

June 21, 1996

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**THIS CORRESPONDENCE IS A LEGAL GUIDELINE OF THE
ATTORNEY GENERAL SUBMITTED FOR YOUR GUIDANCE**

Re: Opinion Request City of Emmett Lease-Purchase Agreement

Dear Mr. Bjorkman:

QUESTION PRESENTED

I am responding to a request for an Attorney General's opinion regarding the City of Emmett's proposed acquisition of a new city hall by use of a lease-purchase arrangement. You have raised several questions concerning the legality of a lease-purchase arrangement. You also have questioned whether the public works requirements would apply to the construction of a facility built under a lease-purchase arrangement.

BACKGROUND

The city owns certain real property upon which the city wants to construct a new city hall. It has been suggested that the city utilize a lease-purchase financing arrangement for this project. The actual lease-purchase transaction is incomplete. No documents have been prepared, and the project is only in the concept stage. The current thinking is to have a facility built with financing provided by a third party with the city acquiring the property by lease-purchase from the third party. This transaction contemplates the city's acquiring an ownership interest in the building during the lease with the city owning the facilities at the end of the lease term.

ANALYSIS

1. Constitutional Requirements of Art. 8, Sec. 3 of the Idaho Constitution

a. Art. 8, sec. 3 of the Idaho Constitution

Idaho cities have the power to acquire and lease real property and erect buildings or structures of any kind for use by the city. Idaho Code § 50-301. This power is not

unlimited. The state constitution limits the city's authority to incur indebtedness or other obligations.¹

The Idaho Constitution, art. 8, sec. 3, states:

No county, city . . . or school district . . . shall incur any indebtedness, or liability, in any manner, or for any purpose, exceeding in that year, the income and revenue provided for it for such year, without the assent of two-thirds of the qualified electors thereof.

b. Purpose of Debt Limitation

The Idaho Supreme Court has stated the purpose of art. 8, sec. 3, is to maintain the credit of the state and counties by keeping them on a cash basis, Ball v. Bannock County, 5 Idaho 602, 51 P. 454 (1897); to prevent indebtedness incurred in one year from being paid from the income and revenues of a future year, Theiss v. Hunter, 4 Idaho 788, 45 P. 2 (1896); and to preclude circuitous and evasive methods of incurring debts and obligations, Feil v. City of Coeur d'Alene, 23 Idaho 32, 129 P. 643 (1912).

c. Meaning of Indebtedness or Liability

What constitutes an "indebtedness or liability" has been a recurring subject of litigation over the last century. The Idaho Supreme Court has adopted a far more restrictive view of this term than courts from other jurisdictions. The court recognized that obligations payable from current year's revenues were exempt from the constitutional provision. Foster's, Inc. v. Boise City, 63 Idaho 201, 118 P.2d 721 (1941).

The Idaho Supreme Court has defined "debt" or "indebtedness" within the meaning of art. 8, sec. 3, as an obligation, incurred by the state or a municipality, which creates a legal duty on its part to pay from its general funds a sum of money to another, who occupies the position of a creditor, and who has a lawful right to demand payment. Idaho Water Resource Board v. Kramer, 97 Idaho 535, 548 P.2d 35 (1976). "Liability" has been given a broader and more comprehensive definition than "indebtedness." "Liability" refers to all kinds and characters of debts and obligations for which a municipality may become bound in law or equity to perform. Feil, 123 Idaho at 50-51. The court in Feil held that a voter approval requirement of art. 8, sec. 3, applied not only to general obligation debt payable from property taxes, but also indebtedness payable solely from revenues from "special funds." Some types of obligations are recognized by the court to not constitute "indebtedness or liability" within the constitutional provisions.

d. Debt Limitation Does not Apply to Ordinary and Necessary Expenses

Art. 8, sec. 3, does not apply to “ordinary and necessary” expenses. Hanson v. City of Idaho Falls, 92 Idaho 512, 446 P.2d 634 (1968). A thorough analysis of the meaning of “ordinary and necessary” expenses, as interpreted by the Idaho Supreme Court in Asson v. City of Burley, 105 Idaho 432, 670 P.2d 839 (1983), *cert. denied* 469 U.S. 870 (1984), is found in Attorney General Opinion No. 88-3, which states:

Recent cases construing the “ordinary and necessary” clause, therefore, do not make a simple distinction of whether the project is a construction of a new building or the repair of an old one. Rather, the court will find an expense to be “ordinary and necessary” if a governmental entity has had a long-standing involvement in a given enterprise; if the existing facilities are obsolete and in need of repair, partial replacement or reconditioning; if failure to upgrade facilities would jeopardize the safety of the public; and if any failure to do so would create potential legal liability.

1988 Idaho Att’y Gen. Ann. Rpt. 21, 25.

The overarching issue is whether the “lease-purchase” payment is an ordinary and necessary expenditure. The determination of an ordinary and necessary expense is fact-specific. If the lease payments are an “ordinary and necessary” expense, then the city does not need to have voter approval. It is advisable for the city to seek a declaratory ruling by a court to determine if the final lease-purchase transaction is constitutional. Judicial confirmation may be required by the third-party financier.

e. Constitutional Debt Limitation Applies if Liability is Beyond Current Year

The city may also avoid the requirements of art. 8, sec. 3, if the lease-purchase agreement does not obligate the city beyond a current year’s tax revenue. The lease-purchase agreement, to avoid the debt limitations of art. 8, sec. 3, must have a non-appropriation clause that simply reflects that the annual lease-purchase payments are subject to the annual availability of budgeted funds. Non-appropriation clauses subject to annual renewal are frequently included in contracts to avoid constitutional debt limitations. The effect is to obligate the city for no more than the current year’s revenue and income. The lease is subject to an annual renewal. Thus, the obligation is only for a one-year period. The non-appropriation clause must provide that there is no penalty to the city for nonrenewal of the lease due to the lack of current funding. Of course, the lease would end and the city would have to vacate the premises if funds were inadequate and the city elected not to renew the lease.²

2. Constitutional Prohibition Against Pledge of Credit

a. Art. 8, sec. 4, of the Idaho Constitution

The Idaho Constitution prohibits indebtedness and subsidies to private individuals. Art. 8, sec. 4, states:

No county, city, . . . shall lend, or pledge the credit or faith thereof directly or indirectly, in any manner, to or in aid of any individual, association or corporation, for any amount or for any purpose whatever, or become responsible for any debt, contract or liability of any individual, association or corporation in or out of this state.

The proposed financing transaction may require the city to encumber the municipal property by a deed of trust or mortgage. This encumbrance may conflict with art. 8, sec. 4, which prohibits lending or pledging the credit of the city to another. This constitutional provision has been interpreted by the Idaho Supreme Court to prohibit transactions creating the traditional relationship of borrower and lender. Bannock County v. Citizens Bank and Trust Company, 53 Idaho 159, 22 P.2d 674 (1933).

Additionally, liens and encumbrances placed upon the public property may violate art. 8, sec. 3 of the Idaho Constitution. See Feil, 123 Idaho at 51-56, and Boise Payette Lumber Company v. Challis Independent School District, 46 Idaho 403, 268 P. 26 (1928).

3. Public Works and Bid Laws Apply

Your second question is whether the public works statutes apply to the construction of the city hall acquired through a lease-purchase transaction. Based upon our review of Idaho Code, it appears that the construction of a city hall acquired by lease-purchase is a “public work” as defined by Idaho Code §§ 54-1901, *et seq.* Consequently, the contractor must be a licensed public works contractor, and payment performance bonds must be received in compliance with Idaho Code. Further, expenditure of public funds must occur in accordance with the competitive bid requirements set forth in Idaho Code § 50-341. See Swenson v. Buildings, Inc., 93 Idaho 466, 463 P.2d 932 (1970).

CONCLUSION

The acquisition of a new city hall through the use of a lease-purchase arrangement is no simple matter. The city must comply with the Idaho Constitution, particularly, art. 8, secs. 3 and 4. This requires voter approval of the debt, unless the transaction qualifies as an “ordinary and necessary” expense or does not obligate the city beyond the current

year's revenue. This type of lease-purchase transaction is further complicated by the possible security interest in city property.

We suggest that you carefully follow the applicable statutes relating to the acquisition and disposal of property and the bidding of the project. Additionally, we suggest that you carefully draft any lease-purchase agreements to protect and limit the city from unlawful debt or prohibited liability.

Finally, because of the uncertainty on how the lease-purchase transaction will operate, and whether the project is an "ordinary and necessary" expense, it is advisable for the city to seek a declaratory judgment to judicially confirm the legality of the final lease-purchase arrangement.

Very truly yours,

MICHAEL R. JONES
Deputy Attorney General
Contracts & Administrative Law Division

¹ For authoritative discussion of art. 8, sec. 3, *see* Michael C. Moore, Constitutional Debt Limitations on Local Governments in Idaho, Article 8, Section 3, Idaho Constitution, 17 Idaho L. Rev. 55 (1980).

² Nonrenewal for lack of funding causes other problems for the city. The "equity" ownership in the building is a problem that must be addressed.