

# Supreme Court of Florida

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No. 70,161

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STATE OF FLORIDA, Appellant,

v.

CITY OF PANAMA CITY BEACH, Appellee.

[May 26, 1988]

PER CURIAM.

The state appeals a circuit court order validating certain bonds which Panama City Beach proposes to issue. We have jurisdiction under article V, section 3(b)(2) of the Florida Constitution.

In January 1987 the city commission adopted a resolution authorizing, pursuant to chapter 166, part II, Florida Statutes (1985), the issuance of up to \$300,000,000 in "investment" revenue bonds. According to the terms of the trust indenture, the bulk of the proceeds from the sale of the bonds will be invested with an insurance company or other investment institution having an appropriate credit rating. The investment contract is to have a guaranteed rate of return. The principal invested in the contract plus the earnings thereon will be pledged as security for repayment of the bonds and will constitute the sole source for that repayment. The proceeds will

be sufficient to retire the bonds at maturity. The resolution also provides that the bonds will not constitute a general indebtedness of the city and that the bondholders cannot look to the taxing and assessing powers of the city or the state for repayment. The interest paid to the holders of these bonds will not be exempt from federal taxation.

Testimony at the validation hearing indicated that the amount owed on the bonds is expected to be one-half of one percent less than the interest received from the investment contract. This difference would produce a profit for the city of approximately \$1,500,000. The profit thus realized on this bond issue would be used for park and recreational facilities, self-insurance reserves, or other municipal purposes, all to be designated by subsequent resolution. At the hearing the parties claimed that this is a case of first impression for validation of investment revenue bond, commonly called "arbitrage" bonds, in Florida.

Arbitrage bonds apparently grew out of a bond refunding scheme developed in Phoenix, Arizona, by the city and its bond dealer in 1961. Mumford, Arbitrage and Advance Refunding, 1976 Duke L.J. 1239. By using the proceeds of relatively low-interest tax-exempt bonds to purchase federal securities paying a higher rate of interest, local and state governmental entities could make a profit on their bond issues. Arbitrage bonds exploit the federal tax exemption because the federal government must pay higher interest on its securities than is paid on local tax-exempt bond issues but receives nothing back through the income tax. Thus, in effect, the federal government subsidizes local governments. The Tax Exempt Status of Local Government Bonds Used in Arbitrage Transactions, 35 Geo. Wash. L. Rev. 574 (1967). The Treasury Department and the Internal Revenue Service began studying this new type of bond, and in August 1966 the IRS issued Technical Information Release 840, stating that it would stop issuing rulings on the tax-exempt status of arbitrage bonds. Without a favorable tax-exempt ruling local

bonds are difficult to sell. Later IRS regulations and amendments to the federal tax code increased the restrictions on arbitrage bonds. Zarin, Tax Exemption of Municipal Bonds -- A Report on Recent Developments, 1 Urb. Lawyer 336 (1969); Goldberg, The New Proposed Arbitrage Bond Regulations -- And a Comparison with the Old, 6 Urb. Lawyer 48 (1974); Lane and Schwarz, New Proposed Arbitrage Regs. Require Revised Approaches to Refunding Issues, 46 J. Tax'n 358 (1977). These new regulations decreased the desirability of arbitrage bonds by sharply restricting the amount of profit an issuing agency could receive and still maintain the tax-exempt status of its bonds. See McCroskey v. Gustafson, 638 P.2d 51 (Colo. 1981). The instant bonds are not tax exempt so they may not face some of the restrictions on arbitrage bonds. They do, however, have to pass this Court's scrutiny.

As the parties state, this appears to be the first time arbitrage bonds have come before this Court. Neither the city nor the state has cited a Florida arbitrage bond validation case, and this Court has been unable to find one. An examination of the controlling constitutional and statutory provisions, as well as case law, governing bond issues is, therefore, in order.

The scope of judicial inquiry into bond validations is sharply limited. State v. City of Sunrise, 354 So.2d 1206 (Fla. 1978). Limited does not mean nonexistent, however, because a court must determine if a public body has the authority to issue the subject bonds, must determine if the purpose of the obligation is legal, and must insure that the bond issuance complies with the requirements of law. Taylor v. Lee County, 498 So.2d 424 (Fla. 1986). This includes determining "whether the [issuing] agency may legally expend the proceeds for the contemplated purpose." State v. Suwannee County Development Authority, 122 So.2d 190, 193 (Fla. 1960); State v. Miami Beach Redevelopment Agency, 392 So.2d 875 (Fla. 1980).

The main question presented here is whether these bonds are for a proper municipal purpose. The city argues that providing parks and recreational facilities and funding a self-insurance program are valid municipal purposes. Therefore, according to the city, the city's obtaining assets for public purposes by serving as a financial conduit is permissible. The state, on the other hand, claims that the future recreational facilities and self-insurance programs are merely secondary and incidental purposes of this bond issue while the immediate and primary purpose is the acquisition of an investment for the city. The state contends that the city is borrowing money primarily for the purpose of investments which is not a recognized municipal function.

Governmental entities have sought to issue revenue bonds for many and diverse projects. They have become popular vehicles for public borrowing for several reasons. Because they are not supported by the full faith and credit of the issuer, revenue bonds do not have to be submitted to the electorate for approval. Moreover, revenue bonds are not considered to be, strictly speaking, debts of the issuer. Patterson, Legal Aspects of Florida Municipal Bond Financing, 6 U. Fla. L. Rev. 287, 316 (1953); B.U. Ratchford, American State Debts (1941). See Wilson v. Palm Beach County Housing Authority, 503 So.2d 893 (Fla. 1987); State v. City of Miami, 113 Fla. 280, 152 So. 6 (1933). Thus, they can also be used to circumvent constitutional debt limitations.

The constitution contains numerous provisions dealing with bonds. Article VII, section 11(a) of the state constitution requires a vote of the electorate on state bonds pledging the state's full faith and credit and limits the "total outstanding principal" of such state bonds to "fifty percent of the total tax revenues of the state for the two preceding fiscal years." Revenue bonds, on the other hand, are to "be payable solely from funds derived directly from sources other than state tax revenues" and do not have to be voted on by the electors.

Art. VIII, § 11(d), Fla. Const. Local bonds can be issued to finance or refinance capital projects authorized by law when approved by the electorate or to refund outstanding bonds. Art. VII, § 12, Fla. Const. State bonds can be issued for pollution control and abatement and other water facilities. Art. VII, § 14, Fla. Const. Revenue bonds, when authorized by law, can be issued for financing or refinancing capital projects for airports or port facilities and for industrial or manufacturing plants, for scholarship loans, or for housing and related facilities. Art. VII, §§ 10(c), 15, 16, Fla. Const. The constitutional authority to issue such bonds is a far cry from previous state constitutions.

Florida has a checkered history regarding bonds. As a frontier state it issued bonds to promote the building of railroads and canals, most of which failed or were destroyed. Florida repudiated its bonds numerous times in the mid-1800s and after the Civil War. B.U. Ratchford, American State Debts (1941); A.J. Heins, Constitutional Restrictions Against State Debt (1963); Patterson, Legal Aspects of Florida Municipal Bond Financing, 6 U. Fla. L.Rev. 287 (1953). Due to the excesses of the carpetbag government during Reconstruction (1865 to 1876), the state constitution was amended to limit the legislature's power to issue bonds only for the purposes of repelling invasion or suppressing insurrection. Art. IX, § 6, Fla. Const. (1885). This Court characterized the constitutional restriction as necessary to "'prevent the profligate increase of the public burden'" and to "'prevent the depreciation of our credit.'" In re Advisory Opinion to the Governor, 94 Fla. 967, 984, 114 So. 850, 855 (1927), quoting Cheney v. Jones, 14 Fla. 587, 615 (1874).

Although the 1885 constitution restricted state bond issues, the only restriction on local governments was the article IX, section 10 provision that the "Legislature shall not authorize any county, city, borough, township or incorporated district to become a stockholder in any company, association or

corporation, or to obtain or appropriate money for, or to loan its credit to, any corporation, association, institution or individual." The legislature, therefore, authorized many local projects and, according to two commentators, local governments "had a field day" issuing bonds. Herring and Miller, Florida Public Bond Financing -- Comments on the Constitutional Aspects, 21 U. Miami L. Rev. 1, 4 (1966); Patterson, Legal Aspects of Bond Financing, at 313. Florida's land boom collapsed in the 1920s, however, followed by ever-increasing local, state, and national financial difficulties. In the 1930s Florida had the highest number of local bond defaults in the United States. Herring and Miller, Public Bond Financing. See State v. Florida State Improvement Commission, 60 So.2d 747 (Fla. 1952).

In 1930 article IX, section 6 of the constitution, which restricted the state's power to issue bonds, was amended. The amendment provided in part that

the Counties, Districts, or Municipalities of the State of Florida shall have power to issue bonds only after the same shall have been approved by a majority of the votes cast in an election in which a majority of the freeholders who are qualified electors residing in such Counties, Districts, or Municipalities shall participate.

The "outstanding purpose" of the amendment was to restrain "the spendthrift tendencies of political subdivisions to load the future with obligations to pay for things the present desires, but cannot justly pay for as they go." Leon County v. State, 122 Fla. 505, 514, 165 So. 666, 669 (1936). This provision limited the risk associated with bond issues to only that which real property owners chose to accept. Herring and Miller, Public Bond Financing, at 5; Patterson, Legal Aspects of Bond Financing, at 314; Alloway, Constitutional Law, 8 Miami L.Q. 158, 193 (1954). To avoid having to go to the electorate pursuant to article IX, section 10, local governments turned to issuing revenue bonds.

The constitutional prohibition against pledging public credit to private enterprise, article IX, section 10, Florida Constitution (1885) (now contained in article VII, section 10), was designed "to restrict the activities and functions of the State, county and municipality to that of government and forbid their engaging directly or indirectly in commercial enterprises for profit." Bailey v. City of Tampa, 92 Fla. 1030, 1035, 111 So. 119, 120 (1926); Brautigam v. White, 64 So.2d 781 (Fla. 1953). This prohibition is closely related to revenue bonds and to what constitutes a proper public purpose. As with other aspects of bond law, the definition of public purpose has undergone changes.

In Adams v. Housing Authority of City of Daytona Beach, 60 So.2d 663 (Fla. 1952), this Court struck down a redevelopment plan. The Court commented:

It is inconceivable that any one would seriously contend that the acquisition of real estate for the declared purposes set forth in the proposed Redevelopment Plan is for a public use or purpose. No one has ever heard of any corporation, association or individual going into any of the above mentioned businesses [retail, office, wholesale, and restricted industry] except for profit or gain. If the municipalities can be vested with any such power or authority, they can take over the entire field of private enterprise without limit so long as they can find a blighted area containing sufficient real estate.

Id. at 668-69. This statement echoed a previous pronouncement that the "financing of private enterprises by means of public funds is entirely foreign to a proper concept of our constitutional system. Experience has shown that such encroachments will lead inevitably to the ultimate destruction of the private enterprise system." State v. Town of North Miami, 59 So.2d 779, 785 (Fla. 1952). In North Miami the Court reversed an order validating certificates of indebtedness to be used to purchase land and build an aluminum manufacturing plant to be leased to a private corporation.

Shortly after Adams and North Miami, however, the Court affirmed the validation of a revenue bond issue to provide municipal off-street parking facilities, pursuant to a legislative declaration that such was a proper public or municipal purpose. Gate City Garage, Inc. v. City of Jacksonville, 66 So.2d 653 (Fla. 1953). The Court distinguished North Miami and Adams and embraced the principle that, if a project's paramount purpose is a public purpose, the project may incidentally benefit private corporations or individuals. The Court followed the paramount public purpose doctrine and "flatly refused to approve the issuance of public securities" to assist "industrial developments, housing projects, . . . apartment houses, baseball stadiums and projects of such nature" if the main benefit went to private enterprise rather than to the public. State v. Jacksonville Port Authority, 204 So.2d 881, 883 (Fla. 1967). In the mid 1960s the Court also reiterated its earlier interpretation of article IX, section 10 and commented that "it is patent that the design of it was to keep the State out of private business; to insulate State funds against loans to individual corporations or associations and to withhold the State's credit from entanglement in private enterprise." Dade County Board of Public Instruction v. Michigan Mutual Liability Co., 174 So.2d 3, 5-6 (Fla. 1965).

The 1968 revision of the state constitution amended article IX, section 10 of the 1885 constitution and moved it to article VII, section 10, adding to that section paragraph (c) regarding local government revenue bonds. This Court continued to apply the paramount public purpose doctrine. E.g., Orange County Industrial Development Authority v. State, 427 So.2d 174 (Fla. 1983) (reversed revenue bond issue because construction of a commercial television station does not serve a paramount public purpose); International Brotherhood of Electrical Workers, Local Union No. 177 v. Jacksonville Port Authority, 424 So.2d 753 (Fla. 1982) (affirmed revenue bond issue for constructing floating drydock that would be sold to a private



















