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PUBLICLY OWNED UTILITIES AND THE PROBLEM OF MUNICIPAL DEBT LIMITS

*Lawrence L. Durisch**

THE far-reaching contest being waged between the advocates of municipal ownership of public utilities and the private ownership group, between those who "want the government to get out of business" and those who desire to see an increase in its proprietary functions, has produced a number of sharp legal controversies. One of the most interesting of these, recently litigated in a number of state courts, is whether an obligation incurred for the purchase or repair of a municipally-owned utility is a "municipal debt" within the meaning of constitutional or statutory debt limits. Because of the wide-spread interest in, and the recognized importance of, this question a brief survey of the court decisions on the subject may well be made at this time.

THE NATURE AND PURPOSE OF DEBT LIMITS

The purpose of constitutional and statutory debt limits is quite obvious. The municipal corporation must be protected from its own extravagance,[1] the minority taxpayers must have this means of checking the improvident majority.[2] An early Illinois case stated that the object of the constitutional prohibition was "to effectively protect persons residing in municipalities from the abuse of their credit, and the consequent oppression of burthensome, if not ruinous taxation." [3]

The restrictions may be imposed by the state constitution, by statute, or by the provisions of municipal charters. Most of the States have imposed either constitutional or statutory limits, but a few States, such as Colorado, have left municipalities free except for such provisions as they themselves adopt in their home-rule charters.

The constitutional and statutory restrictions imposed by the States vary to a considerable extent. They may, however, be classified as of three general types:

1. Those forbidding indebtedness in excess of a certain per cent of the value of the taxable property in the municipality.

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[1] Levy v. McClellan, 196 N. Y. 178, 89 N. E. 569 (1909).

[2] C. B. Nash Co. v. Council Bluffs, (C. C. S. D. Iowa 1909) 174 Fed. 182.

[3] Law v. People, 87 Ill. 385 (1877). A similar statement was made by the court in the recent case of Faught v. City of Sapulpa, 145 Okla. 164, 292 Pac. 15 (1930).

2. Those limiting the amount of indebtedness incurred in any one year to the income and revenue for the year.
3. Those combining the provisions of 1 and 2.

The limit on indebtedness may be absolute, or additional debts may be permitted only after approval by the voters at an election. Where provision for referendum is made, it is usual to require more than a simple plurality of the voters to favor the proposal.

Since the amount of direct indebtedness which may be incurred is frequently very low, and often insufficient to meet the needs of the municipality under changing conditions, it is sometimes imperative that means of increasing contractual capacity be found so that the city can perform even the minimum functions conceded to it by the most conservative.

METHODS OF EVADING RESTRICTIONS

Where the restriction is statutory it may be removed by subsequent legislation. And normally the limitation is of importance only if it antedates the legislative grant of special power to the municipality.[4] A difficult question of construction may be presented when the statutory restriction is not expressly repealed but the legislature simply authorizes the municipality to undertake projects inconsistent with the limitation (as, for example, to acquire a public utility plant). The court may then be called upon to decide whether the subsequent statute *pro tanto* repeals the limitation. By accepted canons of statutory construction this must necessarily be the result if the two are in fact inconsistent.

If the restriction is in the form of a constitutional provision, the legislature must resort to other methods in order to aid the hard-pressed municipalities. It has become quite common for the legislature to authorize the formation of special districts, super-imposed upon the territory of the city. These special districts may then contract in their own corporate capacity, and the districts' debts and the debts of the city will not be aggregated in determining the borrowing capacity of either of them.[5] Since the limit upon the amount of corporate indebtedness applies to each municipal corporation separately, a number of corpora-

[4] Amey v. Allegheny City, 24 How. (65 U. S.) 364, 16 L. ed. 614 (1861); Wharton v. Greensboro, 149 N. C. 62, 62 S. E. 740 (1908); Klein v. Louisville, 224 Ky. 624, 6 S. W. (2d) 1104 (1928).

[5] Recent cases on the obligations of special districts as a city indebtedness: City of Dawson v. Bolton, 166 Ga. 232, 143 S. E. 119 (1928); State v. Curtis, 319 Mo. 316, 4 S. W. (2d) 467 (1928); Shelton v. City of Los Angeles, 206 Cal. 544, 275 Pac. 421 (1929); People v. Bergin, 340 Ill. 20, 172 N. E. 60 (1930); Collins v. City of Phoenix (Ariz.), (C. C. A. 9th, 1932) 54 F. (2d) 770.

tions may occupy the same territory, and each may contract indebtedness up to the full amount of the constitutional limitation.[6] The device of forming special districts has been used extensively, and the maze of taxing districts existing in many metropolitan areas, particularly in Chicago, is a direct result of attempts to evade rigid constitutional debt limit provisions. Where such a situation results, not only are the constitutional restrictions annulled but the responsibility of spending officers to the electorate is so confused and divided as to encourage municipal profligacy if not actual fraud.

A far sounder method is to amend the constitution so as to except certain expenditures from the constitutional limitations. Several States have provided that bonds issued in order to acquire public utility plants shall not be subject to the usual limitations.[7] In this manner responsibility is not diffused, even though expenditures are increased. State constitutions, however, are notoriously hard to change, and so the general tendency has been to impose special district upon special district until the whole financial structure of local government rocks and is in danger of crashing.

Another important method of evading the restrictive force of debt limits is that which is the subject of this paper. It is now being proposed in a number of jurisdictions to make certain obligations payable out of the earnings of the municipally-owned utilities; in this manner it is sought to increase the contractual capacity of the municipal corporation. How far is this possible and proper? What is the attitude of the courts toward it?

BONDS PAYABLE FROM UTILITY EARNINGS

It is well established that cities do not "incur indebtedness" by the issuance of warrants payable out of a special fund to be created by assessment upon property to be benefited by a local improvement. The city, in such cases, may negotiate the contract for paving, for street lighting, for an extension of gas, sewer, or water mains, but the contractor agrees to accept for payment the fund raised by special assessment, and to waive all right to hold the municipality liable for the cost. Since the city does not assume a general liability, the courts have quite uniformly held that an indebtedness of the city, within the meaning of the debt limit provisions, is not thereby created.[8]

[6] 6 MCQUILLIN, THE LAW OF MUNICIPAL CORPORATIONS, 2d ed., sec. 2373 (1928).

[7] Constitution of Michigan, Art. VIII, sec. 24. Constitution of South Carolina, Art. VIII, sec. 7.

[8] Quill v. City of Indianapolis, 124 Ind. 292, 23 N. E. 788 (1890); Davis v.

This line of cases opened up the way for a number of courts to give a like ruling with respect to obligations payable out of the earnings of municipally-owned utilities. The lead seems to have been taken by the Supreme Court of Washington when it declared that there was no difference in principle between obligations payable out of utility earnings and warrants payable by assessment upon property in an improvement district. The fact that no liability on the general tax fund was created was held to be controlling in both situations.[9] Even if it were conceded that the payment of the bonds might not leave sufficient money for the operating expenses of the plant, the court was still unwilling to hold that the contract created a debt, for it was not apparent, it stated, that the deficit would be met in an unlawful manner.[10] These cases made it possible for the city of Seattle later to acquire its street railway system without the creation of a debt within the meaning of the constitution, even though it was provided that the bonds were to be a charge senior to the operating expenses of the acquired system.[11]

Many cities have issued bonds in order to obtain the purchase price of a utility plant. Where the city assumes no obligation other than to turn over the net revenues produced by the acquired utility, it has been held that the debt limit provisions do not apply.[12] The Kentucky court stated that such obligations are "in the nature of special assessments" and not subject to debt limits.[13] When, however, even a small part of the purchase price was to be paid by funds raised by general taxation, a contrary result was reached.[14] The city may even obligate itself to

City of Des Moines, 71 Iowa 500, 32 N. W. 470 (1887); Kelly v. City of Minneapolis, 63 Minn. 125, 65 N. W. 115 (1895); Little v. City of Portland, 26 Or. 235, 37 Pac. 911 (1894); Goshen v. Jackson, 165 Ill. 17, 45 N. E. 1000 (1897); In re North Terrace Park, 147 Mo. 259, 48 S. W. 860 (1898); Wickliffe v. City of Greenville, 170 Ky. 528, 186 S. W. 476 (1916); Collins v. City of Phoenix (Ariz.), (C. C. A. 9th, 1932) 54 F. (2d) 770; but where the special assessments do not meet the entire cost of the improvement see: McAnulty v. City of Pittsburgh, 284 Pa. 304, 131 Atl. 263 (1926); Williams v. City of Emmett, 51 Idaho 500, 6 Pac. (2d) 475 (1931).

[9] Winston v. City of Spokane, 12 Wash. 524, 41 Pac. 888 (1895).

[10] Faulkner v. City of Seattle, 19 Wash. 320, 53 Pac. 365 (1898).

[11] Twichell v. City of Seattle, 106 Wash. 32, 179 Pac. 127 (1919).

[12] Winston v. City of Spokane, 12 Wash. 524, 41 Pac. 888 (1895); Dean v. Walla Walla, 48 Wash. 75, 92 Pac. 895 (1907); Brockenborough v. Board of Water Commissioners of Charlotte, 134 N. C. 1, 46 S. E. 28 (1903); State ex rel Smith v. Neosho, 203 Mo. 40, 101 S. W. 99 (1907); Evans v. Holman, 244 Ill. 596, 91 N. E. 723 (1910); Shields v. City of Loveland, 74 Colo. 27, 218 Pac. 913 (1923); Larimer Commissioners v. Fort Collins, 68 Colo. 364, 189 Pac. 929 (1920); Butler v. Ashland, 113 Or. 174, 232 Pac. 655 (1925); Searle v. Town of Haxtum, 84 Colo. 494, 271 Pac. 629 (1928).

[13] City of Bowling Green v. Kirby, 220 Ky. 839, 295 S. W. 1004 (1927).

[14] Ottumwa v. City Water Supply Co. (Iowa), 56 C. C. A. 219, 119 Fed. 315 (1902).

maintain utility rates high enough to pay off the bonds, showing that restrictive provisions are for the benefit of the taxpayers but not the ratepayers.[15]

Some courts have held that the agreement of the city to pay specified amounts on the contract out of the light or water fund created a present indebtedness for the entire amount.[16] The Missouri court, however, held that a similar agreement did not create a debt,[17] and the Colorado court reached the same conclusion.[18]

Where the income from a plant already belonging to the city was charged, the Illinois court held that an indebtedness within the purview of the constitutional limitation had been created, since the holders of the certificates would have the right to take and appropriate a pre-existing income of the city for payment.[19] The same court pointed out a seemingly clear distinction between obligations payable out of special assessments and obligations payable out of the earnings of municipally-owned utilities. In the first case the city is not the owner of the fund it collects; in the second case it is, and for this reason obligations payable out of utility earnings are the debts of the city, to be paid with money belonging to it. Debt limits are, or ought to be, applied whenever the city is the owner of the fund involved in the transaction. "All obligations," stated the court, "are in fact payable out of some fund, and it is immaterial that the obligation is payable out of a special fund if the city is the owner of that fund." [20]

The Illinois court seems to have thus established a tenable logical criterion for deciding whether debt limit provisions should be applied. On principle, however, it may well be questioned whether any of these methods of evading debt limits should be sustained. On the one hand is perhaps the great need for exceeding a wooden limit. But on the other is the obvious fact that ratepayers and taxpayers are substantially the same group and fall equally within the protective purpose of the limitation.

[15] Garrett v. Swanton, (Calif. 1931) 3 Pac. (2d) 1025.

[16] Feil v. Coeur D'Alene, 23 Idaho 32, 129 Pac. 643 (1913); Williams v. City of Emmett, 51 Idaho 500, 6 Pac. (2d) 475 (1931); Evans v. Holman, 244 Ill. 596, 91 N. E. 723 (1910); and see Hight v. City of Harrisonville, 328 Mo. 549, 41 S. W. (2d) 155 (1931).

[17] State ex rel Smith v. Neosho, 203 Mo. 40, 101 S. W. 99 (1907), but see Missouri case in preceding note.

[18] Shields v. City of Loveland, 74 Colo. 27, 218 Pac. 913 (1923).

[19] City of Joliet v. Alexander, 194 Ill. 457, 62 N. E. 861 (1902); Schnell v. City of Rock Island, 232 Ill. 89, 83 N. E. 462 (1908).

[20] People v. Chicago, etc., R. R., 253 Ill. 191, 97 N. E. 310 (1911).

MORTGAGES AND CONDITIONAL SALES CONTRACTS

If the purchase price is secured by a mortgage a more difficult situation is presented. Where the mortgage covers property not obtained by the transaction, an indebtedness is created.[21] Where the mortgage covers only property acquired by the transaction, the cases are divided. An Indiana case holds that no indebtedness is created.[22] But in Pennsylvania when the transaction involved a mortgage on the acquired property, debt limit provisions were held to apply. While it was argued that the borough assumed no liability and could not be injured by the transaction, it was pointed out that it could lose the acquired property, any money paid out under the contract, and any improvements that might have been made on the property.[23]

The common practice is to issue the bonds unsecured by any mortgage lien. The case of *Klein v. City of Louisville* presented an interesting argument to the Kentucky Court of Appeals in connection with the issuance of bonds for the erection of a toll bridge. The bonds, payable solely from the revenues of the bridge, were unsecured by any lien against the structure. The novel argument that even if the city did not become legally indebted, its good faith would be impugned if there was a default on the bonds, was advanced to the court as a reason for applying the debt limit provisions to the transaction. The court, however, refused to accept this plea, and held that no purchaser of the bonds could labor under any misapprehension as to the liability of the city, since the bonds themselves contained a statement that payment would be made from the special fund only.[24]

The conditional sales contract has very recently been employed as a means of allowing cities to use the proceeds of their utility plants for the purchase of new equipment without creating an "indebtedness." Legal title remains in the vendor until the final payment is made from the revenue of the plant. No general liability against the city is created and the utility plant itself is not mortgaged.

This contract has been held not to be subject to debt limit provisions in a number of States.[25] In a Missouri case the machinery sold under a

[21] City of Joliet v. Alexander, 194 Ill. 457, 62 N. E. 861 (1902).

[22] Fox v. Bicknell, 193 Ind. 537, 141 N. E. 222 (1923).

[23] Lesser v. Warren, 237 Pa. 501, 85 Atl. 839 (1912).

[24] 224 Ky. 624, 6 S. W. (2d) 1104 (1928).

[25] Johnston v. City of Stuart, (Iowa 1929) 226 N. W. 164; Barnes v. Lehi City, 74 Utah 321, 279 Pac. 878 (1929); Lang v. City of Cavalier, 59 N. D. 75, 228 N. W. 819 (1930); Carr v. Fenstermacher, 119 Neb. 172, 228 N. W. 114 (1930); McCutchen v. City of Siloam Springs, 185 Ark. 846, 49 S. W. (2d) 1037 (1932).

conditional sales contract did not constitute an entire utility operating system. The court pointed out that the purchase price was to come not alone from the earnings of the acquired property, but from the earnings of property already belonging to the city as well. Such an obligation was held not to be different than the obligation to pay with any other funds,[26] and the debt limit provisions were applied to the transaction.[27]

LEGALITY OF THE METHOD ADOPTED

Even though the obligation to pay from the earnings of a publicly-owned utility does not create a debt to which debt limits apply, this obligation may be affected by provisions controlling the *method* of creating municipal obligations; the question may arise whether the method of creating the obligation is within the scope of the powers delegated to the municipality.

It has been the custom to construe statutory or constitutional grants of power to municipalities as limitations of power, and the methods set out as mandatory even though they be permissive in form. Thus, if a municipality is empowered to acquire a utility plant by an issue of bonds, authorized by a vote of the people, it may not acquire such a plant by a conditional sales contract.

The recent case of *Van Eaton v. Town of Sydney* presented this exact question, and the Iowa court held that the uncertainty must be resolved against the municipality.[28] The rule of strict construction of municipal powers was also applied by the Iowa court in the case of *Christensen v. Town of Kimballton.*[29] The proposed bonds for an addition to an existing municipal electric light plant, payable from the revenue of the entire plant, were held to be invalid unless an election were held.[30] The controversy presented to the court involved the method of incurring the indebtedness, rather than the amount of the obligation.

Even though a contract to purchase an electric generator did not

[26] Bell v. City of Fayette, 325 Mo. 75, 28 S. W. (2d) 356 (1930).

[27] A like result was recently reached by the United States Circuit Court of Appeals in a case arising in Missouri. City of Campbell, Mo. v. Arkansas-Missouri Power Co., (C. C. A. 8th, 1932) 55 F. (2d) 510.

[28] 211 Iowa 986, 231 N. W. 475 (1930).

[29] 212 Iowa 384, 236 N. W. 406 (1931).

[30] Hesse v. City of Watertown, (S. D. 1930) 232 N. W. 53; see also Feil v. City of Coeur d'Alene, 23 Idaho 32, 129 Pac. 643 (1913); Baltimore & O. S. W. R. Co. v. People, 200 Ill. 541, 66 N. E. 148 (1902); Zachary v. City of Wagoner, 146 Okla. 268, 292 Pac. 345 (1930); and 1 DILLON, MUNICIPAL CORPORATIONS, 5th ed., sec. 237 (1911).

create an "indebtedness" within the constitutional limitation, the statutory method of creating an obligation was held by the Utah court to be exclusive. The contract was held to be void because it had not been submitted to the voters of Lehi City.[31]

Some courts have been less inclined to restrict the city in similar cases. In North Carolina it has been held that the issue of bonds, providing they shall be paid from the income of the city waterworks, was not the contracting of a debt which the constitution inhibits except on vote of the people.[32] The North Dakota court has held that the constitutional provision authorizing a city to issue bonds to acquire a revenue-producing utility was a grant, not a limitation of power.[33] And the Supreme Court of Nebraska goes even further. It declares that "may" in the statute authorizing second-class cities to defray the most of municipal lighting plants by a tax levy, or a bond issue, does not necessarily mean "shall." The two methods mentioned are not exclusive, and the city can provide for the payment of the purchase price out of the net earnings of the plant. In other words, a grant of power to a city may imply a means of exercising it in addition to specified methods.[34]

An amendment to the Arkansas Constitution provided the manner in which cities may acquire light plants, *i.e.*, by bond issues and special assessment after a majority of the qualified electors shall vote in favor of the project. The Arkansas court refused to rule that the method was exclusive, and allowed the city to acquire a power plant by a contract providing for payment solely from the plant earnings.[35]

An examination of the conflicting decisions shows that a few courts hold that the statutory or constitutional methods prescribed for the acquiring of municipally-owned utilities are not mandatory. It is safe to say that these courts are departing from the fundamental conceptions of the municipal corporation heretofore prevailing. The municipal corporation has been considered to be limited by a strict construction of its powers. It is only in cases where powers are expressly or plainly granted but the mode is not limited or prescribed that the municipal authorities may exercise their discretion as to the manner of carrying

[31] Barnes v. Lehi City, 74 Utah 321, 279 Pac. 878 (1929).

[32] Brockenborough v. Board of Water Commissioners of Charlotte, 134 N. C. 1, 46 S. E. 28 (1903).

[33] Lang v. City of Cavalier, 59 N. D. 75, 228 N. W. 819 (1930); but compare Hesse v. City of Watertown, (S. D. 1930) 232 N. W. 53.

[34] Carr v. Fenstermacher, 119 Neb. 172, 228 N. W. 114 (1929).

[35] McCutchen v. City of Siloam Springs, 185 Ark. 846, 49 S. W. (2d) 1037 (1932).

the powers granted into effect, subject in all cases to the judicial test of reasonableness.[36] In spite of the positive language adopted by the Arkansas, Nebraska, North Carolina, and North Dakota courts it may be a matter of doubt whether they intended to depart from this time-honored principle for interpreting municipal powers.

CONCLUSION

The cases holding that obligations payable out of the earnings of municipally-owned utilities are part of a city's "indebtedness" are in the minority. They seem, however, to be supported by sound legal reasoning. Even in cases where there is no pledge of property already belonging to the city, there is a promise to pay the obligation out of a fund of which the city is, or will be, the owner. Ownership of the fund out of which payment is to be made might well be made the controlling factor by a greater number of courts.

A majority of the courts have followed a policy of non-interference with the proprietary enterprises of the city whenever possible. In order that programs of municipal ownership shall not be too greatly handicapped by debt limit provisions, the courts have been willing to give an extremely narrow interpretation of the intent of the people as embodied in the fundamental law. Many courts have been unwilling to recognize that the ratepayers and taxpayers are in substance the same group, and that constitutional provisions limiting municipal indebtedness do not serve their fundamental purpose unless they are construed so as to protect the individual in both capacities. As public ownership programs increase in scope and importance, however, there will no doubt be an even greater tendency to use the earnings of municipally-owned utilities to increase contractual capacity. This tendency to evade debt limit provisions suggests strongly that the whole policy of fixing rigid municipal debt limits is in need of re-examination and revision.

[36] See 1 DILLON, MUNICIPAL CORPORATIONS, 5th ed., sec. 239 (1911); 43 C. J. 119 (1927).