707

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## Term longer than a year for obligation.

- In City-County, the “anticipated” term specified in the lease exceeds one fiscal year, and so the lease is a “debt” ..., unless it reserves to the Board the right to terminate at the end of each year.
- The termination 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 is, therefore, void.” 813 S.W.2d. 707

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## 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.
- The waste company claimed the City Council had authorized additional compensation to pay the pecuniary obligation for which the City had not otherwise not made any provision.



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## Southwest Sanitation and Time

- "Southwest contended that the City could have and should have increased the fee ...d and (that)then it would have had sufficient revenues to pay its alleged contract. Such an action, however, would not have satisfied the constitutional requirement *unless it was lawfully in force and dedicated at the time the alleged contract with Southwest was negotiated.*" 871 S.W.2d 769

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## Remedies for unlawful debt.

- The court noted "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.* (citing) *Sluder v. City of San Antonio*, 2 S.W.2d 841 (Tex. Comm'n App. 1928, judgm't adopted.

871 S.W.2d. at 768

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## Section 271.093, Local Government Code

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.*

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## Special Funds Exception

- This general exception to the tax and sinking fund rule, is that if 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, no prohibited debt is created.
  - McNeill v. City of Waco, 89 S.W. at 324

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## City of Dayton v. Allred

- 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 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. Citing City of Fort Worth v Bobbitt, 41 S.W 2d. 473.

83 S.W. 2d 629 (Tex 1935)

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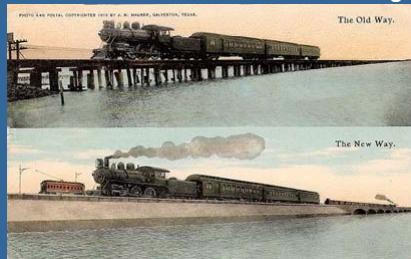
## Contingent Provisions for Pecuniary Obligations

- The debt and indemnity cases- *Texas and New Orleans Railroad v Galveston County*, 169 S.W. 2d 714, Tex Comm. App. (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.

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## Galveston County Indemnity

- A 999 year contract for construction of a cause way and draw bridge with railroads in 1908.
- Railroads operated the draw bridge, and the County agreed to indemnify the railroads.
- 1936 accident kills two and injures another



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## The indemnity



"...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."

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## The Texas Supreme Court speaks

- 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. 169 SW 2d 716

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## Brown v. Jefferson County

- A declaratory judgment action and bond validation suit for the local portion of the Sabine-Neches Waterway Project.
- The “hold harmless” provision was part of a local project commitment to the United States for the construction of a bridge.
- The Commissioners Court had levied a tax and established a sinking fund at the time it approved of the agreement and issued its bonds for its share of the bridge cost.

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## Galveston Distinguished by Supreme Court

- "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." 406 S.W.2d at 188

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## Indemnity Public Policy

- "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." 406 S.W.2d. 188

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## Brown and Future Taxes



- 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. " 406 S.W.2d at 188

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## Municipal Administrative Services v. City of Beaumont

- The City had contracted with an audit firm to review their telephone franchise gross receipt payments under their city franchise.
- 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 an contingent payment contract was an invalid debt under Sections 5 and 7 of Article 11 of the Texas Constitution. 969 S.W2d 31

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## Contingency Fee

- 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." 969 S.W.2d 31, 37

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## Debt under other provisions of the Constitution

- The Save our Springs v. Bee Caves Case and an amendment of the Texas Constitution.
- In the Bee Cave litigation, the District Court had held that the Chapter 380 sales tax agreement , enacted as a program under the authority of Article 3, section 52-a was an unconstitutional debt.
- 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

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## The 2005 amendment to Art 3, section 52-a

- "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***"

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## Municipal Debt under other provisions of the Texas Constitution

- Article 8, Section 1-g (b) authorizes city municipal tax increment debt:
  - "(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.)"
- Chapter 311, Tax Code authorizes Tax Increment Reinvestment Zones and city bonds and notes.

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## 2011 Amendments to Article 11, Sections 5 and 7

- Senate Intergovernmental Affairs committee interim report to the 82d Legislature recommends:
  - Multiyear interlocal contracts under Chapter 791, Government code
  - Excepting interlocal contracts from the tax and sinking fund requirements of Sections 5 and 7 of Article 11 of the Texas Constitution.

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## New provision for Section 5

- (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).



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## New Provision for Section 7

(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).

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## 2011 Amendments to Sections 5 and 7

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 types of Interlocal contract- a "city-city" contract, a "city-county" contract or a "county-county" contract, or any combination of these interlocal contracts.

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

- Local Government Corporation created 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.
- 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.

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## Debt

- 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.

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