



---

Winter 1-1-1980

## Municipal Finance: Conflicts of Interests and Their Effect on the Validity of Municipal Bond Issues

Follow this and additional works at: <https://scholarlycommons.law.wlu.edu/wlulr>



Part of the [Banking and Finance Law Commons](#)

---

### Recommended Citation

*Municipal Finance: Conflicts of Interests and Their Effect on the Validity of Municipal Bond Issues*, 37 Wash. & Lee L. Rev. 201 (1980).

Available at: <https://scholarlycommons.law.wlu.edu/wlulr/vol37/iss1/11>

This Note is brought to you for free and open access by the Washington and Lee Law Review at Washington and Lee University School of Law Scholarly Commons. It has been accepted for inclusion in Washington and Lee Law Review by an authorized editor of Washington and Lee University School of Law Scholarly Commons. For more information, please contact [christensena@wlu.edu](mailto:christensena@wlu.edu).

## MUNICIPAL FINANCE: CONFLICTS OF INTERESTS AND THEIR EFFECT ON THE VALIDITY OF MUNICIPAL BOND ISSUES

In recent years, state legislatures have passed new conflict of interests legislation intended to prevent public officials' personal interests in municipal business transactions.<sup>1</sup> At common law and under statutory authority, municipal contracts tainted by prohibited interests are either void in their inception or voidable at the discretion of the municipality.<sup>2</sup> As a result, bond counsel responsible for assuring that municipal bond issues comply

---

<sup>1</sup> See, e.g., CAL. GOV'T CODE §§ 1090-1097 (West 1966); MD. ANN. CODE art. 40A, §§ 3-101 to 3-108 (Supp. 1979); W. VA. CODE §§ 8-27-22 (1976), 13-2C-20 (1979), 13-2D-18 (1979), 16-26-21 (1979), 29-18-22 (1976), 31-15-12 (1975). See generally 2 J. DILLON, COMMENTARIES ON THE LAW OF MUNICIPAL CORPORATIONS § 772 (5th ed. 1911) [hereinafter cited as DILLON].

Both common and statutory law prohibit public officials' conflicts of interests. See *Trainer v. City of Covington*, 183 Ga. 759, \_\_\_, 189 S.E. 842, 842 (1937) (common law prohibition); *Githens v. Butler County*, 350 Mo. 295, \_\_\_, 165 S.W.2d 650, 652 (1942) (statutory prohibition). In *Githens*, a statute provided that no county official should be interested, directly or indirectly, in any county contracts. *Id.* at \_\_\_, 165 S.W.2d at 652. The defendant was a member of a county board which approved the sale of county property to the defendant's wife. *Id.* at \_\_\_, 165 S.W.2d at 651. The court found that the defendant's interest in the property purchased by his wife was prohibited under the statute, reasoning that the opportunity existed for self-dealing in public office. *Id.* at \_\_\_, 165 S.W.2d at 652-53. The court held the contract of sale void. *Id.*

<sup>2</sup> See, e.g., *Henderson v. McCormick*, 70 Ariz. 19, \_\_\_, 215 P.2d 608, 610 (1950) (contract voidable under statute); *Trainer v. City of Covington*, 183 Ga. 759, \_\_\_, 189 S.E. 842, 842 (1937) (contract void at common law). The purpose of the "void or voidable" rule is to discourage the exercise of conflicting interests. See text accompanying notes 9 & 12 *infra*. Therefore, the *Trainer* court, relying on the common law rule that municipal contracts tainted by conflicts of interests are void, struck down a contract between a city and its mayor for the purchase of a truck by the city. 183 Ga. at \_\_\_, 189 S.E. at 842. In *Henderson*, a state statute provided that city councilmen should not be interested in any sale made by them in their official capacity. 70 Ariz. at \_\_\_, 215 P.2d at 610. The statute further provided that a prohibited sale might be avoided at the instance of any person except the interested party. *Id.* A city councilman's agent purchased a truck from the city and local taxpayers brought suit to set aside the sale. *Id.* at \_\_\_, 215 P.2d at 609. The court concluded that the taxpayer failed to show any financial loss resulting from the sale, and, therefore, had no standing to sue for rescission of the sale. *Id.* at \_\_\_, 215 P.2d at 611.

Statutes which render contracts tainted by conflicting interests voidable represent a significant departure from the stringent common law rule nullifying such contracts. As the *Henderson* case illustrates, the statutory "voidable" rule provides courts with some discretion in determining whether tainted municipal contracts, especially those advantageous to the municipality, should be avoided. See 70 Ariz. at \_\_\_, 215 P.2d at 611. Where a contract is void under common law principles, an action for recovery in quantum meruit may be allowed, but where a contract is avoided under statute, an action brought in quantum meruit will likely be denied. See *Heese v. Wenke*, 161 Neb. 311, \_\_\_, 73 N.W.2d 223, 226-27 (1955). The distinction apparently is founded on the proposition that the public is presumed to know the written law while knowledge of common law principles arising out of public policy cannot fairly be presumed, especially where such presumption might operate to deprive an individual of his property. See *Town of Boca Raton v. Raulerson*, 108 Fla. 376, \_\_\_, 146 So. 576, 576-77 (1933). See generally Note, *Conflict of Interests: State Government Employees*, 47 VA. L. REV. 1034 (1961) [hereinafter cited as *State Government Employees*].

with requirements of law should consider the possible effect of conflicts of interests on the validity of such issues.<sup>3</sup> The existence of conflicts of interests in contracts underlying the issuance of municipal bonds may render the bonds void or voidable. Thus, bond counsel should familiarize themselves with methods which will insulate municipal bonds from challenges based on conflicting interests.<sup>4</sup>

Public policy forbids a public official's misconduct in office. A public official must serve only the public interest and may not abandon his duty in order to pursue personal interests at the expense of his constituency.<sup>5</sup> Common law and statutory prohibitions of conflicts of interests have developed in support of this policy.<sup>6</sup> In addition, the judiciary has created a prophylactic rule which voids municipal contracts tainted by conflicts of interests.<sup>7</sup> Courts have consistently applied the rule to supplement state

<sup>3</sup> See text accompanying notes 24-70 *infra*. See also W. VA. CODE §§ 13-2C-20 (1979), 13-2D-18 (1979). Section 13-2C-20 provides in pertinent part:

No member of . . . the governing body of a municipality issuing revenue bonds . . . shall have any financial interest, directly or indirectly, in the leasing, sale or other disposition of an industrial project or commercial project acquired, constructed or financed pursuant to [the Industrial Development and Commercial Development Bond Act].

The question arises whether a violation of these provisions is intended to invalidate issued bonds. See text accompanying notes 68-70 *infra*; *cf.* N.C. GEN. STAT. § 159C-16 (1976) (violation of conflicts of interests provision has no effect on validity of bonds issued).

<sup>4</sup> See text accompanying notes 71-91 *infra*. For an overview of the law relating to municipal bond financing, particularly the validity of bonds issued and the rights of holders, see 2 DILLON, *supra* note 1, §§ 870-961; 15 E. McQUILLIN, *THE LAW OF MUNICIPAL CORPORATIONS* §§ 43.01-43.161 (Rev. 3d ed. 1970) [hereinafter cited as McQUILLIN]. For an introduction to the practice of the municipal bond lawyers, see Greenberg, *Municipal Securities: Some Basic Principles and Practices*, 9 URB. LAW. 338 (1977); INVESTMENT BANKERS ASSOCIATION OF AMERICA, *FUNDAMENTALS OF MUNICIPAL BONDS* 121 (6th ed. 1968).

<sup>5</sup> See *Mayor of Ensley v. J.E. Hollingsworth & Co.*, 170 Ala. 396, \_\_\_\_, 54 So. 95, 96 (1910); *Strowbridge v. City of Chiloquin*, 130 Or. 444, \_\_\_\_, 280 P. 657, 658 (1929). In *Ensley*, a city councilman was a partner in a firm contracting with the city for sewer construction. 170 Ala. at \_\_\_\_, 54 So. at 96. The court concluded that the councilman had the duty to act in the interest of the municipality in negotiating the contract. *Id.* However, his partnership interest in the contract created a conflict between his personal interests and his public duty. *Id.* The court held the contract void as against public policy. *Id.*

<sup>6</sup> See note 1 *supra*. The prohibition of public officials' conflicts of interests arises out of theory borrowed from the law of trusts. *State Government Employees*, *supra* note 2, at 1034. A public official stands in a fiduciary relationship to the public. *Id.* See 2 DILLON, *supra* note 1, § 772; 10 McQUILLIN, *supra* note 4, § 29.97.

<sup>7</sup> See *City of Bristol v. Dominion Nat'l Bank*, 153 Va. 71, \_\_\_\_, 149 S.E. 632, 634 (1929); *Cimino v. Board of Educ.*, \_\_\_\_, W. Va. \_\_\_\_, \_\_\_\_, 210 S.E.2d 485, 488 (1974). In *Bristol*, the city entered a contract with one of its councilmen and others to exempt certain property from taxes. 153 Va. at 74-75, 149 S.E. at 632. A portion of the exempt property was owned by the councilman. *Id.* The court concluded that the councilman's participation in making the contract with himself was against public policy because of the temptation it created to profit through self-dealing. *Id.* at 79-80, 149 S.E. at 636. Therefore, the contract was not enforceable against the municipality. *Id.*

Municipal contracts tainted by prohibited interests generally are void even though the interested party did not approve the contract or otherwise participate in its negotiation. See *Trainer v. City of Covington*, 183 Ga. 759, \_\_\_\_, 189 S.E. 842, 842-43 (1937). Whether the

constitutional<sup>8</sup> and statutory<sup>9</sup> prohibitions of conflicts of interests where necessary to enforce public policy.<sup>10</sup>

---

contract is fair, free from fraud or even the best available opportunity for the municipality is of no consequence in determining the contract's validity. *Id.* See also 2 DILLON, *supra* note 1, § 773.

Although the result may be harsh, common law and statutory prohibitions of conflicts of interests are strictly enforced. Some courts seek to remove any opportunity for abuse of the public trust. See *State v. City of Cape May*, 60 N.J.L. 78, —, 36 A. 1089, 1090 (1897). In *Cape May*, the city council entered into a contract with a private company for the city's lighting. A council member held one share of the contracting company's stock as collateral for a debt owed him. *Id.* at —, 36 A. at 1091. The applicable conflict of interests statute did not discriminate as to the type or size of interests prohibited. *Id.* The court held the councilman's interest prohibited, concluding that measuring the different effects a given interest might have on different minds was impossible. *Id.* Since an illegal conflict of interest was present, the contract was void. *Id.* Other courts seem intent on removing even the appearance of impropriety in government. See *State Government Employees*, *supra* note 2, at 1034.

<sup>8</sup> See, e.g., MISS. CONST. art. 4, § 109. Section 109 provides that no public official shall be interested, directly or indirectly, in any municipal contract authorized by a governmental body of which he is a member. *Id.* This provision represents a broad constitutional prohibition of public officials' conflicts of interests. Most constitutional conflicts of interests provisions prohibit only public officials' interests in government printing and supply contracts. See, e.g., ARK. CONST. amend. 54; KY. CONST. § 247.

<sup>9</sup> See, e.g., MD. ANN. CODE art. 40A, §§ 3-101 to 3-108 (Supp. 1979); VA. CODE §§ 2.1-347 to 2.1-358 (1979). State statutes vary in their approaches to the problem of protecting government from the misconduct of public officials. Some state codes include a general conflict of interests provision which applies to all phases of government activity. See, e.g., CAL. GOV'T CODE §§ 1090-1097 (West 1966); Virginia Conflict of Interests Act, VA. CODE §§ 2.1-347 to 2.1-358 (1979). Other states attempt to prevent conflicts of interests in specific situations. See, e.g., W. VA. CODE §§ 8-27-22 (1976), 13-2C-20 (1979), 13-2D-18 (1979), 16-26-21 (1979), 29-18-22 (1976), 31-15-12 (1975). Some states employ a combined approach. See MD. ANN. CODE art. 40A, §§ 3-101 to 3-108 (Supp. 1979); MD. ANN. CODE art. 25, §§ 30-32 (1973); MD. ANN. CODE art. 41, §§ 14, 266 AA, 266 HH-12 (1978).

MD. ANN. CODE art. 40A, §§ 3-101 to 3-108 (Supp. 1979) represent a well-planned approach to the problem of public officials' conflicts of interests. Section 3-101 of this article is an extremely broad prohibition of government employees' conflicts of interests. MD. ANN. CODE art. 40A, § 3-101 (Supp. 1979). A public officer or employee may not participate in any matter in which he or a member of his immediate family has an interest or in which an organization of which he is an owner or employee is a party. *Id.* The term "interest" includes both financial and pure employment interests. *Id.*

<sup>10</sup> See *Rogers v. Sangster*, 180 Ark. 907, —, 23 S.W.2d 613, 614 (1930); *City of Bristol v. Dominion Nat'l Bank*, 153 Va. 71, 78, 149 S.E. 632, 634 (1929). The principal reason for supplementing conflict of interests statutes with the common law is the public policy of protecting government from self-dealing by public officials. See *id.*; text accompanying notes 5 & 6 *supra*. For example, in *City of Bristol*, the city entered a contract with a group of individuals, including a city councilman, to exempt certain property from taxes. 153 Va. at 74-75, 149 S.E. at 633. The councilman had abstained from voting on the contract because of his interest in the property. *Id.* at 74, 149 S.E. at 633. A state statute provided that no councilman should be interested, directly or indirectly, in any contract to be performed by the city he represented. *Id.* at 78, 149 S.E. at 634. The court read the statute in light of the common law which provides that contracts tainted by conflicting interests are void even though the interested party has not voted for approval of the contract. *Id.* at 79-80, 149 S.E. at 634-35. The court cited public policy as the basis for its construction of the statute and held the contract void. *Id.* at 80, 149 S.E. at 635.

Common law and statutes generally define a prohibited interest as a personal, financial interest in municipal contracts.<sup>11</sup> In order to constitute a financial interest, an interest must offer an opportunity for profit.<sup>12</sup> Therefore, courts have prohibited shareholders' interests,<sup>13</sup> partners' interests,<sup>14</sup> and employee interests in compensation dependent on employer profitability.<sup>15</sup> Some statutes, however, prohibit "any" interest or "being interested," omitting the word "financial."<sup>16</sup> Under these statutes, the range of prohibited interests is potentially much broader than at common law because interests which do not afford an opportunity for profit may come within the purview of the statute.<sup>17</sup> Common and statutory law forbid public officials' interests in municipal contracts whether direct or indirect.<sup>18</sup> Direct interests include an individual's interest in a personal con-

<sup>11</sup> See *City of Stuart v. Green*, 156 Fla. 551, \_\_\_\_, 23 So. 2d 831, 834 (1945); W. VA. CODE § 13-2C-20 (1979). Even where a statute expressly prohibits "any" interest in government contracts, courts may read the statute to prohibit only financial interests. See *Mumma v. Town of Brewster*, 174 Wash. 112, 116, 24 P.2d 438, 440 (1933). But see *Miller v. City of Martinez*, 28 Cal. App. 2d 364, \_\_\_\_, 82 P.2d 519, 522 (1938) (disqualifying interest need not be financial); MD. ANN. CODE art. 40A, § 3-101 (Supp. 1979); text accompanying notes 18 & 19 *infra*.

<sup>12</sup> See *Martin Bros. v. City of Concord*, 110 Cal. App. 2d 215, \_\_\_\_, 242 P.2d 406, 407 (1952).

<sup>13</sup> See, e.g., *Ganntt v. Arkansas Power & Light Co.*, 189 Ark. 449, \_\_\_\_, 74 S.W.2d 232, 233 (1934).

<sup>14</sup> See, e.g., *Mayor of Ensley v. J.E. Hollingsworth & Co.*, 170 Ala. 396, \_\_\_\_, 54 So. 95, 96 (1910).

<sup>15</sup> See, e.g., *Gland v. Mayor of North Arlington*, 13 N.J. Misc. 521, \_\_\_\_, 179 A. 380, 381 (1935); *Mumma v. Town of Brewster*, 174 Wash. 112, 116-17, 24 P.2d 438, 440 (1933).

Financial interests may take many other forms. See, e.g., *People v. Becker*, 112 Cal. App. 2d 324, \_\_\_\_, 246 P.2d 103, 104-05 (1952) (interest in insurance commissions paid on policy issued to corporation engaged in busing school children); *Githens v. Butler County*, 350 Mo. 295, \_\_\_\_, 165 S.W.2d 650, 652-53 (1942) (husband's interest in wife's purchase of property from municipality).

<sup>16</sup> See, e.g., MD. ANN. CODE art. 41, § 266 AA (1978); N.C. GEN. STAT. § 14-234 (1969). See 2 DILLON, *supra* note 1, at 1146 n.1; note 11 *supra*. Courts have taken two approaches to construction of statutes prohibiting "any interest" or "being interested." Compare *Panozzo v. City of Rockford*, 306 Ill. App. 443, \_\_\_\_, 28 N.E.2d 748, 752-53 (1940) and *Ganntt v. Arkansas Power & Light Co.*, 189 Ark. 449, \_\_\_\_, 74 S.W.2d 232, 233 (1934) with *Edward E. Gillen Co. v. City of Milwaukee*, 174 Wis. 362, \_\_\_\_, 183 N.W. 679, 681 (1921). The *Panozzo* court concluded that a state statute prohibiting "any" interest should be interpreted to preclude only "financial" interests in conformity with the common law. 306 Ill. App. at \_\_\_\_, 28 N.E. 2d at 752-53. Although a pure employment interest is not usually considered a financial interest, the *Gillen* court concluded that such an interest was prohibited under a statute which forbade "being interested" in certain contracts. 183 N.W. at 681.

<sup>17</sup> See *Byrne & Speed Coal Co. v. City of Louisville*, 189 Ky. 346, \_\_\_\_, 224 S.W. 883, 884 (1920); *Edward E. Gillen Co. v. City of Milwaukee*, 174 Wis. 362, \_\_\_\_, 183 N.W. 679, 681 (1921); note 16 *supra*. In *Byrne*, an employee of a coal company contracting with the city was also a member of the city council. 224 S.W. at 884. His interest as an employee was expressly prohibited under a statute providing that councilmen should not be directly or indirectly interested in any contract with the city. *Id.* A number of states have narrowed the coverage of these statutes by establishing a minimum value for interests prohibited. See N.C. GEN. STAT. § 159C-16 (Supp. 1979).

<sup>18</sup> See *Arthur v. Trindel*, 168 Neb. 429, 438, 96 N.W.2d 208, 215 (1959) (statutory prohibi-

tract with a municipality,<sup>19</sup> an owner's interest in a business contracting with a municipality,<sup>20</sup> and an employee's interest in the profits of a business contracting with a municipality.<sup>21</sup> An indirect interest includes any financial interest which might affect a public official's independent judgment in contracting on behalf of a municipality.<sup>22</sup> The definition of indirect interests provides courts with broad discretion in protecting the government from abuse by public officials. Thus, the connection between a public official's personal interest and a municipal contract may be attenuated, yet result in a prohibited interest.<sup>23</sup>

Although a municipality may avoid its obligations under municipal contracts tainted by conflicts of interests, the question remains whether the taint of conflicting interests will permit an issuer of municipal bonds to avoid its obligations on such bonds. When considering the effect of government misconduct on the validity of bonds, courts and legislatures treat municipal bonds differently from other municipal contracts for public policy reasons. Public policy requires that municipal officials deal fairly with the public, including bond purchasers. A municipality may not bor-

---

tion); *Terry v. Bender*, 143 Cal. App. 2d 198, 206-07, 300 P.2d 119, 125 (1956) (statutory prohibition discussed in light of common law derivation). See generally *State Government Employees*, *supra* note 2, at 1042-44. The question addressed by the prohibition of direct or indirect interests is the proximity of personal interest to government activity. See text accompanying notes 24 & 25 *infra*. A small minority of courts also have considered the size of a personal financial interest in determining whether the interest should be prohibited. See *Bourne v. Sullivan*, 104 N.H. 348, —, 186 A.2d 834, 838 (1962); *Jordan v. McCourt*, 135 W. Va. 79, —, 62 S.E.2d 555, 561 (1950) (sale of bolts and rivets worth \$1.30 considered *de minimis*). But see *State v. City of Cape May*, 60 N.J.L. 78, —, 36 A. 1089, 1090 (1897) (one share of stock held as collateral for debt constitutes prohibited interest). Moreover, where the interest of a public official is shared generally by his constituents, such as a community's interest in a contract for the lighting of city streets, such interest will not constitute a prohibited interest. See *Beale v. City of Santa Barbara*, 32 Cal. App. 235, —, 162 P. 657, 661 (1916); *Downs v. Mayor of South Amboy*, 116 N.J.L. 511, —, 185 A. 15, 15-17 (1936).

<sup>19</sup> See, e.g., *Town of Boca Raton v. Raulerson*, 108 Fla. 376, —, 146 So. 576, 577 (1933) (voiding town commissioner's sale of real estate to town); *Trainer v. City of Covington*, 183 Ga. 759, —, 189 S.E. 842, 842 (1937) (mayor's sale of truck to city held void).

<sup>20</sup> See, e.g., *Douglas v. Pittman*, 239 Ky. 548, —, 39 S.W.2d 979, 981 (1931) (board of education member's ownership interest in company contracting with board prohibited under statute).

<sup>21</sup> See, e.g., *Gland v. Mayor of North Arlington*, 13 N.J. Misc. 521, —, 179 A. 380, 380-81 (1935) (city councilman's employment interest in accounting firm contracting with city for services renders such contract void).

<sup>22</sup> *Terry v. Bender*, 143 Cal. App. 2d 198, 206-07, 300 P.2d 119, 125 (1956). Although direct interests are often quite obvious and their potential for conflict with public duty apparent, indirect interests are not so easily managed. Consequently, the courts have broadly defined indirect interests and have struck down most interests which present the possibility for abuse of public trust. See, e.g., *People v. Becker*, 112 Cal. App. 2d 324, —, 246 P.2d 103, 104-05 (1952).

<sup>23</sup> See *State Government Employees*, *supra* note 2, at 1034; note 22 *supra*. Some courts may use the flexibility inherent in the concept of prohibited indirect interests to remove the mere appearance of impropriety in government. *State Government Employees*, *supra* note 2, at 1034.

row from the innocent public and later refuse to repay on the ground that the bonds issued are invalid because tainted by government misconduct.<sup>24</sup> Furthermore, the efficient operation of government depends heavily on access to favorable financial markets.<sup>25</sup> If the existence of official misconduct invalidated municipal bonds, purchasers would be required to investigate every facet of bond issuance to discover irregularity.<sup>26</sup> Placing the responsibility of personal investigation on purchasers would impede municipal borrowing, limit the transferability of municipal bonds, and ultimately impair bond values.<sup>27</sup> Therefore, courts have protected bona fide holders of municipal bonds from financial loss resulting from defects in the bonds.

Under the common law doctrine of estoppel, a municipal issuer may not contest the validity of its bonds in the hands of a bona fide holder<sup>28</sup> or his

---

<sup>24</sup> *Bissell v. City of Jeffersonville*, 65 U.S. (24 How.) 287, 299-300 (1860). See *Driscoll v. Burlington-Bristol Bridge Co.*, 8 N.J. 433, —, 86 A.2d 201, 226, cert. denied, 344 U.S. 838 (1952). In *Driscoll*, a county commission had sold municipal revenue bonds to finance purchases of two bridges by the commission. *Id.* at —, 86 A.2d at 216. Alleging that the purchases contravened public policy, plaintiffs brought an action for rescission. *Id.* at —, 86 A.2d at 207. The court found that irregularity in the purchase of the bridges amounted to an abuse of the public trust, *id.* at —, 86 A.2d at 221, and concluded that the purchases should be set aside to the fullest extent possible, consistent with the rights of bond purchasers qualifying as holders in due course. *Id.* at —, 86 A.2d at 226. The bonds were enforceable in the hands of holders in due course, even though the bonds were wrongfully disposed of by public officials and notwithstanding irregularity, fraud or misconduct on the part of those involved in the purchase of the bridges. *Id.* The court ruled, however, that bonds held by those purchasers not qualifying as holders in due course were void and no obligation was to be recognized thereon. *Id.* at —, 86 A.2d at 235. The purchases underlying the bond issue were also void, but only to the extent that sellers of the bridge properties were required to disgorge their profits on the transactions. *Id.* at —, 86 A.2d at 234.

<sup>25</sup> *Driscoll v. Burlington-Bristol Bridge Co.*, 8 N.J. 433, —, 86 A.2d 201, 226 (1952).

<sup>26</sup> *Id.*

<sup>27</sup> See *id.* The *Driscoll* court reasoned that since municipal bond markets are geographically broad, it would be impractical in most cases for a purchaser to make the investigation necessary to protect himself from loss due to the invalidity of bonds. 8 N.J. at —, 86 A.2d at 226. An investigation requirement prior to purchase of municipal bonds would, therefore, restrict bond markets. *Id.* Furthermore, if the court were to invalidate municipal bonds because of irregularity in their issuance, municipalities would lose their access to favorable financial markets because of shaken investor confidence. *Id.* The court, therefore, concluded that it should not readily create exceptions to the general rule that a municipality may not challenge the validity of its securities in the hands of bona fide holders. *Id.*

<sup>28</sup> See *Cairo v. Zane*, 149 U.S. 122, 141 (1893); *Anderson County Comm'rs v. Beal*, 113 U.S. 227, 240 (1885). The common law rule of estoppel is founded on public policy of protecting innocent purchasers from official misconduct and protecting municipal access to financial markets. See *Driscoll v. Burlington-Bristol Bridge Co.*, 8 N.J. 433, —, —, 86 A.2d 201, 222, 226 (1952); text accompanying notes 24-27 *supra*. See generally Powe, *Rehearsal for Substantive Due Process: The Municipal Bond Cases*, 53 Tex. L. Rev. 738 (1975). The strength of the estoppel doctrine is exemplified by *Mercer County v. Hackett*, 68 U.S. (1 Wall.) 83 (1863). In *Mercer*, a Pennsylvania county issued bonds to finance construction of a rail line through the county. *Id.* at 83-84. The county attempted to show that the county commissioners had acted illegally in issuing the bonds. *Id.* at 86-87. The court held that as long as the bonds on their face did not betray non-compliance with the law authorizing issuance,

successor.<sup>29</sup> A bona fide holder is a good faith<sup>30</sup> purchaser for value<sup>31</sup> without notice of any defect<sup>32</sup> in the bonds. The determination of bona fide holder status often turns on the issue of "notice of defect."<sup>33</sup> Courts charge purchasers with notice of constitutional and statutory provisions authorizing the issuance of municipal bonds<sup>34</sup> and all matters disclosed on the face of such bonds.<sup>35</sup> If a purchaser has actual notice of any defect in municipal bonds or is charged with such notice, he will not qualify as a bona fide holder.<sup>36</sup> Courts, however, do not charge purchasers with notice of fraud,

---

Hackett, who was a non-resident, and other purchasers were not bound to search facts surrounding issuance of the bonds to discover defects in the bonds. *Id.* at 96. See generally 2 DILLON, *supra* note 1, at 1351-52; 15 McQUILLIN, *supra* note 4, §§ 43.78-43.161.

<sup>29</sup> See *Hackett v. Ottawa*, 99 U.S. 86, 95-96 (1878) (bona fide holder defined); *Board of Educ. of Carmen v. James*, 49 F.2d 91, 102 (10th Cir. 1931) (transferee of bona fide holder entitled to rights of such holder even though not otherwise qualified as bona fide holder). *But see Bolton v. Wharton*, 163 S.C. 242, —, 161 S.E. 454, 457-58 (1931) (bona fide holder is second or subsequent holder; original purchaser cannot qualify). See generally 2 DILLON, *supra* note 1, § 931.

<sup>30</sup> "Good faith" is honesty of intention and freedom from knowledge of circumstances which ought to put the holder upon inquiry. See *Siano v. Helvering*, 13 F. Supp. 776, 780 (D.N.J. 1936); note 52 *infra*.

<sup>31</sup> Negotiable Instruments Law § 25 (1896) defines "value" as any consideration sufficient to support a simple contract including an antecedent debt. See F. BEUTEL, BRANNAN'S NEGOTIABLE INSTRUMENTS LAW, § 25 at 128 (7th ed. 1948) [hereinafter cited as BEUTEL]. See note 63 *infra*.

<sup>32</sup> Negotiable Instruments Law § 56 (1896) defines "notice of defect" as actual knowledge of the defect or knowledge of such facts that one's actions in taking an instrument amount to bad faith. See BEUTEL, *supra* note 31, § 56 at 140.

<sup>33</sup> See, e.g., *Driscoll v. Burlington-Bristol Bridge Co.*, 8 N.J. 433, —, 86 A.2d 201, 224-26 (1952) (applying Negotiable Instruments Law § 57 (1896)). See notes 24 & 32 *supra*; note 47 *infra*.

<sup>34</sup> See *Life & Casualty Ins. Co. v. City of Florida*, 63 F.2d 195, 198 (5th Cir.), *cert. denied*, 290 U.S. 630 (1933) (statutory provision); *Union Bank of Richmond v. Commissioners of Oxford*, 119 N.C. 214, —, 25 S.E. 966, 967-70 (1896) (constitutional provision). See generally 2 DILLON, *supra* note 1, §§ 889-99 (particularly §§ 889 & 897).

Where there is no constitutional or statutory authority for the issuance of bonds, purchasers are charged with notice of the lack of authority and the consequent illegality of the bonds. See *Life & Casualty Ins. Co. v. City of Florida*, 63 F.2d 195 (5th Cir. 1933). In *Life & Casualty Ins. Co.*, appellant insurance company brought suit on street improvement bonds issued by a municipality for payment of principal and interest due. *Id.* at 196. A statute conferred power on the municipality to issue the bonds. *Id.* at 197. The statute, however, also provided that the bonds were not to be general obligations of the city, and set out those parties who were to be liable on the bonds. *Id.* at 197-98. The court concluded that the city was without power to incur the liability asserted by the appellant, held the appellant charged with notice of lack of authority, and denied recovery. *Id.* at 198.

Several courts have followed an alternative theory to reach the same result. These courts avoid the "notice" question by simply stating that bonds issued in the absence of municipal power to incur indebtedness or issue securities are void in their inception. See *Barnett v. Denison*, 145 U.S. 135, 139, 140 (1892); *Louisiana Savings Bank & Trust Co. v. Board of Supervisors*, 202 La. 176, —, 11 So. 2d 521, 523-24 (1942).

<sup>35</sup> See *McClure v. Township of Oxford*, 94 U.S. 429, 433 (1876); *City of McLaughlin v. Turgeon*, 75 F.2d 402, 406 (8th Cir. 1935).

<sup>36</sup> See, e.g., *Nesbit v. Riverside Independent Dist.*, 144 U.S. 610, 617-18 (1892); notes 34



misconduct, or similar irregularities in the issuance of municipal bonds.<sup>37</sup> In order to protect innocent purchasers and prevent disruption of municipal financial markets, the few courts which have considered the effect of conflicting interests on municipal bonds have applied common law estoppel to prevent the municipality's challenge to the validity of its bonds in the hands of bona fide purchasers.<sup>38</sup>

Estoppel by recital, a derivative of the more general common law estoppel, may provide additional protection for bona fide holders of municipal bonds.<sup>39</sup> Municipal issuers often recite, or state on the face of bonds, that all legal requirements for bond issuance have been met.<sup>40</sup> The rule of estoppel by recital provides that, if a municipality has the power to issue bonds, the municipality may not challenge the truth of its recitals even if the power of issuance has been improperly exercised.<sup>41</sup> Thus the doctrine of

& 35 *supra*. The *Nesbit* Court stated that a holder of municipal bonds was bound to take notice of the amount of taxable property within the municipality at the date of issuance of the bonds and was charged with knowledge of the overissuance of the bonds. *Id.* at 618. See 15 McQUILLIN, *supra* note 4, §§ 43-82 to 43-86.

<sup>37</sup> See *Mercer County v. Hackett*, 68 U.S. (1 Wall.) 83 (1863); *Driscoll v. Burlington-Bristol Bridge Co.*, 8 N.J. 433, —, 86 A.2d 201, 226 (1952). Although there was blatant fraud in the issuance of municipal bonds in *Mercer*, the Supreme Court concluded that the bonds were valid in the hands of bona fide purchasers because of the "necessities of commerce." 68 U.S. (1 Wall.) at 95-96. See text accompanying notes 24-27 *supra* (policy underlying common law doctrine of estoppel). See also 15 McQUILLIN, *supra* note 4, §§ 43.93 & 43.95.

<sup>38</sup> See *Hewitt v. Board of Educ.*, 94 Ill. 528, 533 (1880); *Sherlock v. Village of Winnetka*, 59 Ill. 389, 399-400 (1871), *modified on other grounds*, 68 Ill. 530 (1873). Since the issuer sets the price of bonds to be sold and therefore establishes the return on investment in the bonds, an opportunity exists for abuse of public trust by public officials who could set the price of the bonds and reap substantial financial gains by selling the bonds to themselves. Therefore, bonds sold by a municipality to public officials who approve their issuance are void. *Id.* at 399. However, bonds in the hands of the general public (bona fide purchasers) are valid under the common law doctrine of estoppel. *Id.* at 399-400. In essence, courts have taken the approach that obligations on bonds tainted by conflicts of interests may be avoided by the issuer to the extent that such avoidance is consistent with the rights of innocent purchasers which must be honored. See *Driscoll v. Burlington-Bristol Bridge Co.*, 8 N.J. 433, —, 86 A.2d 201, 226 (1952).

<sup>39</sup> See generally 2 DILLON, *supra* note 1, §§ 904-930; 15 McQUILLIN, *supra* note 4, §§ 43.97-43.116.

<sup>40</sup> See 15 McQUILLIN, *supra* note 4, § 43.97 at 647.

<sup>41</sup> *Town of Coloma v. Eaves*, 92 U.S. 484, 490-91 (1876). See *Gunnison County Comm'rs v. Rollins*, 173 U.S. 255, 273 (1899); *Chaffee County v. Potter*, 142 U.S. 355, 364-65 (1892) (quoting *Town of Coloma v. Eaves*, 92 U.S. 484, 491 (1876)). See also 2 DILLON, *supra* note 1, § 908. In *Coloma*, municipal bonds were issued pursuant to a statute providing that bonds could be issued only on approval by popular vote of the township. 92 U.S. at 486. The bonds recited compliance with the voting requirement. *Id.* at 490. The Court concluded that where legislative authority was given for issuance of the bonds and where it might be inferred from the statute that representatives of the issuer had the power to determine whether conditions precedent to issuance had been met, recital of satisfaction of conditions precedent would be binding on the municipality as against bona fide purchasers. *Id.* at 491-92. The Court considered Dillon's statement of the rule of estoppel by recital too conservative. *Id.* at 491. According to Dillon, recitals of substantial compliance would preclude an issuer's defense of invalidity only where statute expressly conferred the power to make such a determination. See 2 DILLON, *supra* note 1, §§ 908 & 909.

estoppel by recital usually will afford protection coextensive with that provided by the more general common law estoppel.<sup>42</sup> The protection afforded by the two forms of estoppel differ only when the issuer has failed to comply substantially with conditions precedent to issuance of bonds. Under the general common law doctrine of estoppel, failure to comply substantially with conditions precedent to issuance set forth in enabling constitutional and statutory provisions may invalidate bonds.<sup>43</sup> Under the doctrine of estoppel by recital, recitals will preclude an issuer's defense to the validity of bonds despite failure of substantial compliance.<sup>44</sup> The rule of estoppel by recital will not prevent the issuer's denial of authority to issue bonds<sup>45</sup> or protect purchasers if non-compliance with the law is disclosed on the face of the bonds.<sup>46</sup>

Article 8 of the Uniform Commercial Code (UCC) codified the common law doctrines of estoppel and estoppel by recital. Section 8-202(2) is central to the protection afforded holders of challenged securities under the UCC.<sup>47</sup> However, section 8-202(2) protects only purchasers<sup>48</sup> for value<sup>49</sup> without

---

<sup>42</sup> See *Driscoll v. Burlington-Bristol Bridge Co.*, 8 N.J. 433, —, 86 A.2d 201, 226-27 (1952).

<sup>43</sup> See *Provident Life & Trust Co. v. Mercer County*, 170 U.S. 593, 600 (1898). *But see* *Commissioners of Knox v. Aspinwall*, 62 U.S. (21 How.) 539, 544-45 (1859). Courts favor constitutional and statutory construction which avoids invalidating securities for failure of substantial compliance with conditions precedent to their issuance. *Provident Life & Trust Co. v. Mercer County*, 170 U.S. 593, 600 (1898). *But see* *Brenham v. German American Bank*, 144 U.S. 173, 182 (1891).

<sup>44</sup> See *Town of Coloma v. Eaves*, 92 U.S. 484, 490-92 (1876).

<sup>45</sup> See *Katzenbach v. Aberdeen*, 121 U.S. 172, 176 (1887); *Union Bank of Richmond v. Commissioners of Oxford*, 119 N.C. 214, —, 25 S.E. 966, 969-70 (1896).

<sup>46</sup> See *Chaffee County v. Potter*, 142 U.S. 355, 364 (1892) (issuer not bound by recital if information on face of bond discloses that recital is false); *Chemical Bank & Trust Co. v. Oakland County*, 264 Mich. 673, —, 251 N.W. 395, 399 (1933). See also text accompanying note 35 *supra*.

<sup>47</sup> U.C.C. § 8-202(2) provides that a municipal security in the hands of a purchaser for value without notice of a defect going to the security's validity is valid

if either there has been substantial compliance with legal requirements governing the issue or the issuer has received a substantial consideration for the issue as a whole or for the particular security and a stated purpose of the issue is one for which the issuer has power to borrow money or issue the security.

If a defect in the security involves a violation of state constitutional provisions, however, the security may not be valid in the hands of the original purchaser, but is valid in the hands of a subsequent purchaser for value without notice of the defect. *Id.*

The statutory predecessor of U.C.C. § 8-202(2) was Negotiable Instruments Law § 57 (1896) which provided:

A holder in due course holds the instrument free from any defect of title of prior parties, and free from defenses available to prior parties among themselves, and may enforce payment of the instrument for the full amount thereof against all parties liable thereon.

Negotiable Instruments Law § 57 was adopted in all fifty states with minor modifications, see BEUTEL, *supra* note 31, at 1353-54, 1362-83; however, this section and the Negotiable Instruments Law were largely ignored by the courts which tended to rely on the common law rules of estoppel and estoppel by recital. See *id.* at 8, 823-32.

<sup>48</sup> U.C.C. § 1-201 (32), (33).

notice<sup>50</sup> of any defect going to the validity of securities.<sup>51</sup> The UCC discontinues the common law requirement of good faith<sup>52</sup> and, in contrast to the common law, defines notice in terms of an objective standard. A purchaser has notice if, from all the facts and circumstances known to him at the time of issuance, he has reason to know of a defect in a security.<sup>53</sup>

Generally, a municipal issuer<sup>54</sup> of certificated securities<sup>55</sup> may not challenge their validity if the securities are held by purchasers for value without notice of any defect going to the validity of such securities.<sup>56</sup> There are, however, four exceptions to the general rule. First, a municipal issuer of bonds may invoke the defense of invalidity against an original purchaser if the bond issue violates state constitutional provisions,<sup>57</sup> but the issuer may not assert the defense against a subsequent purchaser.<sup>58</sup> The special status conferred on subsequent purchasers does not exist under common law which invalidates constitutionally defective bonds in the hands of any purchaser.<sup>59</sup> Second, section 8-202(2) will preclude a municipal issuer's

---

<sup>49</sup> U.C.C. § 1-201(44).

<sup>50</sup> U.C.C. § 1-201(25).

<sup>51</sup> See U.C.C. §§ 8-104 & 8-202(2), (3). The phrase "defect going to the validity of a security" is not defined in the U.C.C. In such a case, guidance may be found in the common law. See U.C.C. § 1-103. Fraud, misconduct, and irregularity in the issuance of securities and lack of power of issuance represent a few of the defects which may "go to the validity of securities." See generally text accompanying notes 28-48 *supra*.

<sup>52</sup> The deletion of the good faith requirement is not explained in the Code. See U.C.C. § 8-202(2), Comments; *cf.* U.C.C. § 8-302 (good faith requirement employed in situations involving rights acquired by purchaser of securities). See also text accompanying notes 28-32 & 39 *supra*.

<sup>53</sup> U.C.C. § 1-201(25)(c).

<sup>54</sup> See U.C.C. § 8-201. The term "issuer," with respect to defenses to a security, includes persons who become responsible for or in place of any other person described as an issuer under U.C.C. § 8-201. U.C.C. § 8-201(1)(d). This definition apparently is broad enough to include a pass-through obligor in an industrial revenue or pollution control financing. See *id.* A pass-through obligor is a corporation or other entity which agrees to make payments to a municipality sufficient to cover repayment of bonds issued by the municipality. The agreement is made in return for use of equipment purchased or constructed by the municipality with proceeds of the bonds issued.

<sup>55</sup> U.C.C. § 8-102(1)(a). The term "certificated security" includes any obligation of an issuer which is represented by an instrument issued in bearer or registered form, of a type commonly traded in securities markets, and one of a class or series of obligations. *Id.* The definition is broad enough to include the vast majority of municipal bonds issued. See *id.* Purchasers of uncertificated securities are also protected by U.C.C. § 8-202(2) if the purchaser has received an initial transaction statement. See U.C.C. §§ 8-102(1)(b) & 8-408. See generally *Bankhaus Herman Lampe KG v. Mercantile-Safe Deposit and Trust Co.*, ACF, 466 F. Supp. 1133, 1141 (S.D.N.Y. 1979).

<sup>56</sup> U.C.C. § 8-202(2).

<sup>57</sup> U.C.C. § 8-202(2). The drafters of Article 8 stated that, in the event of a constitutional defect in securities, the rights of an original purchaser are determined by reference to state law. See U.C.C. § 8-202(2), Comment 3. No negative implication is intended by a grant of rights to a subsequent purchaser. *Id.*

<sup>58</sup> U.C.C. § 8-202(2). See U.C.C. § 8-102(2).

<sup>59</sup> See *Citizens' Savings and Loan Assoc. v. Perry County*, 156 U.S. 692, 701-02 (1895) (constitutional defect gives rise to issuer's defense of invalidity against even bona fide holder);

defense to the validity of its bonds only if one of two conditions is present. The issuer must have substantially complied with the legal requirements governing the issue.<sup>60</sup> Alternatively, the issuer must have received a "substantial" consideration for the issue as a whole or for the particular bond and a stated purpose of the issue must have been one for which the issuer had power to borrow money or issue bonds.<sup>61</sup> These conditions merely codify common law estoppel and estoppel by recital theory relating to municipal issuers.<sup>62</sup> A third exception to the general rule that municipal issuers may not challenge the validity of their bonds allows an issuer to raise the defense of lack of genuineness to counterfeit or forged securities.<sup>63</sup> Finally, an issuer may raise the defense of overissue.<sup>64</sup> Section 8-104(1) states that provisions of Article 8 which validate securities, including section 8-202(2), do not apply to the extent that validation would result in overissue. Overissue is, therefore, a defense to the validity of that portion of an issue which exceeds constitutional or statutory limits.<sup>65</sup>

The protection afforded purchasers by section 8-202(2) against an issuer's defenses thus is limited. Section 8-202(2) protects only purchasers for value without notice. Furthermore, an issuer may raise certain defenses to the validity of its securities even in the hands of a purchaser for value without notice. The taint of a conflict of interests in transactions underlying the issuance of municipal bonds may establish two of these defenses, violation of constitutional provisions and failure of substantial compliance.

Under section 8-202(2), a constitutional defect in a municipal bond may be ground for an issuer's defense of invalidity against an original purchaser. Since several state constitutions prohibit public officials' conflicts of interests in specified instances, the existence of constitutionally prohibited interests in municipal bond issues might create an issuer's defense to the validity of such bonds.<sup>66</sup> In light of public policy and the

---

text accompanying notes 34 & 36 *supra*. The U.C.C. does not explain its departure from the common law on this point. See U.C.C. § 8-202(2), Comment 3; note 53 *supra*.

<sup>60</sup> U.C.C. § 8-202(2); see note 39 *supra*.

<sup>61</sup> U.C.C. § 8-202(2).

<sup>62</sup> See U.C.C. § 8-202(2), Comment 3. The comment states that "[a]s a practical matter, the problem of policing municipal issuers has been alleviated by the present practice of requiring legal opinions as to the validity of [an] issue." *Id.* In other words, the drafters of § 8-202(2) were content to follow the common law "substantial compliance" and "power of issuance" tests, which might interfere with efficient trading in municipal securities, since the practice has developed that bond counsel, rather than individual purchasers, now investigate compliance with legal requirements of issuance. See *id.*

<sup>63</sup> U.C.C. § 8-202(3). See U.C.C. § 1-201(18).

<sup>64</sup> See U.C.C. § 8-104. "Overissue" is the issuance of securities in an amount exceeding authorized limits. U.C.C. § 8-104(2).

<sup>65</sup> See U.C.C. § 8-104(1). The section is merely declaratory of the common law. See, e.g., *Sutro v. Petit*, 74 Cal. 332, —, —, 16 P. 7, 8, 9 (1887). See 2 DILLON, *supra* note 1, § 961.

<sup>66</sup> See, e.g., MISS. CONST. art. 4, § 109 (general prohibition of public officials' conflicts of interests); KY. CONST. § 247; MONT. CONST. art. XIII, § 4 (Supp. 1977); TEX. CONST. art. III, § 18; cf. ARK. CONST. amend. 54 (conflicts of interests prohibited with respect to government printing and supply contracts). See generally *State Government Employees*, *supra* note 2, at

common law foundation of section 8-202(2), courts should avoid such a reading of the statute.

At common law, courts charge purchasers with notice of constitutional provisions authorizing municipal bond issues. However, purchasers need not investigate facts and circumstances surrounding issuance to discover the existence of irregularity or misconduct. This line of reasoning seeks to accommodate public policy protecting innocent purchasers from financial loss and bond markets from disruption.<sup>67</sup> Courts should construe the constitutional violation exception of section 8-202(2) in light of this history. Although courts may charge purchasers with notice of a constitutional conflict of interests prohibition, they should not charge purchasers with discovery of such conflicts.

The existence of conflicting interests may also establish an issuer's defense of failure of substantial compliance with the law governing an issue.<sup>68</sup> In light of the recent tendency of states to include conflict of interests prohibitions in municipal finance legislation, courts might interpret such prohibitions as conditions precedent to issuance of municipal bonds.<sup>69</sup> Thus, the existence of a conflict of interests would constitute failure of substantial compliance with the law governing issuance and might render purchasers' protections under section 8-202(2) ineffective against a municipal issuer. As a result, innocent purchasers would suffer loss of their investment and municipal bond markets would suffer the loss of investor confidence.

Bond counsel, however, need not subject purchasers to this risk. Section 8-202(2) provides bond counsel with an alternative method of ensuring that the protections afforded purchasers under the subsection will be available against a municipal issuer's defenses. Counsel should require the issuer to recite the purpose of the issue on the face of the bonds and make

1042 n.26. *See also* note 8 *supra*. Theoretically, proceeds from a municipal bond issue might be used to make payments under government contracts tainted by a public official's conflict of interests, giving rise to a connection between bonds issued and the conflict. The connection between a conflict of interests and a bond issue would be strengthened in the case where the interested official participates in negotiation and authorization of the sale of bonds. The question then is whether the taint of a conflict of interests runs to bonds issued so as to create a defect going to their validity within the meaning of U.C.C. § 8-202(2). If so and a state constitution expressly prohibits the conflict of interests, a strict reading of U.C.C. § 8-202(2) would leave the defense of invalidity of the bonds available to the issuer.

<sup>67</sup> *See* text accompanying notes 24-27, 37 & 38 *supra*.

<sup>68</sup> *See* text accompanying notes 60-62 *supra*; note 39 *supra* (common law background).

<sup>69</sup> *See, e.g.*, Industrial Development and Commercial Development Bond Act, W. VA. CODE §§ 13-2C-1 to 13-2C-20 (1979). The statute confers on counties and municipalities the power to issue industrial revenue bonds to finance industrial and commercial projects. *See* W. VA. CODE §§ 13-2C-4, 13-2C-7 (1979). Section 13-2C-20 provides that no member of a county commission or municipal board issuing bonds shall have any financial interest in the leasing, sale or other disposition of an industrial project financed pursuant to the act. *See* W. VA. CODE § 13-2C-20 (1979). Therefore, the existence of a prohibited conflict of interests may constitute failure of substantial compliance with the requirements of the Industrial Development Act. *See id.*; note 3 *supra*.

sure that the purpose recited is one for which the issuer has power to issue bonds.<sup>70</sup>

Since section 8-202(2) protects only purchasers for value without notice and a conflict of interests may establish an issuer's defense even against such purchasers, bond counsel must employ other methods of ensuring that the taint of conflicts of interests will not invalidate bonds. The most effective guarantee of validity is the prevention or removal of conflicting interests. Therefore, bond counsel should collect the names of all public officials and employees involved in any manner in the bond issuance procedure.<sup>71</sup> Counsel should determine whether any of the named individuals or members of their immediate families have any personal interest in the bond issue.<sup>72</sup> Bond attorneys should also ascertain whether any of the named persons have any interest in parties to contracts underlying the bond issue, particularly an ownership or employment interest in such parties.<sup>73</sup> Counsel must then measure any such interests against statutory prohibitions to determine their legality.<sup>74</sup> In many cases, however, discovery of conflicting interests may not be practical or removal of the taint of existing conflicts may not be possible.<sup>75</sup> Other measures may offer the purchaser more complete protection.

Bond counsel should not rely on statutory disclosure provisions to cure conflicts of interests defects. Although statutes may require disclosure of conflicts of interests, such statutes generally will not expressly provide that disclosure will remove the taint of conflicts of interests from transactions subject to such interests.<sup>76</sup> Furthermore, counsel should not assume that

---

<sup>70</sup> See U.C.C. § 8-202(2).

<sup>71</sup> See, e.g., MD. ANN. CODE art. 40A, § 3-101 (Supp. 1979).

<sup>72</sup> *Id.*

<sup>73</sup> *Id.* See text accompanying notes 18-21 *supra*.

<sup>74</sup> Compare MD. ANN. CODE art. 40A, § 3-101 (Supp. 1979) with VA. CODE § 2.1-349 (1970). MD. ANN. CODE art. 40A, §§ 3-101 to 3-108 (Supp. 1979) represent a broad prohibition of state officials' and employees' conflicts of interests. For example, section 3-101 prohibits family members' interests in municipal contracts. MD. ANN. CODE art. 40A, § 3-101 (Supp. 1979). Many conflicts of interests statutes are not written so broadly. See, e.g., VA. CODE § 2.1-349 (1979); W. VA. CODE § 13-2C-20 (1979). Although the nature and extent of the conflicts of interests investigation to be performed by counsel will depend on the applicable statutory provision, counsel should be aware that such statutes are broadly construed. See note 10 *supra*. For example, although a statute may not expressly prohibit interests of family members in municipal contracts, courts are not likely to allow a public official to avoid a conflict of interest by transferring his personal interest in a municipal contract to a member of his immediate family. See *Githens v. Butler County*, 350 Mo. 295, \_\_\_, 165 S.W.2d 650, 652-53 (1942).

<sup>75</sup> See, e.g., MD. ANN. CODE art. 40A, § 3-101 (Supp. 1979). Under this section, a public official's proffering of advice with respect to the issuance of municipal bonds may create a conflict of interests. *Id.* This type of activity will often occur prior to bond counsel's involvement in a financing, making discovery of such a conflict of interests difficult. See note 71 *supra*.

<sup>76</sup> See, e.g., VA. CODE §§ 2.1-349(a)(2), 2.1-350, 2.1-352 (1979). *But see* S.C. CODE § 4-9-180 (1976). Section 4-9-180 provides that any county official who has a substantial financial interest in any business which contracts with the county or personally contracts with the

such statutes impliedly provide that disclosure will cure a conflict of interests defect. At common law, a public official's disclosure of his conflict of interests prior to participation in negotiating and approving municipal contracts will not save the contract from invalidity.<sup>77</sup>

Validation proceedings, however, provide a reliable method of determining the validity of municipal bonds prior to their issuance.<sup>78</sup> A validation proceeding involves a judicial determination of any issues, including constitutional questions, raised concerning the compliance of a bond issue with requirements of law.<sup>79</sup> The purpose of validation proceedings is to

---

county shall disclose the interest and refrain from voting or otherwise participating in the contracting process. *Id.* The contract is rendered voidable only if there has been a violation of the section and the private contracting party knows of the violation. *Id.*

<sup>77</sup> See *Mayor of Ensley v. J.E. Hollingsworth & Co.*, 170 Ala. 396, \_\_\_, 54 So. 95, 96-97 (1910); *City of Bristol v. Dominion Nat'l Bank*, 153 Va. 71, 79-80, 149 S.E. 632, 634-35 (1929). The *Ensley* court decided that it was "of no moment that the plaintiff . . . was not present, or that 'he did not vote upon the acceptance of his bid,' at the meeting of the city council . . ." 170 Ala. at \_\_\_, 54 So. at 96. In *Bristol*, the court concluded that even though the interested party disclosed his interest and refrained from voting on a municipal contract, the contract was void as against public policy. 153 Va. at 79-80, 149 S.E. at 634; see note 7 *supra*.

<sup>78</sup> See, e.g., GA. CODE ANN. §§ 87-301 to 87-315 (1979); VA. CODE §§ 15.1-213 to 15.1-215 (1973), § 15.1-216 (Supp. 1979), §§ 15.1-217 to 15.1-221 (1973). See generally 15 McQUILLIN, *supra* note 4, §§ 43.143-43.148. VA. CODE § 15.1-214 (1973) provides that the governing body of any political subdivision proposing to issue bonds may bring a proceeding to establish the validity of the bonds, the legality of all proceedings theretofore taken in connection with the authorization or issuance of the bonds, and the validity of the method of payment of the bonds. The governing body may bring the proceeding by filing a motion for judgment describing the bonds in question and the proceedings relating to issuance of such bonds and alleging that the bonds, when issued, will be valid obligations of the issuer. *Id.* Section 15.1-214 requires joinder of all persons interested in or in any way affected by the issuance of the bonds in the motion for judgment. *Id.*

Where there is no statutory authorization for validation proceedings, an action for validation may be brought under declaratory judgment law. See *McNichols v. Denver*, 101 Colo. 316, \_\_\_, 74 P.2d 99, 102 (1937). See also 15 McQUILLIN, *supra* note 4, at 743. Occasionally, statutory language may expressly provide that breach of a conflict of interests prohibition will not affect the validity of bonds issued. See, e.g., CAL. GOV'T CODE § 1102 (West 1966); N.C. GEN. STAT. § 159C-16 (1976). See also MD. ANN. CODE art. 43, § 433 (1977).

<sup>79</sup> See *Thompson v. Town of Frostproof*, 89 Fla. 92, \_\_\_, 103 So. 118, 119 (1925); *In re Validation of \$50,000 Serial Funding Bonds*, 187 Miss. 512, \_\_\_, 193 So. 449, 452 (1940). See also *Abell v. Town of Boynton*, 95 Fla. 984, \_\_\_, 117 So. 507, 509 (1928) (constitutional validity of bonds tested). Validation proceedings provide courts with jurisdiction to determine whether bonds to be issued are, in any respect, legally deficient. *Thompson v. Town of Frostproof*, 89 Fla. at \_\_\_, 103 So. at 119. For example, in *Thompson*, a lower court entered a decree validating bonds issued to finance street construction. *Id.* at \_\_\_, 103 So. at 118. On appeal, plaintiff argued that the proposed construction was not a purpose for which bonds could legally be issued. *Id.* After a determination that plaintiff's question might appropriately be raised in a validation proceeding, the court agreed with plaintiff and reversed the lower court decree. *Id.* Courts may also determine whether bond issues comply with constitutional requirements. *Rohde v. City of Newport*, 246 Ky. 476, \_\_\_, 55 S.W.2d 368, 369 (1932). In *Rohde*, a statute provided for validation of municipal bonds and forbade issuance of bonds until their constitutional validity had been tested in the courts. *Id.* at \_\_\_, 55 S.W.2d at 369. See generally 15 McQUILLIN, *supra* note 4, at 748.

protect the public from improper creation of municipal debts,<sup>80</sup> to assure the regularity of issuance and validity of municipal bonds,<sup>81</sup> and to protect the public's interest in stable, efficient markets for municipal obligations.<sup>82</sup> Courts have held statutes authorizing validation proceedings constitutional<sup>83</sup> and their procedural elements consistent with the requirements of due process.<sup>84</sup>

Statutes generally provide that the state or one of its political subdivisions may bring an action for validation of municipal securities.<sup>85</sup> Named defendants in a validation proceeding may include the issuer, its citizens and, where appropriate, taxpayers and property owners.<sup>86</sup> Service of process on parties joined as defendants is accomplished by publication of the motion for judgment and the time and place fixed for hearing.<sup>87</sup> The plaintiff must place all questions regarding the validity of bonds before the court

<sup>80</sup> *Williams v. City of Raceland*, 245 Ky. 212, \_\_\_, 53 S.W.2d 370, 373 (1932).

<sup>81</sup> *State v. Citrus County*, 116 Fla. 676, \_\_\_, 157 So. 4, 5 (1934); *Street v. Town of Ripley*, 173 Miss. 225, \_\_\_, 161 So. 855, 859 (1935).

<sup>82</sup> *Street v. Town of Ripley*, 173 Miss. 225, \_\_\_, 161 So. 855, 859 (1935); see text accompanying notes 30-32 *supra*.

<sup>83</sup> See *Rohde v. City of Newport*, 246 Ky. 476, \_\_\_, 55 S.W.2d 368, 370 (1932); *Castevens v. Stanly County*, 211 N.C. 642, \_\_\_, 191 S.E. 739, 745 (1937). But see *Hatten v. Houston*, 373 S.W.2d 525, 535 (Tex. Ct. App. 1963).

Validation statutes are often challenged on the ground that they confer a nonjudicial function on courts. See *Castevens v. Stanly County*, 211 N.C. at \_\_\_, 191 S.E. at 745. Courts uphold these statutes reasoning that it is the distinctive nature of judicial power to determine rights and obligations that exist at the time of exercise of power, such as the power to issue bonds. See *Rohde v. City of Newport*, 246 Ky. at \_\_\_, 55 S.W.2d at 370. In fact, there is little to distinguish a validation proceeding from an action for declaratory judgment. See *McNichols v. Denver*, 101 Colo. 316, \_\_\_, 74 P.2d 99, 103 (1937).

<sup>84</sup> See *Tennessee Elec. Power Co. v. Mayor of Fayetteville*, 173 Tenn. 111, \_\_\_, 114 S.W.2d 811, 814 (1938) (statute providing that no proceeding questioning the validity of bonds shall be brought after 20 days from date of publication of bond resolution held valid under due process clause of state constitution).

<sup>85</sup> See, e.g., *Darby v. City of Vidalia*, 75 Ga. App. 804, \_\_\_, 44 S.E.2d 454, 456, cert. denied, 43 S.E.2d 152 (1947); *State v. City of Daytona Beach*, 160 Fla. 204, \_\_\_, 34 So. 2d 309, 310 (1948); VA. CODE §§ 15.1-214 & 15.1-216 (1973). Statutes set forth proper or necessary parties to validation proceedings. For example, VA. CODE § 15.1-214 (1973) provides that the governing body of a political subdivision proposing to issue bonds may bring an action for validation of such bonds. VA. CODE § 15.1-216 (Supp. 1979) provides that any person, corporation or association may contest the issuance of bonds by filing a motion for judgment within 45 days of a resolution authorizing issuance. A court decree validating bonds, absent timely appeal, is forever binding as to the validity of the bonds and constitutes a permanent injunction against any person's contesting the validity of the bonds. VA. CODE § 15.1-220 (1973). See 15 McQUILLIN, *supra* note 4, § 43.145.

<sup>86</sup> See, e.g., *State v. City of Daytona Beach*, 160 Fla. 204, \_\_\_, 34 So. 2d 309, 310 (1948). See 15 McQUILLIN, *supra* note 4, § 43.145.

<sup>87</sup> See, e.g., VA. CODE § 15.1-214 (1973). See 15 McQUILLIN, *supra* note 4, § 43.146. Notice by publication is sufficient to satisfy requirements of due process. *State v. City of Venice*, 147 Fla. 70, \_\_\_, 2 So. 2d 365, 365-67 (1941); *State v. Special Road and Bridge Dist. No. 4*, 127 Fla. 631, \_\_\_, 173 So. 716, 718 (1937). If notice is improperly given, however, an equity court may review the appropriateness of a decree validating bonds and enjoin the issue. See *May Land Co. v. City of Fort Lauderdale*, 125 Fla. 146, \_\_\_, 169 So. 642, 642 (1936).



since a judgment rendered without adequate pleading and proof is ineffective.<sup>88</sup> The judgment rendered is conclusive with respect to matters determined against such defendants.<sup>89</sup> Thus, counsel may prompt a judicial determination of the existence of conflicting interests and their effect on the validity of bonds prior to issuance. A validation proceeding will preclude later challenge to the validity of such bonds by parties to the action.

Purchasers may find further protection in statutes of limitations which bar challenge to the validity of municipal bonds after a certain time.<sup>90</sup> The allowable period for challenge of an issue's validity under such statutes is relatively short, running ten to thirty days from the date of authorization of the issue.<sup>91</sup> Where practical, parties involved in the issuance of municipal bonds should allow the limitations period to run prior to issuance in order to preclude later challenge to the bonds' validity.

The existence of conflicting interests in transactions underlying the issuance of municipal bonds may invalidate the issue. Bond counsel should carefully investigate facts and circumstances surrounding the issuance of municipal bonds to determine the existence of conflicts of interests. The difficulty of discovering such conflicts, however, creates the risk that counsel will not uncover existing prohibited interests. If a municipal bond issue is later challenged on the basis of conflict of interests, courts should be reluctant to declare the bonds invalid, especially where bond counsel have attempted to discover conflicts prior to issuance. In light of competing policy considerations, courts should not allow common law and statutory

---

<sup>88</sup> See *Harrell v. Town of Whigham*, 141 Ga. 322, \_\_\_, 80 S.E. 1010, 1011-12 (1914). If allegations made in a petition for validation are contested by defendants, the burden is on the state or other plaintiff seeking validation of bonds to prove material facts required to obtain validation. *Id.* at \_\_\_, 80 S.E. at 1011-12. Where there is a total absence of such proof it is error for a court to render judgment validating contested securities. *Id.* Merely alleging facts required to obtain validation, however, will not suffice if parties do not contest the proceeding. The responsibility is then on the court to see that a bond issue complies with requirements of law. *Id.*

<sup>89</sup> See *North Miami v. Meredith*, 121 F.2d 279, 281 (5th Cir.), *cert. denied*, 314 U.S. 674 (1941); *cf. Jenkins v. Mayor of Savannah*, 165 Ga. 121, \_\_\_, 139 S.E. 863, 863 (1927) (judgment in validation proceedings conclusive against citizens and taxpayers who could have made themselves parties to action); *Ballard County v. Kentucky County Debt Commission*, 290 Ky. 770, \_\_\_, 162 S.W.2d 771, 773 (1942) (judgment conclusive on all questions concerning validity of bonds which might have been raised).

<sup>90</sup> See, e.g., S.C. CODE § 11-15-30 (1976) (20-day limitation period); VA. CODE § 15.1-212 (1973). VA. CODE § 15.1-212 (1973) provides that within 30 days of filing with the court a certified copy of a resolution of the municipality authorizing the issuance of bonds, any person in interest may contest the validity of such bonds. If no such challenge is made within the 30-day period, the authority to issue and all proceedings in connection with the authorization and the issuance of the bonds are conclusively presumed to have been legally taken and no court has the power to inquire into such matters. *Id.*

<sup>91</sup> See *Morgan v. Feagin*, 230 S.C. 315, \_\_\_, 95 S.E.2d 621, 622 (1956). In *Morgan*, the court upheld a 30-day statute of limitations period as reasonable. *Id.* The court concluded that purchasers would be unwilling to invest in bonds which might be attacked for illegality upon their issuance. *Id.* Furthermore, a long statutory limitations period might hinder sales of bonds which are frequently timed to take advantage of favorable markets. *Id.*

prohibitions of public officials' conflicting interests to cause disruption in already unsettled municipal bond markets and burden innocent purchasers with government misconduct.

STEVEN M. JOHNSON

