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Irvin Long
Member of Detroit bar

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THAT branch of municipal bond litigation in which the character and validity of the obligations is involved has usually been conducted in the federal courts. Bondholders pressing for payment of their defaulted bonds usually are nonresidents of the state where the city, county or other defaulting municipality is located. Varying and contradictory state court decisions taught them that no settled rule of decision in the state courts could be expected. The arguments of their counsel, which many of the earlier volumes of the Supreme Court reports preserve, show that they distrusted a judiciary elected for short terms, as was the case in most of the states where repudiations occurred, and expected that judgments in state courts would be influenced by the prevailing popular clamor for public debt relief, resentment against the so-called moneyed interests, etc. As a result, the federal courts have taken the lead in formulating rules, which so far have furnished a comprehensive guide for the decision of almost every question that can be presented concerning a bond of this character. Incidental to such development, the federal judiciary on many occasions found itself unable to agree with state court decisions, which ordinarily it would have considered itself bound to follow. This class of cases has constituted perhaps the most numerous and important exception to the rule laid down in section 34 of the Federal Judiciary Act[1] of 1789. The new vigor with which the Supreme Court[2] has invested section 34 must now give investors in public bonds some concern as to whether in the future they can look to the national courts with as much confidence as they have in the past.

It is well known that validity of a municipal bond must depend upon some express grant of authority from the state legislature. These corporations do not have plenary powers to borrow money and emit notes or bonds as evidence of indebtedness. Many limitations are im-

* A.B., LL.B., Michigan. Member of Detroit bar.—*Ed.*

[1] 1 Stat. L. 92, Rev. Stat., § 721, 28 U. S. C. (1934), § 725: "The laws of the several States, except where the Constitution, treaties, or statutes of the United States otherwise require or provide, shall be regarded as rules of decision in trials at common law, in the courts of the United States, in cases where they apply."

[2] Erie R. R. v. Tompkins, 304 U. S. 64, 58 S. Ct. 817 (1938).

posed upon the exercise of this power, as to conditions which must exist, procedure to be followed, and purpose of the borrowing. Often great obscurity is encountered in governing statutes, and many perplexing questions can arise as to whether such statutes are constitutional. If unconstitutional, it must logically follow that the law is a nullity, and the bonds or other securities issued under it void. Equitable considerations based upon retention and use of the bond proceeds, recognition and acquiescence, cannot be relied upon to make an ultra vires municipal bond good.

Few investors in this type of securities realize the important role played by the United States Supreme Court and the various circuit courts of appeals in formulating the law which protects their bonds and makes them enforceable. Had there been no federal courts vested with jurisdiction to decide cases involving these obligations, and rightly or wrongly willing to disregard state precedents on the subject, there would be little respect for municipal securities as enforceable obligations, without which municipal financing would have been paralyzed. Starting with the famous case of *Gelpcke v. Dubuque*,[3] relating to Iowa railroad aid bonds, hardly a term of the Supreme Court has failed to present cases in which the Court was obliged to pass on the validity of municipal obligations, against every possible defense which a hard-pressed debtor could present. Professor Warren, in his work on the Supreme Court, discussing particularly the Court's disposition to exercise an independent judgment upholding these obligations notwithstanding adverse state court decisions, says:[4]

> "While it was difficult to reconcile this equitable doctrine with the duty imposed on Federal Courts by the Thirty-Fourth Section of the Judiciary Act to follow the laws of the State, and while from time to time the Court advanced varying grounds for its action, nevertheless, it continued for the next twenty years consistently to disregard opinions of the State Courts denying the validity of these municipal railroad aid bonds, to formulate its own commercial law on the subject, and to discountenance every form of attempted repudiation of debt. While the doctrine thus firmly asserted by the Court had an inestimable effect upon the material and moral prosperity of the country in restoring confidence in a class of securities which were an indispensable factor in the development of municipal and industrial enterprises, it

[3] 1 Wall. (68 U. S.) 175 (1864).

[4] 2 WARREN, THE SUPREME COURT IN UNITED STATES HISTORY, rev. ed., 530-531, 532 (1932).

became, on the other hand, a somewhat serious factor in the history of the relations of the Court to the American people. . . . That the Court had taken a position in the bond cases which must bring it into disfavor with large portions of the public had been predicted at the outset by Judge Miller in his strong dissenting opinion in the *Gelpcke Case*; and the fulfillment of his prophecy was seen in the numerous clashes which ensued during the next thirty years, and which resulted in bringing before the Court for its decision during that period approximately three hundred municipal bond cases—a larger number than on any other subject presented for its consideration."

The *Gelpcke* opinion contained the vigorous, if intemperate, language of Judge Swayne, as follows:

"We shall never immolate truth, justice and the law, because a State tribunal has erected the altar and decreed the sacrifice."[5]

The situation presented in this and many other cases which immediately followed it involved hardship both to the bondholders and taxpayers of the various states whose municipalities had gone wild in issuing railroad aid bonds. The bonds originally were issued to railroads either as an outright donation, or in connection with stock subscriptions. The expected benefit which the location of a railroad in or near the county, city, town, etc., would confer was considered to justify the creation of the debt. In many cases the road was never built, but more often it merely failed to produce the incidental benefits expected. The construction companies which obtained the bonds were not very successful in selling them, until the state supreme courts had been persuaded to rule that the laws empowering the issuance of these bonds were constitutional, and frequently the decisions so ruling were accompanied by vigorous minority dissents. The favorable court rulings, even though by divided courts, were then accepted by investors (or speculators) as assurance that the laws were constitutional and would be so held when the date of reckoning arrived. Their expectations were doomed to disappointment, for in state after state the courts of last resort changed their opinions and held the laws invalid, thus cutting away the authority for the issuance of the bonds and requiring decisions against bondholders. Creditors turned to the federal courts for enforcement, and convinced the Supreme Court that it must exercise an independent judgment on the constitutionality of the state law,

[5] Gelpcke v. Dubuque, 1 Wall. (68 U. S.) 175 at 206-207 (1864).

and was not obliged to follow the last decision of the state court on the subject.[6]

The cases in which the Supreme Court exercised this independent judgment are so numerous and the opinions so varying that it is possible to gather therefrom several lines of reasoning. In the *Gelpcke* case it is clear that the Supreme Court considered the statute in question to be no violation of the state constitution, although it used some language which might indicate a belief that the bondholder had acquired by virtue of the earlier decisions a vested right, which a change of judicial opinion could not impair, a doctrine which the Court later expressly repudiated. In the many cases involving the question whether railroad aid was a public or private purpose, the Court admitted that any statute authorizing the lending of public credit for a private enterprise would violate the state constitutions, but differed with the state courts in holding that aid to railroads, either by stock subscription or outright donation, was a private purpose. It would be useless now to thresh over the arguments pro and con on this subject. It is sufficient to say that the earlier state decisions, and the Supreme Court decisions, held that a railroad was no different from a canal or turnpike, which assuredly was a public improvement. Although the railroad was privately owned and managed, its public character was evident from the fact that its rates could be regulated, and it was granted powers of eminent domain. The later state court opinions emphasized the private ownership characteristic and could see no difference between a railroad and any other private enterprise. In placing its decision on the ground that railroad aid was a public purpose, notwithstanding the state court's contrary decision, the Supreme Court frequently said that it was not construing or interpreting the state constitution, but merely holding as a matter of common law that the purpose was public, thus cutting away the constitutional objection. In exercising an independent judgment on what was public and private, it was merely applying the doctrine of *Swift v. Tyson*,[7] i.e. exercising an independent judgment in matters of general law.

As a result of these decisions, the following rules have long been recognized:

1. If it is clear that the constitution or statute had prior to the

[6] A collection of the many cases in which the Supreme Court and circuit courts of appeal have exercised an independent judgment, where the constitutionality of the bond statute, or its interpretation, is involved, may be found in 97 A. L. R. 515 (1935).

[7] 16 Pet. (49 U. S.) 1 (1842).

issuance of the bonds been construed in a manner adverse to the contentions of the bondholder by the state court, and subsequent decisions were consistent therewith, the federal court should not exercise an independent judgment. The court decisions were given the same effect as a clarifying amendment in the constitution or statute. In that type of case the court stayed well within the provisions of section 34 of the Judiciary Act.

2. Where a bondholder's right accrued at a time when state court decisions were favorable to such right, and subsequent state court decisions were unfavorable, federal courts must exercise their independent judgment. In doing so, they should give the subsequent state court decisions attention as precedents, but should be free to decide adversely thereto, though in cases evenly balanced with doubt adherence to the rule laid down by the state court is suggested.

3. Where at the time of the accrual of the right, the state court decisions furnished no guide as to the interpretation to be given to the statutory or constitutional provision, but subsequent state court decisions are adverse to the right asserted by the bondholder, the federal court is free to follow its independent judgment as to the proper interpretation, although as above stated, it should in a case evenly balanced with doubt lean to agreement with the state court.

So numerous have been the cases in which these rules have been applied that almost every conceivable circumstance has been encountered, and the rule has been by no means confined to municipal bond cases. Many times a circuit or district court had construed a state constitution or statute favorable to the claims of one of the parties, and on appeal the successful party was faced by an intervening decision of the state supreme court adverse to his contention. Sometimes one may suspect that the state court case was more or less fictitious, and rushed through the state court in order to have a supposedly binding precedent to cite to the federal court.

Aside from matters pertaining to interpretation of statutes authorizing municipal bond issues and their constitutionality, is the ever-recurring question of the effect of bond recitals. A municipal bond, or other instrument of indebtedness, would be a curiosity if it did not contain a recital that the bond complied with all provisions of the law under which it was issued, the charter of the city or town, the happening and performance of all conditions precedent, and that it was within every debt limit provision of the statutes and constitution. Notwithstanding careful examination of bond proceedings by counsel for

investment bankers who underwrite the issues, these recitals are of the utmost importance to the investor. The attorney who examines the proceedings may err in interpreting the law as to the procedure to be followed, and such errors frequently are understandable, due to ambiguity in the governing statutes. Sometimes municipal officers cast their proceedings in a legal form, but fraudulently conspire to issue the securities for an illegal purpose. Sometimes the fact which must exist in order that the power may be lawfully exercised rests upon so many outside circumstances that no certain determination can be made with respect thereto.[8] In all such situations the recitals must be relied upon to estop the issuing body to assert invalidity of the obligations because of the improper or unlawful exercise of the power.

Many years of litigation in the federal courts have developed rules in those courts which protect the innocent bondholder, or one succeeding to his rights, against the assertion of any fact or condition upon which an improper exercise of the power can be predicated, provided that such assertion is inconsistent with the recital and the bonds are signed or authorized by the proper officers. Federal court decisions on this subject have at least fulfilled Judge Story's expectation expressed in *Swift v. Tyson*, that substantial uniformity would result if federal courts would exercise an independent judgment in matters of general law, for state courts have in the main followed federal decisions in announcing rules relating to the subject of estoppel by bond recitals.[9] Some disagreement between state and federal courts has occurred in regard to how far a bondholder must go in examining public records and still maintain his position as a good faith holder, the federal court being more favorable to such holder than the state court, as might be expected.[10] In only one state does there appear to be a refusal to follow

[8] E.g., whether a project is a drain or a sewer, Royal Oak Drain District v. Keefe, (C. C. A. 6th, 1937) 87 F. (2d) 786; or whether road improvements are primarily for the benefit of private corporations or the public, Hillsborough County v. Keefe, (C. C. A. 5th, 1936) 82 F. (2d) 127. Apparently no definite criterion exists whereby such facts can be determined.

[9] 6 MCQUILLIN, MUNICIPAL CORPORATIONS, 2d rev. ed., § 2486 (1937), shows that at least 18 states, and perhaps others, adhere to general rules laid down by the federal courts on the subject of the effect of bond recitals. Missouri seems to disagree with the federal courts on the subject, its courts requiring proof, other than the recitals, of the happening and existence of conditions precedent, even when the bonds are held by bona fide purchasers.

[10] Town of Newbern v. National Bank, (C. C. A. 6th, 1916) 234 F. 209, L. R. A. 1917B 1019. The decision in this case rests upon Swift v. Tyson. If the question were presented today, it is apparent that a contrary opinion would have to be given.

federal rules on the subject, and a requirement of independent proof of the existence of all conditions precedent in order that judgment on the bonds may be entered.

Now that *Swift v. Tyson* has been declared erroneous, what may a holder of municipal bonds expect will be the future course of decisions on questions so important to his security? Will the federal courts be bound to accept the last state court decision on the subject as the law governing his rights? If so, is there any advantage in resorting to the federal court for enforcement? If a good case on municipal obligations as the law stood at the time the bonds were purchased can be frustrated by some intervening decision of the state court, which the federal court is bound absolutely to follow, the bondholder may as well sue in the state court, where he may at least hope to convince it of the error of its adverse decision.

The majority of the Court certainly held in the *Tompkins* case that federal courts are bound by the Constitution, in diverse citizenship cases, to look first to the state court decisions for a determination of the common-law principles applicable to the case. If the state court has authoritatively expressed itself, that ends the matter. The federal court, from the district to the Supreme Court, must adopt the position of an inferior state tribunal. If a statute authorizes the issuance of bonds for some purpose, which may or may not be public, the federal court must accept the last word of the state court on the subject. Although railroad aid bonds are no longer issued, there still are many opportunities for differences of opinion as to whether statutes authorizing bond issues are designed to benefit the public or some private enterprise. The recent decision of the Mississippi Supreme Court,[11] upholding a statute authorizing municipalities to borrow money for the purpose of erecting factories to be leased to persons, firms and corporations who will bring industries to the community, is an illustration of this. The vigorous dissent of one of the judges may become the controlling opinion in the future. If that happens, the bondholder can expect no greater redress in the federal court than he could in the state court, so long as the *Tompkins* case stands.

The rule of estoppel resulting from recitals has frequently been attacked on the ground that it permits municipal officers to nullify the very statutes or constiutional provisions intended for taxpayer protection. The attack has been met by an application of the rule that taxpayers must accept the burdens caused by the misrepresentations of

[11] Albritton v. City of Winona, (Miss. 1938) 178 So. 799.

their own agents, but the recurring controversies which arise on this subject prove that hope is still entertained that the estoppel rule will either be abolished or greatly restricted. A bondholder may never know when some other bondholder suing in the state court, through careless or inadequate presentation of his case, may permit the court to seriously weaken the rule, and thus require a federal court, which may later be obliged to pass upon some defense urged against his bonds, to adopt the modification imposed by the state court.

Judicial proceedings now authorized in many states, which may be taken for the purpose of obtaining decrees establishing as valid bonds which the municipality proposes to issue, may become a necessity to assure purchasers against defenses to their bonds, where the estoppel rule heretofore furnished such assurance. Even such decrees must be viewed with some caution, as it is doubtful whether they will protect the holder if a constitutional question is involved which was not litigated. In at least one state having such a procedure it has been held that such a decree does not cut off the defense of invalidity grounded on the proposition that it was intended to devote the proceeds to a primarily private use, unless the question was actually litigated.[12] The difficulty with such proceedings is that when taken the community wants to incur the indebtedness, and no one is disposed seriously to question the validity of the proposed bonds. Defenses are usually afterthoughts, developed when the day of reckoning approaches.

From the standpoint of the investor and the borrower, both of whom, at the time of the issuance of the bonds, desire that the obligations be legally incontestable, it will be unfortunate if a breakdown in public confidence in these securities occurs, because of a change in rules of decision in the federal courts. Much might be accomplished toward preserving this confidence if statutes were passed codifying the estoppel rule resulting from recitals, and caution exercised by counsel when asked to approve issues where any possible doubt exists as to constitutionality of purpose.

[12] State v. Town of Belleair, 125 Fla. 669, 170 So. 434 (1937).