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Municipal Corporations-Limitation of Indebtedness

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MUNICIPAL CORPORATIONS—LIMITATION OF INDEBTEDNESS—Action by Jefferson School Township against Jefferson Township School Building Company to secure the cancellation of a lease contract which the former contended placed its indebtedness in excess of the amount which it could incur under Article 13 of the Indiana Constitution. The defendant was organized pursuant to an act of the Indiana General Assembly of 1927 for the purpose of erecting a school building which was to be used by Jefferson School Township, under terms and conditions of a combined lease and contract, object of which was to enable the school township eventually to become owner of the building. The lease was for a term of 26 years, rent to be paid semi-annually, with an option to purchase the property at any time, such purchase price in no event to exceed amount actually invested by the lessor corporation. The school township was to pay taxes and insurance, and make any repairs and improvements necessary. If the rental payments should at any time exceed the amount necessary to meet incidental corporate expenses and to pay dividends and interest on outstanding securities of the lessor, such excess should be used in the redemption and cancellation of its securities at their par value; and if the total excess of rental payments should be sufficient to redeem the outstanding securities of the lessor and pay accrued interest and dividends, it would convey all its right, title, and interest in and to the premises and property in question to the lessee. In conclusion, the lease provided that "nothing herein shall be construed to provide or impose any obligation on the part of the lessee to purchase such schoolbuilding and property from the lessor,

¹⁹ Williston, Liability for Honest Misrepresentation, 24 Harvard L. Rev. 426; Artemus Jones (1909), 2 K. B. 444. (Query, should the interest of reputation be awarded a greater degree of protection by the law than an interest in bodily safety?)

²⁰ For further study in this field see: Miller, Scierter in Deceit and Estoppel, 6 Indiana L. Jl. 153; Bohlen, Misrepresentation as Deceit, Negligence, or Warranty, 42 Harvard L. Rev. 732; Carpenter, Responsibility for Intentional, Negligent and Innocent Misrepresentations, 24 Illinois L. Rev. 749.

nor to create any obligation of the lessee in respect to any creditor, stockholder or other security holder of the lessor." Held, the constitutional debt limitation was not violated.¹

The purpose of the constitutional limitation on indebtedness is to protect persons and property in municipalities from abuse of corporate credit and the consequent burdensome, if not ruinous, taxation.² School districts are universally held to be political or municipal corporations within the constitutional prohibition.³ Although some cases have held that as soon as a contract is made, indebtedness to the amount of all future payments is incurred, irrespective of any conditions connected with the rendition of the services,⁴ the great weight of authority is that where an ordinary lease is entered into by a municipal corporation, at a reasonable rental, for a term of more than one year, a present indebtedness is not created in the aggregate sum of all the annual payments of rent to become due under the lease.⁵ And such a lease, even though it includes an option to purchase the property,⁶ does not violate a constitutional provision limiting the indebtedness which may be incurred by municipal corporation to a stated percentage of the value of taxable property therein, if the annual installments as they become due do not bring the indebtedness to a point beyond the constitutional limit. If the aggregate sum of all yearly rentals were taken as a debt, many cities would be left without means of securing things essential to public welfare and safety.⁷ But if a contract which, though denominated as and purporting to be a lease with option to purchase is in fact a contract to purchase by payments in installments, it is treated as a contract to purchase instead of a lease.⁸ The court ignores the form and looks at the substance.⁹ Intent and purpose of the parties control as to whether the agreement is a lease or contract and a recital that it is a

¹ *Jefferson School Tp. v. Jefferson Tp. School Building Co.* (Ind., 1937), 10 N. E. (2d) 608.

² *Law v. People* (1877), 87 Ill. 385; *Eddy Valve Co. v. Town Crown Point* (1906), 166 Ind. 613, 76 N. E. 536; 1 *Dillon, Municipal Corporations*, p. 342.

³ 1 *Dillon, Municipal Corporations*, p. 348.

⁴ *Schnell v. City of Rockland* (1908), 232 Ill. 89, 83 N. E. 462; *East St. Louis & Interurban Water Co. v. City of Bellville* (1935), 360 Ill. 490, 196 N. E. 442; *Jones v. Rutherford* (1928), 225 Ky. 773, 10 S. W. (2d) 296; *Smith v. Newburgh* (1879), 77 N. Y. 130; 1 *Dillon, Municipal Corporations*, p. 359; 19 R. C. L. 984-5.

⁵ *Valparaiso v. Gardner* (1884), 97 Ind. 1, 49 Am. Rep. 419; *Cason v. City of Lebanon* (1899), 153 Ind. 567, 55 N. E. 768; 1 *Dillon, Municipal Corporations*, p. 351, 361, and cases cited; *Cooley, Handbook Municipal Corporations*, p. 417; 19 R. C. L. 984-5 and cases cited.

⁶ *Cohran v. Town of Middleton* (1924), 14 Del. Ch. 295, 125 A. 459; *Burlington Water Co. v. Woodward* (1878), 49 Ia. 58; *City of South Bend v. Reynolds* (1900), 155 Ind. 70, 57 N. E. 706, 708, 49 L. R. A. 795; *Krenwinke v. City of Los Angeles* (1936), 4 Cal. (2d) 611, 51 P. (2d) 1098; 1 *Dillon, Municipal Corporations*, p. 376 and cases cited.

⁷ *Valparaiso v. Gardner* (1884), 97 Ind. 1, 49 Am. Rep. 419.

⁸ *Voss v. Waterloo Water Co.* (1904), 163 Ind. 69, 71 N. E. 208, 66 L. R. A. 95, 106 A. S. R. 201; *Billings v. Bankers' Bond Co.* (1923), 199 Ky. 490, 251 S. W. 643; *Spilman v. Parkersburg* (1891), 35 W. Va. 605, 14 S. E. 279; *Earles v. Wells* (1896), 94 Wis. 285, 68 N. W. 964; 71 A. L. R. 1323; 19 R. C. L. 984.

⁹ *State ex. rel. Matthews v. Forsythe* (1896), 147 Ind. 466, 473, 44 N. E. 593.

lease¹⁰ or stipulation that it is not to be deemed to create an obligation or indebtedness¹¹ can not change its true character.

Indiana courts have followed the majority rule, upholding as leases contracts by municipal corporations for articles of necessity and services to be supplied in the future and paid for as supplied.¹² In one case, the court extended the doctrine to the leasing of a city hall, reasoning that offices were as essential as light, water, gas, and the like.¹³ But where the court has found the contract to be merely a device to evade the debt limit,¹⁴ it has held that a present indebtedness in the aggregate was created.¹⁵

The difficulty in reconciling cases of this kind comes in deciding just where courts will draw the line between leases and contracts to purchase in installments. In its holding the court in the instant case attempted at length to distinguish the present situation from *Hively v. Nappanee*,¹⁶ declaring a lease a contract to purchase in installments, and to apply the rule of *City of South Bend v. Reynolds*,¹⁷ upholding a lease. In the *Hively* case the school city leased a building for 25 years, which the court ruled was the life of the building, at a certain rental. The school city was to pay taxes, and keep the property insured and repaired, and was to have an option to renew the lease, or to purchase the building at a price not to exceed the amount actually remaining invested in the property by the building company. In the *Reynolds* case, decided 30 years before, a city hall was built by the lessor on the city's property, the city paying rent, taxes, etc., with an option to purchase at any time by paying remainder of contract price plus interest.

In distinguishing the two cases, the court made much of the fact that the rental in the *Hively* case was far in excess of a reasonable amount and that if the city did not go ahead and purchase the property the excess which was applied on the bonds would be lost, while in the earlier case the rent was no more than the fair rental value of the building, the lessee had to perform a further act, that is, exercise its option to buy, before it could become owner of the building, and nothing was mentioned of a possible intent to evade the constitutional provision. In following the *Hively* case in *Bryant v. Town*

¹⁰ *Mahoney v. San Francisco* (1927), 201 Cal. 248, 257 P. 49.

¹¹ *Hively v. School City of Nappanee* (1930), 202 Ind. 28, 169 N. E. 51, 53, 171 N. E. 381, 71 A. L. R. 1311.

¹² *Valparaiso v. Gardner* (1884), 97 Ind. 1, 49 Am. Rep. 419; *Crowder v. Town of Sullivan* (1891), 128 Ind. 486, 28 N. E. 94; *City of Laporte v. Game-well Fire Alarm Telegraph Co.* (1896), 146 Ind. 466, 45 N. E. 588; *Board, etc. v. Gardner* (1900), 155 Ind. 165, 57 N. E. 903; *City of Logansport v. Dykeman* (1888), 116 Ind. 15, 17 N. E. 587; *Scott, Indiana Municipal Law*, p. 51.

¹³ *City of South Bend v. Reynolds* (1900), 155 Ind. 70, 57 N. E. 706, 708, 49 L. R. A. 795.

¹⁴ *Voss v. Waterloo Water Co.* (1904), 163 Ind. 69, 71 N. E. 208, 66 L. R. A. 95, 106 A. S. R. 201.

¹⁵ *Hively v. School City of Nappanee* (1930), 202 Ind. 28, 169 N. E. 51, 53, 171 N. E. 381, 71 A. L. R. 1311; *Bryant v. School Town of Oakland City* (1930), 202 Ind. 254, 171 N. E. 378.

¹⁶ *Hively v. School City of Nappanee* (1930), 202 Ind. 28, 169 N. E. 51, 53, 171 N. E. 381, 71 A. L. R. 1311.

¹⁷ *City of South Bend v. Reynolds* (1900), 155 Ind. 70, 57 N. E. 706, 708, 49 L. R. A. 795.

of *Oakland City*,¹⁸ the court ignored this distinction, and apparently thought that underlying the lease was the same purpose to evade the law in one as in the other. The instant decision does not mention the Bryant case.

Ignoring the cases altogether, it seems, on principle, if we look at the substance of the transaction¹⁹ and remember that the constitutional limitation is effective against both expressed and implied liability,²⁰ that the present decision is incorrect. If and when the rental payments retired the investments of the lessor, the school township became owner of the property without even exercising its option to purchase. The lessor received no profits—it was no more than a dummy through whose hands the cost of construction of the building was to pass from the township to the security holders. Thus, it would seem that this case is an evasion of the constitutional limitation and is inconsistent with both principle and established precedent. M. J. W.

PAYMENTS—SURETY'S RIGHT TO DIRECT APPLICATION.—Defendant was surety for the Karstedt Construction Company on a contract requiring repairs on a school building. Plaintiff, a subcontractor, performed certain work for the Construction Company, and applied payments made out of proceeds of the secured contract on prior claims arising out of other contracts. Plaintiff brought the present action to recover from the surety the amount of the indebtedness arising out of the assured contract. Defendant contends that the payments from funds arising out of the present contract should be applied on debts arising out of the same contract. Held, in the absence of direction by the debtor, the creditor may apply the payments received to any claim due him from the debtor regardless of his knowledge of the source of the funds.¹

In regard to the right of the surety to have the proceeds of the contract which he assures applied to the claims arising out of the contract, there are three distinct rules adopted by the courts: First, regardless of the knowledge of the source of the payments received, the creditor must apply them to the secured claims;² Second, if the creditor knows the source of the payments, he must apply them to the secured claims;³ Third, regardless of knowledge, the creditor may apply the payments as he sees fit.⁴ Before discussing the various rules, it is well to note some of the general rules as to the application of payments. In the first place, the debtor has the right to say how the payments which he makes shall be applied.⁵ In the absence of direction by the

¹⁸ *Bryant v. School Town of Oakland City* (1930), 202 Ind. 254, 171 N. E. 378.

¹⁹ *State ex. rel. Matthews v. Forsythe* (1896), 147 Ind. 466, 473, 44 N. E. 593.

²⁰ *Eddy Valve Co. v. Town Crown Point* (1906), 166 Ind. 613.

¹ *Western & Southern Indemnity Co. v. Cramer* (1937), 10 N. E. (2d) 440, (Ind. App. Court).

² *Columbia Digger Co. v. Sparks* (1915), 227 F. 780; *Crane Co. v. Pacific Heat Co.* (1904), 36 Wash. 95, 78 P. 460.

³ *Maryland Casualty Co. v. Dupree* (1931), 223 Ala. 420, 136 S. 811; *Sturtevant Co. v. Fidelity & Deposit Co.* (1916), 92 Wash. 52, 158 P. 740; *Salt Lake City v. O'Connor* (1926), 68 Utah 233, 249 P. 810.

⁴ *Grover v. Board of Education* (1928), 102 N. J. Eq. 415, 141 A. 81; *City of Marshfield v. United States Fidelity Co.* (1929), 128 Ore. 547, 274 P. 503; *Standard Oil v. Day* (1924), 161 Minn. 281, 201 N. W. 410.

⁵ *Trentman v. Fletcher* (1885), 100 Ind. 105.