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Defences to Municipal Bonds

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Defences to Municipal Bonds.

-by-

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1890.

Municipal bonds are of recent growth and hence strangers to the common law. The reason for this is, that towns, cities and counties were formerly regarded as simply governmental sections of the state and not as having a legal existence. At a still earlier time they were mere geographical divisions with absolutely no power. But with the advancement of civilization and a desire for better government, we find the state granting to these subdivisions certain governmental powers to be used in a prescribed manner. From this they have grown into their present condition with a legal existence similar to private corporations. The same power, which could grant to these subdivisions of state a le-

gal existence, can confer upon them additional authority. This has been plainly shown by acts of legislatures empowering municipalities to make contracts, the most common of which are municipal bonds.

The litigation arising over municipal bonds, as one would naturally expect, has not been entirely harmonious. The Federal Courts, by applying the doctrine of estoppel, apparently favor the rights of bona fide holders; while the state courts require a strict compliance with all conditions, whether or not bona fide holders are affected.

Municipal bonds as a rule have been treated as commercial paper. In New York and Pennsylvania, however, the opposite rule prevails. (Diamond vs. Lawrence Co. 37 Pa. St. ; Alvord vs. Syracuse Savings Bank, 98

N. Y. 599.) In England securities of this character have been made commercial by statute. (51 Geo. III, ch. 64.) Since these bonds are considered commercial paper, one taking them for value, without notice of equities and before maturity is a bona fide holder. He acquires an absolute title which cannot be defeated by equities existing between the original parties.

The title of such a holder may, however, be defeated by showing an entire absence of power on the part of the municipality to issue the bonds. The question now presents itself, can there be a bona fide holding of municipal bonds issued without authority? The New York authorities maintain that there can be no bona fide holding of such paper, within the meaning of the law applicable to negotiable paper. (Cagwin vs. Town of Hancock,

84 N. Y. 532.) The Federal Courts support a similar rule, that where there is a total want of authority to issue such securities, there can be no bona fide holding of them. (Township of East Oakland vs. Skinner, 94 U. S., 255.) The difference in effect between these holdings is, that the New York courts maintain that if the particular bonds are issued without authority, although the municipality may have power to issue bonds, there can be no bona fide holding of them. The Federal Courts, on the other hand, hold that if a corporation has power to issue bonds, there may be a bona fide holding of them, although the particular bonds in question may have been issued without authority. (Supervisors vs. Schenck, 5 Wall. 772.)

Want of power then is an absolute defence, whether

the action arises between the original parties, or, where the bonds are taken with notice, or between the corporation and a bond fide holder. In an action to recover on municipal bonds, the plaintiff must allege in his complaint sufficient facts to enable the court to decide for itself whether or not the municipality had authority to issue them. (Hopper vs. Covington, 128 U. S. 148.) Want of power to issue bonds generally arises from the following causes:-

1. Because the bonds are issued for a private and not for a public purpose.
2. Where the enabling statute is in violation of some provision of the State Constitution.
3. In case the power exercised is different from that delegated.

4. Where the enabling act imposes conditions to the exercise of the power.

The question whether an enterprise, which has been aided by municipal bonds, is public or private, has raised many interesting questions of constitutional law. Among others the right of taxation has been indirectly involved. If a municipal corporation has funds out of which its obligations can be satisfied without resort to taxation, there is no doubt but that it may issue its bonds to a private enterprise which may result in public benefit. But municipal bonds, as a general rule, are paid by taxes raised from the people, living under the municipal government. Hence the power to issue bonds rests, first of all, upon the authority of the municipality to levy taxes. The power of taxation can

be exercised alone for public purposes. Loan Association vs. Topeka, 20 Wall. 655.) This principle is universally accepted as correct, but difficulty is found in its application to particular cases.

The constitutions of all states contain a provision for the protection of private property, which provide that it shall not be taken for public uses without just compensation. It necessarily falls upon the courts to determine whether the purpose for which the property is taken is public or private. If the duty of construing the constitution vested in the legislature, as was erroneously held by some early cases, it would afford little protection to an individual or his property. (Vanck vs. Smith, 5 Paige, 160.)

The courts have labored under many difficulties

in determining whether enterprises aided by municipalities were public or private. Each enterprise must rest solely upon its relation to the public. The New York courts hold that a benefit to be public must be direct and immediate from the purpose to which the aid is given, and that if merely collateral the purpose is private, and bonds issued for such a purpose are void. Weismer vs. Douglass, 64 N. Y. 91. Judge Black in Shappless vs. Mayor, 21 Pa. St. 47, formulated a comprehensive but cumbersome definition of public purposes. This definition includes, among other enterprises, railroads, bounties and colleges. Bonds issued in aid of bounties and colleges have been voided upon the ground that the burden was imposed upon a few persons to benefit all. At present such purposes are held to be

public, and bonds issued in aid of them valid. It is well settled that bonds issued in aid of a railroad are issued for a public purpose. The question has been thoroughly litigated and the ground yielded only after a bitter contest. In Michigan the proposition is denied and bonds are held void as well as the statute authorizing the subscription. (People vs. Salem, 20 Mich. 452.) The Federal Courts deny the Michigan doctrine. (Pine Grove Twonship vs. Talsott, 19 Wall. 660.)

In Iowa the decisions have not been firm, holding in the first instance that bonds issued in aid of a railroad were valid (Clapp vs. Ceder Co. 5 Iowa, 15); then that such bonds were void (Hanson vs. Vernon, 27 Iowa, 28), and later maintaining their validity. (Stewart vs. Polk Co. 30 Iowa, 9.)

A distinction was at one time made between donation and subscription by a municipality to the stock of a railroad. (Whiting vs. The S. & F. R. R. Co., 25 Wis. 167; Sweet vs. Hulbert, 51 Barber, 312.), Bonds donated were held void, but if the municipality become a stockholder they were valid. No such distinction now exists. (Town of Queensbury vs. Culver, 19 Wall. 83.)

In Goddin vs. Crump, 3 Leigh. (Va.) 120, decided in 1837, for the first time the attention of the court was called to municipal bonds issued in aid of a railroad. This case held that the legislature had power to authorize a municipality to aid by the use of its bonds, institutions which were of a public nature, and a railroad was held to be a public purpose.

Railroads first made their appearance in the courts

of New York in *Beekman vs. The Saratoga & Schenectady*

3 Paiges Chan. star p. 45
Railroad, decided in 1831. Although the subject of

municipal bonds was not raised in this case, yet the
 good Chancellor held decidedly that railroads were public
 institutions; so when the age of municipal bond litigation
 arrived, this decision furnished the ground upon
 which railways were easily proven public enterprises,
 and the validity of bonds issued in their behalf sus-
 tained.

By the laws of New York, 1869, ch. 907, all municipal corporations were authorized to aid railroads by the use of their bonds. This was a public statute applying to the whole state. Section eleven of Article eight of the Constitution of New York abrogates this statute, and municipalities now have no power to aid

such enterprises. Could this amendment have been made directly after the decision in *Beekman vs. The Saratoga etc., R. R. Co.*, it would have prevented many exorbitant taxes and hosts of litigation. The history of the litigation and legislative enactments in New York, is the history of the same in nearly every state in the Union. Pennsylvania, Illinois, Indiana, Missouri and Mississippi have followed New York, and amended their constitutions, restricting the power of the legislature to authorize, or of municipalities to aid these enterprises. The necessity of restrictions of this nature is very apparent, and it is but a matter of time when it will be adopted by all states. In many instances judges as well as tax-payers have arrived at this conclusion. Mr. Justice Brewer, in *Lawrence vs. Douglass*,

13 Kas. 184, while laboring under the force of previous decisions, and in speaking of voting to aid railroads, said, "Look not, thou, upon the voting railroad bonds when it is new, for at last it biteth like a serpent and stingeth like an adder."

If then, it appear to the court that the bonds have been subscribed for a private and not a public purpose, it will be an absolute defence, relieving the municipality from all obligations under such contract; whether the bonds have not yet been delivered or whether delivered and in the hands of third parties. (*Coole vs. La Grange*, 113 U. S. 1; *Fieldman vs. Charleston*, 55 Am. Rep. 6; *Loan Association vs. Topeka*, 20 Wall. 655.)

2. Want of power often arises where the enabling statute is in violation of some provision of the State con-

stitution.

The authority of the legislature to pass laws is derived from the people, whose will is declared in the constitution. Therefore, a law to be valid must follow their will. The conflict between the enabling act and the constitution may arise out of some provision affecting the passage of all laws, or some provision applying directly or indirectly to the issue of municipal bonds.

The enabling act may be invalid as well as the bonds issued in pursuance of it, when the legislators fail to observe the provisions of the constitution which require, (a) the yeas and nays to be called and entered on the journals of both houses; (b) that a majority shall vote for the law; (c) that the object of the law shall be ex-

pressed in the title, and that it shall contain but one subject; (d) that the bill shall be signed by the presiding officer of each house; (e) that the bill before it becomes a law shall be read a certain number of times.

It is a very common provision in a state constitution that the vote shall be taken by ayes and nays and recorded in the journal. Such a provision is found in the Constitution of New York. (Art. III, Sec. 15.) It is held in this state that a person must plead the failure to record the ayes and nays, as required by the constitution, if he would take advantage of it. (People vs. Sup. Chenango Co., 3 N. Y., 317.) The provision of the Illinois constitution, requiring the ayes and nays to be recorded, is held to be mandatory and bonds issued in pursuance of a law passed without observing this pro-

vision are void. (Spangler vs. Jacoby, 14 Ill. 297.)

In some of the states the provision as to recording the ayes and nays is held to be simply directory. Bonds issued by virtue of a law defective for this reason are held valid in hands of bona fide holders. (People vs. Sup. Chenango Co., 3 N. Y. 317.) The Kansas constitution requires on the final passage of a law that the ayes and nays shall be called. The courts held a law passed without conforming to this constitutional provision to be valid. (County of Leavenworth vs. Barnes, 94 U. S. 71.) In order that this defect constitute an absolute defence on the part of the municipality, the court must construe the provision as mandatory and not merely directory.

A more common constitutional provision is one re-

quiring a majority, or certain number of the representatives to vote for a law. By the Constitution of New York (Art. III, Sec. 21) three-fifths of all the members elect to either house are necessary to pass a law imposing a tax. In *People vs. Allen*, 42 N. Y., 378, the non-compliance with a provision, similar to the one under consideration, was held to invalidate the law.

The provision was declared mandatory, and not directory as in the case of the provision requiring the ayes and nays to be recorded. It is quite generally held that municipal bonds are void which are issued by force of an enabling statute passed, not observing the constitutional provisions as to the required number of votes.

(c) A constitutional provision frequently violated is one requiring the object of the law to be expressed in

the title, and that it shall embrace but one subject.

At one time it was the practice to include in a single act many matters having no connection whatever. This species of statute is known in England as a "hedge podge" act. The title to laws was formerly prefixed by the Clerk and was considered of no importance. In some states a reform has been made in this respect by constitutional provision.

The title should fairly express the general or leading object of the act. (Burroughs on Public Security, 421) The statute may contain various matter if they are incident to the primary object of the act. (Ibid.)

If there appear to be more than one object in both title and act, the statute will be void. (Ibid. 422) In case the title embraces clearly one object, and the act

embraces two or more objects, it is then difficult to determine whether the whole law shall fall or only a portion. Cooley lays down the rule that, "if by striking out that portion not embraced in the title; a consistent law capable of being executed is left; such part of the act is valid; and that which is not embraced in the title is alone void." (Cooley's Const. Lim. 175.) The fact that a part of a statute is unconstitutional does not authorize the courts to declare the remainder void, unless the provisions are so connected that it cannot be presumed the legislature would have passed on without the other. (People vs. Briggs, 50 N. Y., 553.) Bonds issued by virtue of the law passed ignoring this constitutional provision would undoubtedly be void, though no case has arisen in which failure to comply with this pro-

vision has been made a defence.

(d) The signing of all bills by the presiding officers of both houses is made a constitutional provision in some states. Provisions of this kind are found in the constitutions of Illinois, Nevada and Arkansas. Laws which are passed, ignoring this provision, are void as well as the bonds issued by virtue of it. (Spangler vs. Jacoby, 14 Ill. 297.) In Pennsylvania the constitution contains no such provision, hence a law will be valid though not signed by the presiding officer. (Speer vs. Plank Road, 22 Pa. St. 376.)

(e) The constitutions of nearly all states require that a bill before becoming a law shall be read three times. Judge Cooley says, that the object of this provision "was to secure something more than the mere

orderly transaction of business. It was to prevent hasty legislation and to protect the people at large from its effect." (Cooley's Const. Lim. 170.) The courts of Ohio consider this provision as merely directory and failure to comply with it does not invalidate the act. (Pun vs. Nicholson, 6 Ohio, N. S. 178.) Judge Cooley assails this doctrine as erroneous. (Cooley's Const. Lim. 170.) In Illinois it is necessary to the validity of a law that this provision be observed by the legislators. (Ryan vs. Lynch 68 Ill. 160.)

Constitutional provisions which directly or indirectly affect the issue of municipal bonds.

First, as to provisions which existed at the time power to issue bonds was granted to the municipality; second as to restrictions of the power of the legislature to authorize, or the municipality to aid by the

use of its credit.

IN *Queensbury vs. Culver*, 19 Wallace, 83, it is held that the constitutional prohibition against taking private property for public use does not operate to prohibit municipal aid and other similar public objects.

The provisions that taxation shall be uniform has been

held not to invalidate a law authorizing the issue of

bonds. (*Pine Grove vs. Talcott*, 19 Wall. 660.) The

constitutionality of acts authorizing municipal aid to

railroads, has been carried to the extent of holding

that a county may be empowered to donate bonds to a

railroad outside of the county and even outside of the

state. (*R. R. CO. vs. County of Ote*, 16 Wall. 667.)

But an act authorizing the issue of bonds without an

election, contrary to the constitutional prohibition, is

void.

void. (Holl vs. Memphis, 23 Fed. Rep. 872.)

The effect of constitutional limitations made after the power to issue the bonds has been given is a question which has received much attention from the courts. It will perhaps, be sufficient to state here, that the rule to be gathered from the authorities is, that if the restriction is directed to legislative action, it simply limits the future action of the legislature. While if the restriction is directed to the municipality, and there has been no actual contract of subscription under the power to issue, such power is abrogated.

Under this rule, it may become important to know when a contract of subscription is made. It has been held that a vote in favor of subscription did not constitute a contract; that until the subscription was ac-

tually made the contract was executory. (Conrad vs. Savings Bank, 92 U. S. 625.) The resolutions or ordinances of a municipality will be treated as a subscription when so intended, and upon acceptance will constitute a contract. (Ibid. 631.) The delivery to the railroad Company by the proper officer and their acceptance by the company will amount to a subscription. (East Lincoln vs. Davenport, 94 U. S. 801.) Where there is an agreement to subscribe upon the performance of certain conditions, and the bonds are placed in the hands of a third party to be delivered when the conditions are performed, does not constitute a complete subscription, and the contract will be affected by subsequent legislation. (Falconer vs. The D. E. & J. R. R. Co., 69 N. Y., 491.)

3. Where the power exercised is different from that def-

delegated.

The exercise of power different from that which is delegated, usually arises where the object intended to be aided is divided into two or more; or consolidated with another enterprise, and the aid is given to the newly created corporation, or corporations as the case may be.

In *Marsh vs. Fulton County*, 10 Wall. 676, the bonds were authorized to be issued to one railroad corporation, but before they were issued the corporation divided into three independent corporations and the bonds were delivered to one of them. They were held void, having been authorized in aid of one object and delivered to another. The same principle was applied to consolidated roads in *Harshman vs. Bates County*, 92 U. S. 569. The election was held to subscribe to the stock of the Lexington,

Chillicothe & Gulf R. R., the bonds were issued to the Lexington L. & G. R. R., which was formed by the consolidation of the former with another road. The subscription was made by the county on behalf of the township. Litigation arising over the bonds, they were held void on the ground that the authority to subscribe was revoked before it had been executed, by the extinction of the first corporation. At this point the decisions turned, and in *County of Scotland vs. Thomas*, 94 U. S. 682, the opposite rule is laid down and has been without exception followed by later decisions. (*Nelson vs. Salamanca*, 99 U. S. 499; *Empire vs. Darlington*, 101 U. S. 87; *Livingston Co. vs. Portsmouth Bank*, 128 U. S. 102.) Mr. Justice Bradley wrote the decisions in the *Bates* and *Thomas County* cases, and he points out as a distinction,

that in the former the county acted as agent for the township and had no discretion to act beyond the precise terms of the power given. In the latter case the county subscribed for itself and, acting in the capacity of principal could subscribe or reject, as it thought best. The Scotland County case indicates that if a municipal corporation has power to subscribe to a railroad, it is a privilege--a vested right--which may be exercised by the new corporation in defiance of the will of the people. Such is not the holding in the United States Courts, neither is it followed in New York. (People vs. Bachellor, 53 N. Y., 123.)

The consolidated company will have no right to the benefit of a subscription to the stock of a component corporation, unless the act allowing the consolidation it vested with such rights. (Shields vs. Ohio, 95 U. S. #19)

After a careful review of the authorities, the following seems to be the true rule: If the act authorizing the consolidation fails to invest the new corporation with the rights of the old corporation, it can have no interest in a subscription to the latter. If the subscription was not an executed contract, creating a vested right, the consolidated company could not be authorized to receive the benefit under the subscription.

But, on the other hand, if the old corporation had acquired a vested right, or had bonds issued to it, such right would pass to the new corporation.

4. Where the enabling act imposes conditions to the exercise of the power.

Since municipal corporations must have an express authority to issue bonds, it is not infrequent that at-

tached to this authority are conditions which must be performed before the bonds can lawfully issue. The conditions most commonly imposed are; an election by the people; written assent of tax-payers; location of the road in a particular place; or completion at a certain time and its corporate existence. These are conditions precedent, and until they are performed, the right to issue the bonds does not arise.

As to the performance of conditions precedent, much diversity exists in opinion between the Federal and State Courts. At every opportunity the Federal Courts have interposed the doctrine of estoppel in behalf of bona fide holders. This accounts for nearly all the municipal bonds litigation being carried on the the United States Courts.

When an election is required before the bonds are issued and a majority are required to vote in favor of the proposition, such a vote is essential to give the officers jurisdiction to act. (Lenox vs. Com. of Bourbon, 12 Kas. 149.) Where the question as to the performance of the condition is raised between the original parties or between the municipality and one taking with notice of the defect, and not deriving his title through a bona fide holder, this doctrine is agreed in by both State and Federal Courts, but from this point they cease to coincide. The state courts maintain that the holder must take notice of all defects in the issue of the bonds. The Federal Courts apply the doctrine of estoppel and hold the municipality concluded by its own acts, or by decisions of the officers of

whose duty it was to issue the bonds, and by recitals

in the bonds. (Dillon on Mun. Corp. Secs. 518, 519.)

This rule of the United States Court was first advanced

in the celebrated case of Knox Co. vs. Aspinwall, 21

How. 539. The action was brought by a bona fide holder

to recover on certain coupons attached to bonds issued

by Knox County in aid of a railway company. The defence

set^{up} was, that the sheriff whose duty it was to give no-

tice of the election, failed to give the notice required

by statute; that this defect invalidated the election;

that the commissioners had no authority to act in conse-

quence of such an election, and that the bonds issued

were therefore void. The court held, that this defence

would^{be} decisive were it not for the fact that the commis-

sioners, who issued the bonds were the sole judges as to

whether they were lawfully issued. Thus the Federal courts by the intervention of estoppel, overthrow a defence sufficient in a majority of the state courts.

This decision, Knox vs. Aspinwall, though affirmed by all subsequent cases in our Federal Courts would apparently be a dangerous precedent to establish. Carrying out the theory advanced in that case no reason appears why under a public statute the commissioners could not at their pleasure issue bonds without observing any of the formalities of the law, and thereby bind the municipal corporation.

The state courts, with scarcely an exception, have laid down the opposite rule and hold all bonds void which are issued in pursuance of an election held without observing the conditions imposed by law. (Lewis vs. Bourbon

County, 12 Kas. 150; J. N. S. & R. Co. vs. Town of Vir-
den, 104 Ill. 330; People vs. Mead, 124 N. Y. 114.)

The burden of showing that the bonds were issued in com-
pliance with a vote of the people rests upon those af-
firming their validity. (Jackson Co. vs. Brush, 77 Ill.
191.)

In the State of New York, statutes authorizing the
bonding of municipal corporation in aid of railways,
requires in place of an election, the consent of a cer-
tain proportion of the tax payers to be given in writ-
ing. In this State, the aid extended to a railway is
considered as a contract between a majority of the tax-
payers and the railroad. This power conferred on a
majority to mortgage the property of all, against the will
of the minority, was unknown to the common law, and de-

pends solely on statutory enactment and therefore, every step required by the statute must be taken in strict compliance with it. (Burroughs on Public Securities, 262.)

The New York Courts, going behind the decisions of the officers whose duty it is to determine when the conditions are performed, require the holder, if he would recover on the bonds, to prove affirmatively the assent of the tax-payer to the proposition. (Gould vs. Town of Sterling, 23 N. Y., 464; People vs. Meade, 24 N. Y. 114.) The United States Courts in Town of Venice vs. Murdock, 92 U. S. 494, in a very able opinion written by Mr. Justice Strong, criticises this holding of the New York Court of Appeals, and lays down the rule that a holder may rest upon showing the decision of the officers. Continuing the learned Justice states, "No sane

person would have bought a bond with such an obligation resting upon him whenever he called for payment of interest. If such was the duty of the holder, it was always his duty. It could not be performed once for all, The bonds retained in the hands of the company would have been no help in the construction of the road. It was only because they could be sold that they were valuable." The New York rule has been criticised by the courts of other states. (Society for Saving vs. New London, 29 Conn. 174; Commissioners vs. Nicholas 14 Ohio St. 260.) Judge Cooley considers the doctrine of the New York Courts as sound. Cooley's Con. Lim. 4th Ed. p. 268.

Where the bonds are issued in aid of a railway the completion and location as well as its corporate ex-

istence are often made condition precedent. If the road is not located or completed as agreed, the bonds in the hands of bona fide holders are generally held to be void, and in all cases the tax payer can prevent the issue of bonds where the condition imposed has not been complied with. (*German Savings Bank vs. Franklin Co.* 128 U. S. 526; *R. R. Co. vs. Hartford*, 58 Me. 23; *State vs. Davies*, 64 Mo. 30.) If the condition is the location of the road in a particular place the state courts require a strict compliance with the condition (*Aurora vs. West*, 22 Ind. 88); while the Federal Courts hold that a practical compliance is sufficient. (*Johnson Co. vs. Thayer*, 94 U. S. 631.)

A condition which arises of itself and is not generally found in acts or imposed by tax-payers is that

there must be a corporation before a contract can be made with it. As a general rule corporations must file a certificate of incorporation as a requisite to legal existence. If the subscription was made before the certificate of incorporation was filed, and while the corporation was in an incomplete form the bonds issued would, no doubt, be void. (Ruby vs. Spain, 54 Mo. 207.) Such a rule is hinted at in the case of Davies vs. Hendekoper, 93 U. S. 104, by Mr. Justice Strong. In this case the election to issue bonds was held while the corporation was incomplete, but the certificate of incorporation was filed before the subscription was actually made. Subscription is the actual contract and if the purposes intended to be aid have a legal existence at that time it is sufficient.

