

## Legal Q&A

By **Bill Longley**, TML Legislative Counsel

### **Q. Where do Texas cities get authority to issue debt?**

**A.** Two constitutional provisions authorize cities to issue debt, albeit in a round about way. *See* TEX. CONST. art. XI, §§ 5 and 7. While they do not expressly state that cities may issue debt, these constitutional provisions serve that purpose by providing that general law and home rule cities may not create any debt unless the cities simultaneously levy and collect a sufficient sum to pay the resulting interest and create a sinking fund of at least two percent. In other words, a debt must be “funded.”

Though the term “debt” is not defined in the Texas Constitution, Texas courts have long-defined it as any pecuniary obligation imposed by contract. *McNeill v. City of Waco*, 33 S.W. 322, 324 (1895). This is not to say that every possible contractual obligation fits the definition, however. Case law also establishes that 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. *See id.*; *see also Municipal Administrative Services v City of Beaumont*, 969 S.W.2d 31, 37 (Tex. App.—Texarkana 1998, no pet.).

Several statutes authorize cities to issue certain types of debt obligations, along with the express authority to pledge taxes or revenues and establish a sinking fund in support of those debts, as required by the Texas Constitution. For example:

- Texas Government Code Chapter 1331 authorizes general obligation bonds (voter-approved bonds payable from property taxes).
- Texas Government Code Chapter 1501 authorizes utility revenue bonds (non-voter-approved bonds payable from utility revenues).
- Texas Local Government Code Secs. 271.041 - 271.064 authorizes certificates of obligation (debt obligations payable from taxes, revenues, or a combination of the two and subject to voter approval if citizens submit petition to hold election on the issuance).
- Texas Government Code Chapter 1431 authorizes tax notes (non-voter-approved and relatively short-term debt obligations payable from revenue, taxes, a combination of the two, or the proceeds of bonds to be issued).

### **Q. Are agreements for a city’s acquisition of real or personal property considered to be debt?**

**A.** No, so long as the contract contains language making clear that the contract is a commitment only of the city’s current revenues and not future revenues. Local Government Code Section 271.903 provides as follows:

Sec. 271.903. COMMITMENT OF CURRENT REVENUE. (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.

A contract to acquire real or personal property is legally permissible only if it contains a clause in the contract: (1) providing the city with the right to terminate the contract at the end of each budget year; (2) conditioning the contract on a best efforts attempt to obtain and appropriate funding for payment of the contract; or (3) containing both a right to terminate the agreement at the end of each budget year and the best-efforts language.

When it approved the language in Local Government Code Section 271.903 in 1993, the Texas Legislature essentially codified the common-law standard established nearly a century earlier by the Texas Supreme Court in *McNeill v. City of Waco*, at least as it applies to a contract to acquire real or personal property. For these types of contracts, a pecuniary obligation that can be satisfied out of the current revenues of a city is not considered to be a debt.

**Q. Would a bank loan to a city be considered a debt?**

**A.** Yes. Using the *McNeill* definition of "debt" quoted above, any multi-year loan from a bank would almost certainly be considered "a pecuniary obligation imposed by contract." Further, assuming the proposed loan was to be paid back over several years, a city would need to pledge taxes or revenues and create a sinking fund to pay back the loan. Unlike the statutes authorizing debt instruments, such as bonds and certificates of obligation, which expressly authorize a city to pledge taxes or revenues and create a sinking fund, no clear statutory authority exists that authorizes a city to pledge taxes or revenues in support of a bank loan, with one narrow exception (see next question).

In 1999, the attorney general addressed the question of whether a county could borrow money by purporting to pledge its taxes to payment of interest and the establishment of a sinking fund, while avoiding the statutorily-authorized mechanisms of bonds, certificates of obligation, or other debt obligations. *See* Tex. Att'y Gen. Op. No. JC-0139 (1999). The opinion concluded that the county could not because it lacked statutory authority to levy taxes to secure a loan in the same way that it has authority to levy taxes to secure bonds, anticipation notes, and certificates of obligation. *Id.* at 4. The authority to levy and pledge taxes for interest and sinking fund purposes is not implied by the Article 11, Sections 5 and 7 of the Texas Constitution, but must be found elsewhere in the statutes. *Id.* According to the attorney general, simply pledging future tax revenue to pay a long-term loan would circumvent the safeguards, such as attorney general approval, that are required of bonds and other debt instruments. *Id.*

While the attorney general's reasoning would seem applicable to cities, the situation is clouded by a section of the Local Government Code that authorizes general law cities to "borrow money based on the credit of the municipality" for certain purposes such as streets, hospitals, and other facilities. *See* TEX. LOC. GOV'T CODE § 101.005(c). An argument could be made that this section constitutes statutory authority for cities to obtain bank loans, though it is unclear how the statute accounts for the limitations on debt in the Texas Constitution, as the statute does not clearly authorize a city to levy a tax to pay down the debt.

It also could be suggested that the loan agreement with the bank contains a clause that the city's obligation to pay back the bank will be satisfied out of current revenues each year, similar to a clause authorized by Local Government Code Section 271.903 for the acquisition of real or personal property. As a practical matter, however, banks are unlikely to sign an agreement that would allow the city council to stop paying back the loan in a future year.

The safest interpretation of the relevant law is that a city can likely only take out a bank loan if the loan is repaid within the current budget year. A city wishing to take out a long-term bank loan should do so only in reliance upon an opinion by its city attorney or bond counsel.

**Q. Are there any instances where a city is expressly authorized to pledge taxes or revenues in support of a bank loan?**

**A.** State law expressly authorizes a city to enter into a financing contract for personal property and pledge taxes or revenues in support of the contract. *See* LOC. GOV'T CODE § 271.005.

Originally passed in 1979, the Public Property Finance Act gives cities the flexibility to finance the purchase of personal property through less formal means than a bond issuance. In relevant part, the law provides that a city "may execute, perform, and make payments under a contract with any person for the use or the purchase or other acquisition of any personal property, *or the financing thereof.*" (emphasis added). LOC. GOV'T CODE § 271.005(a). A contract to purchase personal property or to finance the purchase of personal property is considered to be an obligation of the city. *Id.* As such, the city council "may obligate taxes or revenues for the full term of a contract for the payment of the contract." *Id.* § 271.005(d). It is worth emphasizing that this authority extends only to a contract financing the purchase of personal property, and does not provide similar authority for a city's purchase of real property.

**Q. Is an interlocal agreement involving a city considered to be a debt?**

**A.** No. Voters approved an amendment to the Texas Constitution in 2011 that specifically allows cities and counties to enter into interlocal contracts for longer than one year without the contract automatically constituting a debt for which a sinking fund must be created. *See* TEX. CONST. art. XI, §§ 5(b) and 7(b). The purpose of the amendment was to give local governments greater flexibility to utilize interlocal agreements to consolidate more projects and services.

Prior to the constitutional amendment passing, the statute governing interlocal contracts provided that contracts must be "renewed annually," presumably to protect an interlocal contract from

being characterized as an unfunded debt. This provision was problematic for many local governments, who worried that one party to the contract could back out of the agreement after one year and force the other local government to solely fund a project or services. The statute now provides that an interlocal contract may have a specified term of years. *See* TEX. GOV'T CODE § 791.011(i).

**Q. Is a city economic development incentive agreement considered to be a debt?**

**A.** No. In response to a district court ruling that one city's Chapter 380 economic development incentive agreement was an unconstitutional debt, the voters amended the Texas Constitution in 2005 to expressly provide that an economic development agreement cannot be considered debt. More specifically, the voters approved the addition of the following sentence to Article III, Section 52-a of the Texas Constitution: "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."