STATE OF TENNESSEE
OFFICE OF THE ATTORNEY GENERAL

April 27, 2015

Opinion No. 15-42

Lending of Credit by Municipality

Question 1

Does a municipality lend its credit when it pays a private entity in advance for the purchase of goods?

Opinion 1

Assuming the municipality is advancing payment from accumulated funds, this type of transaction does not come within the purview of article II, section 29 of the Tennessee Constitution.

Question 2

Does a municipality lend its credit when it sells goods or services to a private entity for deferred payment?

Opinion 2

This type of transaction, in and of itself, does not implicate article II, section 29 of the Tennessee Constitution.

Question 3

Does a municipality lend its credit when it sells real property to a developer in exchange for a promissory note, with security subordinated to the developer's other lenders?

Opinion 3

This type of transaction, in and of itself, does not implicate article II, section 29 of the Tennessee Constitution.

ANALYSIS

This opinion addresses whether certain municipal transactions come within the purview of article II, section 29 of the Tennessee Constitution which states, in pertinent part, that the "credit of no County, city or town shall be given or loaned to in aid of any person, company, association or corporation, except upon an election to be first held by the qualified voters of such county, city

or town, and the assent of three-fourths of the votes cast at said election." This constitutional provision is commonly referred to as the "lending-of-credit" clause. *See Cleveland Surgery Ctr. v. Bradley Cnty. Mem'l Hosp.*, 30 S.W.3d 278, 284 (Tenn. 2000); *McConnell v. City of Lebanon*, 203 Tenn. 498, 505, 314 S.W.2d 12, 15 (Tenn. 1958).

Courts have focused upon the meaning of "credit" when deciding whether a transaction implicates this clause.

In *Copley v. County of Fentress*, 490 S.W.2d 164 (Tenn. Ct. App. 1972), Fentress County proposed to construct an industrial building to be used by a private industry which, in turn, would employ local citizens. The county had accumulated funds that would be used for the construction of the building; no money would be borrowed for the project. *Id*. at 165-66. The court rejected the complainants' assertion that the proposal violated the lending-of-credit clause. The court observed that the word "credit" is "[a] term of universal application to obligations due and to become due." *Id*. at 169 (citation omitted). The court then looked to cases from Florida and Idaho, two states that have constitutional provisions similar to Tennessee. The court construed "credit" in the same manner that the high courts had in each of these cases, holding that the word "credit" as used in the lending-of-credit clause of the Tennessee Constitution implies the imposition of some new financial liability upon a county, city or town which in effect results in creation of a public debt for the benefit of private enterprises. *Id*. at 169 (citing *Nohrr v. Brevard Cnty. Educ. Facilities Auth.*, 247 So.2d 304, 309 (Fla. 1971); *Engelking v. Investment Bd.*, 458 P.2d 213, 218 (Idaho 1968)). Accordingly, the court found that Fentress County had not violated the lending-of-credit clause because the county was not borrowing money for the project and, therefore, not taking on a new financial liability. *Id*. at 169.

In *Ragsdale v. City of Memphis*, 70 S.W.3d 56 (Tenn. Ct. App. 2001), the Court of Appeals reiterated its holding in *Copley* when it held that contributions from the accumulated funds of two local governments for the proposed construction of a sports arena did not constitute lending of credit within the contemplation of article II, section 29 of the Tennessee Constitution. *Id*. at 68-69. The court emphasized that "[o]ur courts have made clear that lending of credit involves more than the advancement of accumulated funds, since it does not result in the creation of a future indebtedness." *Id*. at 70.

1. You have asked whether a municipality lends its credit when it pays a private entity in advance for the purchase of goods. There is no mention of the municipality borrowing funds or otherwise taking on a new financial liability in order to make the advance payment. Thus, we assume the municipality is using accumulated funds for the advance payment. Based on the authorities cited above, this type of transaction does not come within the purview of the lending-of-credit clause of the Tennessee Constitution.

2. You have also asked whether a municipality lends its credit when it sells goods or services to a private entity for deferred payment. As explained by the Supreme Court of New Mexico in *City of Clovis v. Southwestern Public Service Co.*, 161 P.2d 878 (N.M. 1945), a municipality generally does not take on a new financial liability in this type of transaction. In *City of Clovis*, the court considered whether a utility company's agreement to pay a city for its light and water system in twenty-four annual installments constituted a lending of the city's credit. The

court found that it did not because "[t]he debts and liabilities of the City, and the burden on its taxpayers, were not increased." *Id*. at 881. The court reasoned:

> Nothing in this phase of the transaction possessed any element of guaranty, suretyship or pledge by the City of Clovis whereby the City became liable to do or perform any act or thing, or to incur any obligation, or pay any sum of money, in behalf of, or for the benefit of, the utility company, or to become liable for, or assure the performance of, any obligation, or the discharge of any liability of the utility to any third person.

Id.

The court concluded that any pledge of credit created by the transaction was a pledge of the utility company, not the city. *Id*. "The most that [the city] did was to give time" to the utility company for the payment of an obligation owed by it to the city. "This is an entirely different matter from the City of Clovis 'lending or pledging' *its* credit." *Id*. (emphasis original).

Similarly, in *Vitacolonna v. City of Philadelphia*, 115 A.2d 178, 190 (Pa. 1955), the Supreme Court of Pennsylvania rejected a lending clause challenge to a city water regulation that proposed a deferred payment plan for meter installation on the premises of water consumers. The court reasoned:

> The City is not lending its credit to the consumer, but rather is at most extending credit to the consumer in a transaction between the consumer and the City. This constitutional provision was designed, *inter alia*, to prevent the City from becoming indebted as a guarantor or endorser for the benefit of any individual, it does not prohibit reasonable collection arrangements with the City's debtors.

Id.

For the reasons stated above, a municipality does not lend its credit when it sells goods or services to a private entity for deferred payment. Accordingly, this type of transaction, in and of itself, does not implicate article II, section 29 of the Tennessee Constitution.[1] For this type of transaction to come within the purview of this constitutional provision, the transaction would have to involve the municipality assuming some new financial liability that is not ordinarily associated with a standard deferred payment agreement.

3. Lastly you ask whether a municipality lends its credit when it sells real property to a developer in exchange for a promissory note, with security subordinated to the developer's other lenders. As stated above, "credit" as used in article II, section 29 of the Tennessee Constitution implies the imposition of some new financial liability upon a county, city or town which in effect results in creation of a public debt for the benefit of private enterprises. *Copley*, 490 S.W.2d at 169 (relying on *Nohrr*, 247 So.2d at 309; *Engelking*, 458 P.2d at 218). In *Nohrr*, the Florida

[1] Municipal charters and codes, though, generally require a sale of property to be in good faith, upon adequate consideration, and upon reasonable and lawful terms. The same is true with respect to the services that it sells. Thus, a municipality could violate a provision of its charter or code if it unreasonably defers payment for the goods and services that it sells.

Supreme Court explained that "[i]n order to have a gift, loan or use of public credit, the public must be either directly or contingently liable to pay something to somebody." *Nohrr*, 247 So.2d at 309. In short, the purpose of the lending-of-credit clause is to protect local government entities from pecuniary liability. *Elliot v. McNair*, 156 S.E.2d 421, 427 (S.C. 1967).

In the transaction you describe, the municipality is a junior lienholder. It is well settled that "[i]t is in the nature of the infirmity of a junior mortgage or lien that it may be extinguished in the enforcement of a superior mortgage or lien." *Third Nat'l Bank v. McCord*, 688 S.W.2d 446, 450 (Tenn. Ct. App. 1985). Consequently, if a senior lienholder were to foreclose on the property upon a default of the developer, the municipality would face the extinguishment of its lien if the foreclosure sale produced insufficient proceeds. *Id*. at 450-51. While the developer's obligation to the municipality on the promissory note would remain, the municipality confronts the loss of its interest in the real property. *Id*. To prevent the loss of its property in this situation, the municipality would have to assume the debt of the developer. Nevertheless, the municipality would not be obligated to do so. Accordingly, this type of transaction does not implicate article II, section 29 of the Tennessee Constitution. *See Carll v. South Carolina Jobs-Economic Dev. Auth*., 327 S.E.2d 331, 335 (S.C. 1997) (lending-of-credit clause not violated if governmental entity not obligated to pay off another's debt).[2] For this type of transaction to come within the purview of this constitutional provision, the municipality must have a contractual obligation to assume the developer's debt in case of default.

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[2] Municipal charters and codes, though, may prohibit this type of transaction. Moreover, there may be restrictions on the property that would prevent this type of transaction. For example, if a municipality has issued bonds and used part of the proceeds to renovate the property or construct a building upon the property, there may be bond covenants that restrict the sale or use of the property until the bonds are fully paid.