# Coates' Canons Blog: Legality of Non-Voted Debt to Finance Capital Projects

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Several governing board officials, impressed by Team USA's recent performance during the group stage at the World Cup, suggest that the unit should capitalize on the wave of soccer-fever sweeping the nation as a means to promote economic development in the unit. They propose building a sports arena in order to attract a professional soccer team to the area. The officials believe that the location of a professional soccer team will serve as a catalyst for community spirit amongst the unit's citizens. And they hope that it also will serve as a catalyst for additional economic development—attracting new restaurants, hotels, retail and other development to the unit, thereby creating additional jobs and increasing the tax base.

The governing board discusses the proposed soccer arena at several meetings. It then votes to hire a national consulting firm with expertise in constructing arenas to design the project, estimate its cost, and help the governing board determine the best method to pay for the arena. At some point during the initial discussions about the project, it becomes apparent that there is vocal opposition to building the arena by a significant number of the unit's citizens. Some citizens speak out against the project during public comment periods at the board's meetings. Other citizens submit editorials to the local newspapers questioning the propriety of undertaking this type of project in such uncertain economic times. A few citizens take to the blogosphere to decry the waste of public funds on an unnecessary and improvident soccer arena, and one citizen even creates a Facebook page opposing the project. (The page has 800 fans to date.) Many of these citizens claim that because the unit will need to borrow funds to construct the arena, the board cannot, and should not, proceed with this project unless and until a majority of citizens voting in a referendum on the project approve. The citizens claim that **Article 5, Section 4 of the North Carolina Constitution**, which provides that a local government may not "contract debts secured by a pledge of its faith and credit unless approved by a majority of the qualified voters of the unit who vote thereon . . . [,]" prohibits the unit from borrowing money for this purpose without holding a voter referendum. Are these citizens correct?

No. The unit likely has four different legal options for borrowing money to fund the soccer arena project, and only one of the options requires voter approval. To understand why, it is helpful to take a closer look at the legal framework for local government debt.

**NC Constitutional Provisions Related to Debt**

The provisions of **Article 5, Section 4 of the North Carolina Constitution** authorize the General Assembly to enact general laws to allow local governments to borrow money. But, the constitutional provisions place one significant limitation on this authority—namely, with a few enumerated exceptions, a local government may not borrow money that is secured by a pledge of its faith and credit unless approved pursuant to voter referendum. Pledging a unit's "faith and credit" is defined as pledging its taxing power.

Note that the voter referendum requirement only applies when a unit pledges its taxing power as security for its loan. (The security for a debt is defined by reference to the contractual rights of the lender—what the lender can require the borrowing government to do or to give up should it fail to repay the loan.) The constitutional limitation is not triggered simply because a local unit uses its property tax or other local tax proceeds to repay a loan. *See* Wayne County Citizens Ass'n v. Wayne County Bd. of Comm'rs, 328 N.C. 24, 399 S.E.2d 311 (1991) ("What is being pledged as security is the constitutionally significant factor . . . . The possibility that appropriations which might include income from tax revenues will be used to repay the indebtedness under the contract is not a constitutionally significant factor.")

For example, if a unit wishes to finance the construction of a new wastewater treatment facility, one option available to the unit is to pledge the revenue stream generated from operation of the facility (wastewater fees and charges) as security for the loan. In the event that that the unit defaults on its loan repayments, the lender may require the government to increase its wastewater fees and charges, but it could not look to any other revenue source for payment. Thus, the unit is not constitutionally required to seek voter approval of the borrowing. This is true even if the unit generally uses property tax proceeds to make some or all of the debt service payments. The constitutional limitation only is triggered if the security pledged for a loan is the unit's taxing power.

**NC Statutory Provisions Related to Debt**

As stated above, the North Carolina Constitution authorizes the General Assembly to enact general laws that authorize local governments to borrow money and to establish the processes and parameters under which the debt transactions are structured.

North Carolina counties and municipalities currently may choose among five basic forms of security when they borrow money. The five forms of security correlate roughly with the five major authorized borrowing methods for local governments, although some methods allow for multiple types of security. The major authorized borrowing mechanisms are listed below, along with a brief description of each of their authorized forms of security. (Note that there are a few additional authorized borrowing mechanisms that may be used under certain circumstances.)

- *General Obligation Bonds (**G.S. 159, Art. 4**)*–Authorizes a local government to pledge its full faith and credit or unlimited taxing power as security for the bonds.
- *Revenue Bonds (including Special Assessment Revenue Bonds) (**G.S. 159, Art. 5**; **G.S. 153A, Art. 9A**; **G.S. 160A, Art. 10A**)*—Authorizes a local government to pledge the revenues from the debt-financed asset or system and to pledge the asset that is being financed. Also authorizes a local government to pledge the revenues generated from special assessments imposed on private property to pay for certain capital projects that benefit those private properties.
- *Installment Purchase Financings (**G.S. 160A-20**)*—Authorizes a local government to pledge the asset that is being financed.
- *Special Obligation Bonds (**G.S. 159I**)*—Authorizes a local government to pledge any unrestricted revenue sources other than local taxes under the unit's control. Also authorizes a local government to pledge the asset that is being financed.
- *Project Development Financings (**G.S. 159, Art. 6**)*—Authorizes a local government to pledge the incremental increase in property tax proceeds generated, at least in part, by new development in a defined area. (Note that this is not a pledge of a unit's taxing power. And, the pledge of the incremental property tax proceeds is specifically authorized by **NC Const. Art. 5, Sect. 14**.) Also authorizes a local government to pledge the asset or assets that are being financed and any additional unrestricted revenue sources other than local taxes under the unit's control.

Among these authorized debt mechanisms, the only one that requires voter approval, pursuant to the constitutional limitation, is the issuance of general obligation bonds because it is the only mechanism that authorizes a pledge of the full faith and credit of the unit. There are some exceptions to the voter referendum requirement even if the unit pledges its taxing power. The two most significant exceptions are refunding bonds—whereby the unit issues general obligation bonds to refund outstanding general obligation debt—and two-thirds bonds—whereby the unit issues general obligation bonds in an amount that does not exceed two-thirds of the amount by which the unit's outstanding indebtedness was reduced during the preceding fiscal year. (Note that there are certain statutory restrictions on the uses of proceeds from refunding bonds and two-thirds bonds.)

**Debt Options for Soccer Arena**

That brings us back to the proposed soccer arena project. What capital financing options are available to the local government? As a legal matter, the local government potentially could fund the project in the following ways:

- Issue general obligation bonds, secured by the taxing power of the unit.
- Impose special assessments on the properties that the governing board deems to be directly benefitted by the proposed project and issue revenue bonds secured by the revenue stream generated by the special assessment payments.
- Borrow proceeds from a lending institution and pledge the soccer arena as security for the installment purchase financing. (Note that if the project (or more precisely the local government's aggregate borrowing) exceeds a certain dollar threshold—currently $30 million—the unit likely would have to issue certificates of participation, pledging the soccer arena as security.)
- If the project is located in an area that currently is blighted or otherwise underdeveloped, the unit could designate a project development financing district and issue project development financing instruments that are secured by a pledge of the increased property tax proceeds generated in the district due to the new development in the district.

And, again, the only borrowing method that requires voter approval is the issuance of general obligation bonds to fund the soccer arena.

**Voluntary Voter Referendums?**

Given the vocal opposition to the proposed soccer arena project by a number of the unit's citizens, could the governing board voluntarily decide to hold a voter referendum on the project, or on the proposed capital financing method, even if a referendum is not statutorily required? The answer to this question likely is no. A local government needs specific authority from the General Assembly to authorize a voter referendum. None of the authorized debt mechanisms, other than the issuance of general obligation bonds, authorizes a governing board to seek direct voter approval in the form of a voter referendum.

**Conclusion**

Which of its available financing options, if any, a local unit chooses to fund a capital project will depend on a number of factors—including the legal procedures and requirements; the feasibility of finding a market for the debt at a reasonable interest rate; whether or not the unit will be able to secure approval from the State's Local Government Commission (if required); and the costs and burdens associated with the borrowing transaction. An additional consideration for many local units is whether or not the governing board wishes to seek direct voter approval before incurring debt.

But a unit only is required (and authorized) to seek explicit voter approval through a referendum before borrowing money if the unit intends to issue general obligation bonds. A unit does not have to hold a voter referendum before issuing general obligation bonds if one of the enumerated exceptions in **G.S. 159-49** applies. Furthermore, a unit may not hold a voter referendum on a proposed borrowing if it intends to use a borrowing mechanism that does not pledge the unit's taxing power.

# Links

- statelibrary.ncdcr.gov/nc/stgovt/article_v.HTM
- www.ncleg.net/EnactedLegislation/Statutes/HTML/ByArticle/Chapter_159/Article_4.html
- www.ncleg.net/EnactedLegislation/Statutes/HTML/ByArticle/Chapter_159/Article_5.html
- www.ncleg.net/EnactedLegislation/Statutes/HTML/ByArticle/Chapter_153A/Article_9A.html
- www.ncleg.net/EnactedLegislation/Statutes/HTML/ByArticle/Chapter_160A/Article_10A.html
- www.ncleg.net/EnactedLegislation/Statutes/HTML/BySection/Chapter_160A/GS_160A-20.html
- www.ncleg.net/gascripts/Statutes/StatutesTOC.pl?Chapter=0159I
- www.ncleg.net/EnactedLegislation/Statutes/HTML/ByArticle/Chapter_159/Article_6.html
- www.ncleg.net/EnactedLegislation/Statutes/HTML/BySection/Chapter_159/GS_159-49.html