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Financing Industrial Development in the South

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NOTE

FINANCING INDUSTRIAL DEVELOPMENT IN THE SOUTH*

I. INTRODUCTION

The increasing pressures for economic growth and higher per capita income have caused our governmental units to expand their activities to attract new industry. One of the major problems of the past half century has been underemployment of resources resulting, among other causes, from the persistence of agrarian ways and low rates of investment. This problem has been especially acute in the southern region of the United States; in an effort to meet this problem, state and local governmental units have undertaken to supplement federal activities in encouraging industrial development by attracting new firms to their region.

Availability of labor supply, transportation facilities, and natural resources proved insufficient inducement for industrialization at the desired rate; under stiff competition among the states, ways to make the region more attractive were devised. One of the "opportunities" offered prospective industries has been the industrial building program authorized by legislation or constitutional amendment in six southern states. It is the purpose of this paper to examine the various methods of industrial building financing available in Alabama, Arkansas, Kentucky, Louisiana, Mississippi, and Tennessee. The three most popular methods of financing have been adopted in Tennessee; therefore, Tennessee legislation is primarily considered here, the statutes of the other states being discussed largely by way of comparison.

Industrial building financing in Tennessee may be by the issuance of revenue bonds under the 1951 act,[1] payable solely from the rental proceeds received from the building lease; by issuance of general obligation bonds under the 1955 act,[2] secured by a pledge of the municipality's credit and taxing power; or by the issuance of industrial development corporation bonds,[3] the security for these being limited to a lien on rentals received from the lease of the building.

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1. TENN. CODE ANN. § 6-1701 (1956).
2. TENN. CODE ANN. § 6-2901 (Supp. 1960).
3. TENN. CODE ANN. § 6-2801 (Supp. 1960).

It is the declared purpose of these acts to curb migration, relieve unemployment and reduce attendant evils, raise per capita income, and balance the economy by creating job opportunities.[4] The expenditure of funds derived from the issuance of general obligation bonds under the 1955 act presents the troublesome question of whether or not the expenditure for industrial buildings meets the "public purpose" limitation which has been written into our state constitution and universally recognized as a limitation on local government spending.

II. INDUSTRIAL REVENUE BONDS

The 1951 legislation and amendments authorize municipalities and counties to issue revenue bonds to finance the construction, purchase, or improvement of buildings within the municipality or county to be leased to industrial concerns. The act requires that the lease be on terms which will provide for the retirement of the principal and payment of the interest on bonds.[5] Revenue bonds issued under this act are not indebtednesses of the municipality nor a loan of its credit. The act specifically provides that no bondholder may compel the municipality to exercise its taxing power to pay the bonds; instead, the bonds constitute a lien on the rentals received under the lease agreement and may be secured by a lien on the buildings and land.[6] The federal government has added an incentive to investment in this type of security by providing that interest income from municipal bonds is not subject to the federal income tax.[7]

A municipality must submit the question of issuance of the bonds to the will of its qualified voters and must receive approval of a three-fourths majority of those voting on the issue.[8] The question of issuance may be determined by the voters without designating the industry to utilize the proceeds, the interest rate (below a maximum), or the method or time of repayment of the principal. This permits a municipality to have issues authorized, "lying-in-wait" for a prospective industrial concern, thus expediting the mechanical processes required to make funds available for constructing the building.

The 1951 act has been upheld as constitutional by the Supreme Court of Tennessee. In *Holly v. City of Elizabethton,*[9] the court stated:

> There is nothing in the Constitution which forbids our Legislature from

4. TENN. CODE ANN. § 6-1703 (1956); Tenn. Pub. Acts 1955, ch. 209.
5. TENN. CODE ANN. § 6-1715 (1956).
6. TENN. CODE ANN. § 6-1708, -09 (1956).
7. INT. REV. CODE OF 1954 § 103(a) (1).
8. TENN. CODE ANN. § 6-1710 (1956).
9. Holly v. City of Elizabethton, 193 Tenn. 46, 241 S.W.2d 1001 (1951).

> authorizing a municipality to promote a private industry in the manner authorized by the aforementioned provision of Chapter 137, since those provisions do not authorize the use of moneys raised by taxation for the accomplishment of the incidental public purpose intended . . . .[10]

Even though the 1951 act was declared constitutional and there was great utility in this method of financing, it was felt that, due to their limited nature, these bonds did not fully utilize the available source of investment capital. The bonds were not secured by a pledge of municipal credit and taxing power and therefore were not "negotiable" under the state's Negotiable Instruments Law. That these bonds are not negotiable seems well settled. Under the Law Merchant and at common law,[11] an instrument payable solely out of a particular fund was not negotiable because it did not carry the general personal credit of the obligor and payment was contingent upon the sufficiency of the fund referred to. This rule has been codified by the Uniform Negotiable Instruments Law.[12] The effect of this non-negotiable characteristic is that an instrument is subject to all defenses of the maker which may be asserted against the bond in the hands of the holder or his transferee. This does not impair the validity or transferability of the bond if no defense exists. The investment securities section of the Uniform Commercial Code, however, removes bonds from the NIL and makes negotiability depend upon whether the security is of the type dealt in upon the securities markets or recognized in the area in which it is issued as a medium for investment. This means that such bonds are negotiable (for the purpose of cutting off defenses) even though they do not meet the formal requirements of the NIL.[13]

It is intended that these revenue bonds entail only limited liability to the issuing municipality; however, it seems that a holder of revenue bonds may have recourse against the municipality for payment of the bonds out of general funds if there was misrepresentation, negligence, breach of an implied covenant or warranty, or breach of trust in issuance. Thus there is need for close scrutiny of the issuance procedure by bond counsel for the purpose of determin-

10. 193 Tenn. at 54, 241 S.W.2d at 1005. See recent case of West v. Industrial Dev. Bd., 332 S.W.2d 201 (Tenn. 1960), which reiterates this position.

11. People's Bank v. Moore, 201 Ala. 411, 78 So. 789 (1918); Rector v. Strauss, 134 Ark. 374, 203 S.W. 1024 (1918); Hanna v. McCrory, 19 N.M. 183, 141 Pac. 996 (1914). BRITTON, BILLS & NOTES § 11 (1943).

12. UNIFORM NEGOTIABLE INSTRUMENTS LAW § 3, which has been adopted by Alabama, Arkansas, Louisiana, Mississippi, and Tennessee, provides that one of the requirements of negotiability is "an unconditional promise to pay." See Public Nat'l Bank & Trust Co. v. Garcia Sugars Corps., 173 Misc. 364, 16 N.Y.S.2d 914 (1939).

13. UNIFORM COMMERCIAL CODE §§ 8-101 to -105, -301 which has been adopted by Kentucky.

ing that no defense to the validity of the bonds exists. If for some reason the general funds of a municipality are utilized in discharging these bonds, the public purpose doctrine, hereinafter discussed in relation to general obligation bonds, may be applicable.[14]

III. GENERAL OBLIGATION BONDS

In order to provide a more attractive investment and to make it feasible for small towns to issue bonds, an act was passed in 1955 authorizing the issuance of general obligation bonds. These bonds carry a pledge of the municipality's full faith and credit and taxing power for their payment, thus constituting an "unconditional promise to pay" as required by the NIL. The proceeds of these bonds may be used for the purchase, construction, or addition to industrial buildings for lease to industrial concerns. The interest income produced by this type bond is also exempt from federal income taxation.

If a municipality desires to issue bonds under this act, it must apply to the Building Finance Committee of the Tennessee Industrial and Agricultural Commission for a "Certificate of Public Purpose and Necessity."[15] After this is granted, the bond issue must be authorized, on the specific terms approved by the committee, by a referendum in which the same is approved by a three-fourths majority of those voting.

The 1955 act, insofar as it authorizes municipalities to pledge their full faith and credit and taxing power, presents a very basic legal question: Is the expenditure for industrial buildings an expenditure of public funds for a public purpose? As heretofore pointed out, the 1951 act was held constitutional because it did "not authorize the use of moneys raised by taxation" for the accomplishment of what the court termed an "incidental public purpose."

A county, town, city, or other political subdivision has no power to impose taxes except where it is granted such power by the state constitution or has been authorized by legislative action.[16] One of

14. Lyman v. Chase, 178 Minn. 244, 226 N.W. 633 (1929); Kinney v. City of Astoria, 108 Ore. 514, 217 Pac. 840 (1923). Note, *Incentives to Industrial Relocation: The Municipal Industrial Bond Plans*, 66 HARV. L. REV. 898 (1953).

15. The committee is charged with the duty of investigating and determining the following: (1) that there are sufficient natural resources available for the use and operation of the particular industrial building and enterprise for at least ten years; (2) that there is available a labor supply to furnish at least one and one-half workers for each operative job within an area of twenty-five miles; and (3) that there are adequate property values and suitable financial conditions so that the total bonded indebtedness of the municipality, for industrial building purposes, shall not exceed ten per cent of the total assessed valuation of all the property in the municipality. TENN. CODE ANN. § 6-2906 (Supp. 1960).

16. Union Ice & Coal Co. v. Ruston, 135 La. 898, 66 So. 262 (1914); City

the areas traditionally forbidden is the levy of a tax to assist a private enterprise.[17] This limitation grew out of public spending in aid of railroads in the early 1830's. The corruption, over-extension of public credit, and attempted repudiation of the public debts are now a part of our history. States, in attempting to prevent a repeat performance, have included prohibitions in their constitutions[18] or have passed statutes prohibiting a loan of credit for private enterprise.

The Supreme Court of the United States gave recognition to the public purpose limitation upon municipal taxation in *Loan Association v. Topeka*.[19] The Court did not base its decision on the due process argument but rather treated it as an inherent limitation of government.

Tennessee has given recognition to the public purpose limitation in its constitution and its case law. Article 2, section 29 sets forth the limitation under which taxing power can be conferred by the General Assembly upon counties and towns. It provides:

> The General Assembly shall have power to authorize the several counties and incorporated towns in this State, to impose taxes for County and Corporation purposes respectively, in such manner as shall be prescribed by law. . . . But the credit of no County, City or Town shall be given or loaned to or 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 provision was interpreted by the Tennessee Supreme Court in *Ferrell v. Doak*,[20] which tested the constitutionality of a private act empowering the town of Lebanon to issue bonds to be used in the construction of a building to be leased to a box manufacturer. The bonds were to be secured by the taxing power and credit of the town of Lebanon. In applying the public purpose doctrine, the court stated:

> However commendable the proposed movement, it must be and is frankly conceded that public funds to be provided by taxation may be

of Boston v. Merchants Nat'l Bank, 338 Mass. 245, 154 N.E.2d 702 (1958); Eisenstadt v. Suffolk County, 331 Mass. 570, 120 N.E.2d 924 (1954); Prince v. Crocker, 166 Mass. 347, 44 N.E. 446 (1896); and Opinion of the Justices, 155 Mass. 598, 30 N.E. 1142 (1892). See also Antieau, *Municipal Power to Tax—Its Constitutional Limitations*, 8 VAND. L. REV. 698, 733 (1955).

17. Laughlin v. Portland, 111 Me. 486, 90 Atl. 318 (1914), and cases cited in note 16 *supra*.

18. TENN. CONST. art. 2, § 29; N.C. CONST. art. v, § 3.

19. Loan Ass'n v. Topeka, 87 U.S. (20 Wall) 655 (1874). See also Cole v. LaGrange, 113 U.S. 1 (1885); Dodge v. Mission Tp., 107 Fed. 827 (8th Cir. 1901); Manning v. Devils Lake, 13 N.D. 47, 99 N.W. 51 (1904); Bolton v. Wharton, 163 S.C. 244, 161 S.E. 454 (1931).

20. Ferrell v. Doak, 152 Tenn. 88, 275 S.W. 29 (1925).

> expended only for a public purpose, and, unless the purpose in view may be reasonably so classified, the act conflicts with article 2, section 29, of our Constitution. By this section the General Assembly is empowered to authorize incorporated towns to impose taxes for corporation purposes only. Is the proposed purpose a corporation; that is, public purpose?[21]

In answering this question the court recognized it to be

> well settled that taxation cannot be imposed for the purpose of establishing, aiding, or maintaining private business enterprises whose sole object is private emolument of the proprietors, no matter how beneficial to the community such enterprises may be.[22]

Thus in 1925 the proposed expenditure of funds for the purpose of bringing an industry to Lebanon by constructing a building was not an expenditure for a public purpose.

In 1955 the legislature of Tennessee empowered towns, cities, and counties to tax for the payment of bonds issued to build industrial buildings. The constitutional validity of this act was questioned in *McConnell v. City of Lebanon.*[23] The trial court held that the bonds issued under this act were for a public purpose and "even though for the sole private purpose to aid private industry, yet since the bonds were issued pursuant to the terms of the statute and ratified by a three-fourths vote in the referendum election . . . they would be valid."[24] The Supreme Court of Tennessee upheld the chancellor in the first of these holdings but found that in order for the bond issue to be a valid pledge of the taxing power, the purpose must be a public purpose. The court, in construing Article 2, section 29, held that the first sentence, declaring that any grant of taxing power must be for municipal or county purposes, prevailed over the latter portion of the section which seemed to authorize use of taxing power for any purpose provided the purpose be sanctioned by three-fourths vote. The question before the court in the later case was the same as that in *Ferrell v. Doak*: Is the proposed purpose a public purpose? In *McConnell* the court recognized that "our own cases declare that what is a county or corporate purpose is incapable of an exact and all-inclusive definition and that each case must turn upon its own facts."[25] The court reviewed various Census Bureau statistics and newspaper stories regarding county and state migration and stated:

> [W]e have presented to us a situation that is quite different from that

21. 152 Tenn. at 90, 275 S.W. at 29.
22. 152 Tenn. at 96, 275 S.W. at 31.
23. McConnell v. City of Lebanon, 203 Tenn. 498, 314 S.W.2d 12 (1955).
24. 203 Tenn. at 504, 314 S.W.2d at 15.
25. 203 Tenn. at 510, 314 S.W.2d at 17.

> existing 30 years ago [apparently referring to the *Ferrell v. Doak* age]. It is the difference between a mere incident and a virtual crisis. Thus becomes applicable the principle of constitutional law that a legislative enactment may be held unconstitutional under one set of facts and constitutional under another set of facts. . . . Hence, we do not overrule *Ferrell v. Doak* . . . .[26]

The court then specifically holds that the "statute and the proceedings of the town of Lebanon thereunder are not in violation of Art. II, Section 29 of the Constitution of this State."

Since the court refused to overrule *Ferrell v. Doak,* the holding in *McConnell v. City of Lebanon* as to the constitutionality of the act based on the existence of a crisis appears to be limited to the town of Lebanon for that particular period of time. The court held that there was an employment and migration crisis in Lebanon and Wilson County which converted the pledge of taxing power from the private purpose of aiding Hartmann Luggage Co. to a public purpose of alleviating the unemployment and migration situation.

Quaere, under the *McConnell* holding is it not necessary for there to be what is tantamount to a "crisis" in a city or other governmental subdivision before a pledge of taxing power can be said to be for a public purpose? Are we to apply literally the rule stated by the court that "what is a county or corporate purpose is incapable of an exact and all-inclusive definition and that each case must turn upon its own facts"? If this be true, would the holder of a bond issued under the 1955 act be able to determine the extent of the municipality's liability thereon without having a judicial determination "upon its own facts"?

Many areas of our state are industrializing at a rapid rate. Where there is an influx of people to an area, with no appreciable unemployment problem, and no real deficit in per capita income in that area as related to the national average, it seems that it would be very difficult to establish a "crisis" sufficient to convert aiding private business into a public purpose.

IV. Comparable Legislation Within the Region

Other states in the region, Alabama,[27] Arkansas,[28] Kentucky,[29] Louisiana,[30] and Mississippi,[31] have provided for financing industrial building.

26. 203 Tenn. at 514, 314 S.W.2d at 19.
27. Ala. Code. Ann. tit. 37 § 511 (20) (1951).
28. Ark. Const., Amend. No. 49.
29. Ky. Rev. Stat. Ann. § 103.200 (1955).
30. La. Const., art. 14, § 14 (b.2) (1952).
31. Miss. Code Ann. § 8936-01 (1953).

Alabama has legislation similar to the 1951 Tennessee act, authorizing revenue bonds payable solely from rentals, and an Industrial Development Corporation act hereinafter discussed. In *Newberry v. City of Andalusia*,[32] the revenue bond act was held constitutional; the bonds did not come under the constitutional definition of "municipal indebtedness."

Arkansas has provided for the issuance of similar bonds by constitutional amendment. This power is limited to cities of first or second class[33] and counties. The question must be submitted to referendum and must pass by vote of a majority of the qualified electors voting on the question. The amendment also provides that the issuing governmental unit *may* levy a special tax for the discharge of the indebtedness.

The Kentucky act authorizes the issuance of industrial revenue bonds without the pledge of municipal credit. Approval of an issue in Kentucky is by ordinance of the legislative body of the municipality. The constitutionality of this act was upheld in *Faulconer v. City of Danville*.[34]

The Louisiana constitutional amendment provides for issuance of general obligation bonds up to twenty per cent of the assessed valuation of the taxable property of the issuing municipality. The validity of this amendment was upheld in *Miller v. Police Jury*, 226 La. 8, 74 So. 2d 394 (1954), as being in the "public interest."

The only legislation in Mississippi authorizes issuance of general obligation bonds. The full faith and credit of the municipality is pledged with a twenty per cent limitation of the total assessed valuation of the property of the municipality. This act was upheld by *Albritton v. City of Winona*[35] which declared relieving unemployment to be a public purpose.

V. ALTERNATIVE METHODS OF FINANCING

In Alabama,[36] Arkansas,[37] and Tennessee[38] an additional method of industrial financing has been provided by legislation authorizing the organization of Industrial Development Corporations. Under these acts a municipality or county may establish an industrial board which obtains a charter of incorporation from the Secretary of State in the same manner as any other corporation. This corporation may

32. Newberry v. City of Andalusia, 257 Ala. 49, 57 So. 2d 629 (1952).
33. Cities with population over 105,000.
34. Faulconer v. City of Danville, 313 Ky. 468, 232 S.W.2d 80 (1950).
35. Albritton v. City of Winona, 181 Miss. 75, 178 So. 799 (1938).
36. ALA. CODE ANN. tit. 37 § 815 (1959).
37. ARK. STAT. ANN. § 9-516 (1956).
38. TENN. CODE ANN. § 6-2801 (Supp. 1960).

issue bonds payable solely from revenues realized from the lease or sale of industrial buildings. This act also provides that the corporation may issue another type bond which, given authority by the municipality, may pledge the full faith and credit of the municipality to payment of the bonds. Authority to pledge the full faith and credit of a municipality under this act is contingent upon obtaining a "Certificate of Public Purpose and Necessity" from a state agency in the same manner as under the 1955 Tennessee Industrial Building Bond Act.

No cases have been decided under the Tennessee act; however, in Arkansas, *Halbert v. Helena-W. Helena Industrial Dev. Corp.*[39] established the constitutionality of a similar act after striking therefrom the provision for the corporation to pledge the municipal credit. The court indicated that this would be permitting cities, towns, and counties to do indirectly what they could not do directly, namely, to grant financial aid to private businesses or corporations.

VI. Conclusion

In attempting to evaluate the industrial building finance program, it must be recognized that the advantages are not without some correlative defects. Generally, the advantages of such a program from the industry's viewpoint are:

(1) The legislative enactments provide a source of financing, in addition to ordinary sources of capital, for the firm interested in expanding or relocating without tying up its capital in fixed investments of building and equipment.

(2) An ad valorem tax advantage is gained by the industry since under the rental agreement the building (and equipment in some states) is the property of the municipality and exempt from local taxation.

(3) A further tax advantage may accrue to the industry since in many cases the industry itself purchases a portion of the revenue or general obligation bonds and the interest income produced is not subject to federal income taxation.

As far as the states are concerned, an advantage is gained by having such laws over competing states in the region not having industrial building legislation when the firm considering moving its location is also seeking some financial assistance. This may well be the decisive factor persuading a firm to choose a particular locale.

39. Halbert v. Helena—W. Helena Industrial Dev. Corp., 226 Ark. 620, 291 S.W.2d 802 (1956).

The opponents of the legislation generally point out the following disadvantages:

(1) Public funds at lower interest rates are placed in competition with private funds and may tend to displace such funds rather than to complement them.

(2) The use of the same type financing (general obligation bonds specifically) which is used for financing conventional public projects, such as schools, roads, water systems, etc., for the purpose of financing plants for private industry is considered by many a departure from the traditional sphere of municipal activity which may lead Congress to re-examine the tax exempt status of municipal bonds.[40] Also, this could seriously hamper the ability of a community to finance more conventional municipal projects if industrial building financing were to absorb the percentage of tax base allowed by the constitution or statutes for total municipal indebtedness.[41] This problem is magnified when one realizes that a new plant and additional population which it attracts will increase the need for roads, schools, and other public facilities.

(3) The existence of municipally owned buildings, exempt from local property taxes, grants the company which occupies them an unfair tax advantage over the industry financing its own building; furthermore, it dilutes the community tax base. In the event of failure of a firm occupying municipal buildings, it would be necessary for the municipality to meet bond obligations resulting in an increase in the tax rate or payment from public funds, thus imposing an additional burden on a self-financing industry which might prove to be a deterrent to future industry location.

Proponents of public industrial building financing justify their position by pointing to the need to supplement private investment and to raise the level of per capita income in areas which have chronically suffered from this condition. The view one adopts of such financing is often couched on the high theme of free enterprise versus governmental participation. Yet the problem may also be viewed from the perspective of the South and its immediate needs. In the long run, it might well be that this program will have served to furnish a starting point for the process of development which would lead to enhanced opportunities for private funds and may have within its structure some elements of its own departure.

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40. SURREY & WARREN, FEDERAL INCOME TAXATION 175-200 (1960); Ratchford, *Revenue Bonds and Tax Immunity*, 7 NAT'L TAX J. 40 (1954); Note, *Legal Limitations on Public Inducements to Industrial Location*, 59 COLUM. L. REV. 618, 637 (1959).

41. *E.g.*, TENN. CODE ANN. § 6-912 (1956), which limits a municipality's total bonded indebtedness to fifteen per cent of the assessed property valuation.