

Memorandum Draft 2: Seattle's Authority to Create a Municipal Bank

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To: Ady Barkan
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Re: Seattle's Authority to Create a Municipal Bank

QUESTIONS PRESENTED

In response to interest in Seattle in establishing a municipal bank, this memo addresses two questions:

- 1) Does Seattle have the power to act under home rule authority to establish a municipal bank?
- 2) Do any provisions in the Washington State Constitution (namely Article VIII, Section 5, Article VIII, Section 7, or Article XII, Section 9) prohibit the city of Seattle from establishing a municipal bank?

BACKGROUND

Municipal banks, an initiative proposed by local advocates, would allow cities to create and operate locally controlled and democratically accountable systems of public finance. More specifically, by leveraging the City's financial resources, municipal banks promote community development and the local economy and increase opportunities for underserved economically disadvantaged segments of the city to access banking services. The duties of a municipal bank could include banking functions, issuing debt, acquiring and refinancing the city's general obligation debt, and offering participation loans for small businesses in partnership with local credit unions, local banks, and CDFIs.

Councilors in Seattle are interested in creating a *municipal* public bank since there is limited political interest for this type of initiative at the state or national level.

LEGAL ANALYSIS

Local governments have no inherent power, as administrative subdivisions of their states (see *Hunter v. City of Pittsburgh*, 207 U.S. 161, 177-190 (1907)). Therefore, in analyzing whether a locality has the ability to act on a specific issue, we must ask: first, whether the local government had the power to act, and second, whether there exists a limitation on that power.

1. It is likely that local governments in Washington have the power to establish a municipal bank under home rule authority granted through the Washington State Constitution.

a) Seattle likely has home rule authority under Article XI, Section 11 of the Washington State Constitution to establish a municipal bank.

The Washington State Constitution grants self-executing power to local governments on local issues. More specifically, Article XI, Section 11 of the Constitution provides that “any county, city, town, or township may make and enforce within its limits all such local police, sanitary, and other regulations as are not in conflict with general laws.”

It is likely that a court would find that the establishment of a municipal bank falls under a city’s local police power. Police powers “extend not only to the preservation of the public health, safety, and morals, but also to the preservation and promotion of the public welfare” (Hudson v. City of Wenatchee, 94 Wash. App. 990 (1999)). As will be described in further detail, the establishment of a municipal bank would clearly help promote public welfare by leveraging the city’s resources to make loans and investments that serve the public good. In addition, decisions over local spending go to the core of a city’s power to self-govern and a city’s expenditure of its funds is a fundamental municipal affair.

Courts have noted that the fact that a governmental service may decrease the demand for a comparable private service does not show that the governmental entity acted outside of its constitutional authority since the deprivation of individual rights and property rights cannot prevent the operation of a police power.

Therefore, the city can exercise certain powers without awaiting further enabling action by the legislature.

b) Alternatively, King County likely has home-rule authority under the King County Charter to establish a public bank.

King County has home rule powers in addition to those provided generally to local and county government by the state constitution. The King County Charter, the county Seattle is a part of, includes two provisions promoting home rule: first, Article I, Section 110 states: “this county shall have all the powers which it is possible for a home rule county to have under the state constitution” and Article I, Section 130 states both that “powers of the county granted by the charter shall be liberally construed” and that “the Charter shall supersede special and general laws which are inconsistent with the Charter and ordinances to the extent permitted by the state constitution.”

Therefore, were courts to find that the city of Seattle did not have authority under home-rule to establish a municipal bank, King County would be a viable alternative.

2. It is likely that a court would find that no provisions in the Washington State Constitution prohibit the city of Seattle or King County from establishing a municipal bank.

Since a court would likely find that both the city of Seattle and King County have the authority without further enabling action by the state legislature to establish a municipal bank, the next level of analysis explores whether any state legislation exists prohibiting the establishment of a municipal bank.

a) It is unlikely that a court would find that the Washington State Constitution, specifically Article VIII, Sections 5 and 7, and Article XII, Section 9 prevent the city of Seattle from depositing and investing its funds in a bank.

Three Sections are very relevant to this discussion. Article VIII, Section 7 of the Washington State Constitution states that:

“No county, city, town or other municipal corporation shall hereafter give any money, or property, or loan its money or credit to or in aid of any individual, association, company or corporation, except for the necessary support of the poor and infirm or become directly or indirectly the owner of any stock in or bonds of any association, company or corporation.”

Article VIII, Section 5 and Article XII, Section 9 of the Washington State Constitution are similar and state that:

VIII, 5: “The credit of the state shall not, in any manner be given or loaned to, or in aid of any individual, association, company or corporation”;
XII, 9: “The state shall not in any manner loan its credit, nor shall it subscribe to, or be interested in the stock of any company, association, or corporation.”

The depositing of public funds in the bank for safekeeping is not considered “a loan, nor investment of funds” within any provision of the State Constitution (*Bardsley v. Sternberg*, 18 Wash. 612, 52 P.251 (1898)). In addition, Washington courts have held that local ordinance ch.39.58, which authorizes municipal funds to be deposited in banks, mutual savings banks, and savings and loan associations does not conflict with Article VIII, Section 7 (*State ex rel. Graham v. City of Olympia*, 80 Wash.2d 672). These deposits also do not constitute purchasing of stock in private corporations in violation of Constitutional Article VIII, Section 7 (*State ex rel. Graham v. City of Olympia*, 80 Wash.2d672).

b) It is unlikely that a court would find that Article VIII, Sections 5 and 7 and Article XII, Section 9 of the Washington State Constitution would prevent a city from lending its money to a municipal bank as long as the court found that a fundamental government purpose existed or that sufficient consideration was given to the public.

Courts in Washington State have held that the prohibitions in Article VIII are “mandatory provision[s]” and “must be strictly observed” (Washington Natural Gas Co.

v. Public Utility Dist. No. 1 of Snohomish County, 77 Wash. 2d 94 (1969)). There is a dual purpose to these provisions. First, it is to “prevent state funds from being used to benefit private interests” (CLEAN v. State, 130 Wash. 2d 782 (1996)) “where public interest is not primarily being served” (Japan Line, Ltd. v. McCaffree, 88 Wash. 2d 93 (1977)). Second, it is to prevent the state from being liable to private actors’ financial risks (State ex rel. Graham v. City of Olympia, 80 Wash.2d 672 (1972)). Further analysis on this second purpose, and the possible ways to avoid local government financial risk follow in Section II.c of the memo.

In the first half of the 20th century, the Washington Supreme Court interpreted the language of the above provisions of the Washington State Constitution strictly and literally, prohibiting the expenditure of public funds on private actors even where public benefit existed (see e.g. Johns v. Wadsworth, 80 Wash. 352, 141 (1914) where the court invalidated the county’s loan of public money to a corporation that was organizing an agricultural fair for the community, even though the court admitted that the fair would have public benefits, interpreting the framers’ intent literally).

Yet, as the need for public capital to finance urban development projects grew, the Washington Supreme Court began to carve out exceptions to its otherwise strict interpretation of the constitutional prohibitions against public lending. The first exception, developed in Miller v. City of Tacoma, carves out a broad public purpose exception to Washington’s ban on gifting of public funds. In City of Tacoma the court rejected a challenge to the city’s plan to redevelop blighted areas by purchasing blighted land through condemnation and reselling it to private development entities since a public purpose existed. The court justified its exception by stating that “as government activities increase with the growing complexity and integration of society, the concept of ‘public use’ naturally expands in proportion” (61 Wash. 2d 374 (1963)). As the court argued in State, Dep’t of Labor & Indus. v. Wendt, “recognized governmental functions are excepted because applying the constitutional debt limitations ... would destroy the efficiency of the agencies established by the constitution to carry out the recognized and essential powers of government. It cannot be conceived that the people who framed and adopted the constitution had such consequences in view” (47 Wash. App. 427, 435 (1987)).

The court next created another exception, allowing lending where the city would become the ultimate owner of the project (see Berglund v. City of Tacoma, 70 Wash. 2d 475 (1967), where the court held that a loan of credit by the City of Tacoma to a local improvement district for purposes of expanding water services outside of the city was not a violation of Article VIII because Tacoma would become the ultimate owner of the district).

The modern test for permissible public lending under the Washington State Constitution is three-fold (*Adams v. University of Washington*, 106 Wash. 2d 312 (1986); also see *City of Tacoma v. Taxpayers of City of Tacoma*, 1-8 Wash. 2d 679 (1987)). As a threshold question, the court asks whether the local government's expenditure of money served a fundamental government purpose. If a fundamental government purpose exists, no further analysis is necessary as the courts have interpreted a public purpose exception to Article VIII's prohibitions. If no government purpose exists, then the court asks whether there was consideration for the local government's payment. If no sufficient consideration exists, the question becomes whether there was any donative intent evidencing a gift. The significance of this test is that any public expenditure could be permitted under Article VIII as long as there was a finding of consideration, even if the expenditure directly benefited private entities, a striking departure from the court's past practice (Nick Beermann, "Legal Mechanisms of Public- Private Partnerships: Promoting Economic Development or Benefiting Corporate Welfare?", *Seattle University Law Review* Vol. 23 (2000)). .

The first prong of the test asks whether funds are being expended to carry out a fundamental purpose of the government. "Recognized governmental functions" are therefore exempted. The court in *Wendt* cites to a number of cases to offer an example of the variety of government actions that fall under "recognized governmental functions" (Cf. *Washington Higher Educ. Facilities Auth. v. Gardner*, 103 Wash. 2d 838, 846 (1985) (higher education is a recognized governmental function); *Washington State Hous. Fin. Comm'n v. O'Brien*, 100 Wash. 2d 491, 498 (1983) (mortgage loan program constitutes a recognized governmental function); *Johnson v. Johnson*, 96 Wash. 2d 255, 263 (1981) (collection of child support for purposes of public assistance constitutes a recognized governmental function); *Washington State Health Care Facilities Auth. v. Ray*, 93 Wash.2d 108, 115 (1980) (necessary support to the poor or infirmed constitutes a recognized governmental function); but not *CLEAN v. State*, 130 Wash. 2d 782 (1996) (where the court concluded that the construction of a baseball stadium was not considered a "fundamental purpose" of the government)).

This standard of "fundamental government purpose" has not been difficult to meet. The court in *Washington Public Ports Association v. State Department of Revenue* held that "an expenditure is for a public purpose and does not violate the state constitutional prohibition on using municipal funds to benefit private interests when it confers a benefit of reasonably general character to a significant part of the public." 148 Wash. 2d 637, 62 P.3d 462 (2003). In fact, the court in *CLEAN v. City of Spokane* emphasized that "where it is debatable as to whether or not an expenditure is for a public purpose, we will defer to the judgment of the legislature" (133 Wash. 2d at 461 (1997)). In addition, "incidental benefit to private individuals or organizations will not invalidate otherwise valid public transactions" (*King County v. Taxpayers of King County*, 133 Wash.2d 584 (1997)).

It is likely that a court could find that the establishment of a municipal bank would fulfill a number of fundamental government purposes, especially considering the language used in *Washington State Housing Finance Com'n v. O'Brien* (100 Wash. 2d 491, 493 (1983)). In *O'Brien*, the Supreme Court of Washington held that authority granted by the Legislature to the Washington State Housing Finance Commission to issue revenue bonds for mortgages did not

violate the Washington State Constitution (100 Wash. 2d 491, 493 (1983)). The court recognized both the “housing need and downward spiral effect on the state's economy if the housing situation were not remedied . . . [and additionally noted that] the primary purpose of the Commission’s program is not to enhance the private sector’s profit at the taxpayer’s expense, but rather to make decent housing available statewide,” and therefore found that the Legislature’s establishment of a home mortgage program was a fundamental purpose of government and therefore not prohibited by the State Constitution (O’Brien at 493). The court concluded that “the adequacy of private housing and the health of the state's economy have traditionally been concerns of state government” (O’Brien at 496).

The establishment of a municipal bank, like the issuance of revenue bonds, would address housing and economic development needs of the community. The public purpose of a municipal bank would be to leverage the city’s resources to make loans and investments that serve the public good. The bank would provide financial support to local small businesses and homeowners, promoting community development. Making loans to small businesses who do not meet the criteria for regular business loans would have the effect of improving the local economy, increasing tax revenues, providing jobs, and preventing neighborhood blight and helping homeowners avoid foreclosures could stabilize neighborhoods, increase property values, increase property taxes, and reduce poverty levels.

If the court were to hold that a municipal bank does not constitute an expenditure of funds to carry out a fundamental purpose of the government, then the court would ask whether the public had received consideration and if not, whether there existed donative intent on the part of the local government.

A gratuitous expenditure of public funds, prohibited by the state constitution, exists where the public entity “neither expects nor receives consideration” (*Ackerley Communications, Inc. v. City of Seattle*, 92 Wash.2d 905 (1979)). A “rendering of services constitutes consideration” (*Washington Pub. Util. Districts' Utilities Sys. v. Pub. Util. Dist. No. 1 of Clallam Cnty.*, 112 Wash. 2d 1, 9 (1989)). In *Adams v. University of Washington*, the court held that unless gift elements such as donative intent or a grossly inadequate return to a use of public funds were proven, the court would not inquire into the adequacy or amount of consideration (106 Wash. 2d 312 (1986)). The court explained that inquiring into the adequacy of consideration would intrude on the government’s power to make its own legislative judgments (*City of Tacoma v. Taxpayers of City of Tacoma*, 108 Wash. 2d 679 (1987)).

For example, in *City of Tacoma*, the court held that the city’s electricity conservation program where it gave payments to ratepayers to install approved equipment to lessen city’s energy consumption did not violate Article VIII because the expenditure was exchanged for sufficient consideration since the city gained energy savings in exchange for public expenditures. However, in contrast, in *O’Connell*, the court considered the expenditure of funds to buy meals and drinks to prospective customers, a gratuitous expenditure because the benefits were too illusory to be considered consideration (*State ex rel. O’Connell v. Port of Seattle*, 65 Wash. 2d 801, 804 (1965)).

One way to determine donative intent is based on whether the municipality retained control over how the funds were spent (*CLEAN v. State*, 130 Wash. 2d 782, 797 (1996)). For example,

in *CLEAN v. State*, where the state gave funding to build a stadium for the Seattle Mariners, there was no donative intent because the funds were to be used on a stadium which would be owned and managed by the District, a public entity, and not the private baseball team (130 Wash. At 799).

The local government establishing the municipal bank would therefore have to meet two tests if the creation of a public bank was not considered a fundamental government purpose. First, it would have to ensure that it received services or alternative consideration for any money given to the bank. Second, it would have to maintain control over money loaned without consideration, in order to meet the donative intent test.

c) It is likely that a court would find that state financing arrangements involved in the establishment of a municipal bank do not implicate the full-faith and credit of the state, and are therefore not prohibited by Article VIII, Section 5 or Article XII, Section 9.

In the 20th century, many municipalities became bankrupt because of the public liabilities incurred in aid of private companies constructing the railroad, as well as from “various other public improvements which were deemed advantageous at the time”

(*Johns v. Wadsworth*, 80 Wash. 352, 354 (1914)). Article VIII, Section 5 and Article XII, Section 9 were included to prevent local governments and states from incurring those same financial risks by implicating the state’s full faith and credit liability. However, the Supreme Court of Washington has stated that “risk flowing from public ventures legitimately undertaking is inherent in our form of government,” so some limited amount of financial liability is permissible (*Washington State Hous. Fin. Comm'n v. O'Brien*, 100 Wash. 2d 491, 495 (1983)).

The Supreme Court of Washington in *O'Brien* outlines the safeguards that can be set up to protect the state against risk when loaning money (*Washington State Hous. Fin. Comm'n v. O'Brien*, 100 Wash. 2d 491, 498 (1983)). The safeguards must ensure that “[t]he public controls both the use of the State conferred ‘asset’ and the extent of its liability ... The state must also retain the means to effectuate the project's public objective.” *O'Brien* at 495. In *O'Brien*, the court found that the Legislature had enacted safeguards that retained public control over risk in the established mortgage loan program. The legislature stated that program funds had to be derived entirely from the investment market, not from state appropriations (*Laws of 1983, ch. 161, § 8(7), p. 700*). The bonds also stated that they were not state obligations, and therefore, all obligations from the sale of bonds or the program were obligations only to the Commission’s special fund, and not the state (§ 3, p. 695; § 28, p. 710).

Courts in other states have also held that constitutional limitations on lending of public credit are not violated when a state or city creates a separate corporation to perform some public function and that corporation then issues bonds or other forms of debt (see *Andres v. First Arkansas Development Finance Corp*, 230 Ark. 594, 599 (1959); *Wain v. City of New York*, 366 NYS2d 885, 889 (1975); and *Ragsdale v. City of Memphis*, 70 S.W.3d 56, 68 (2001)).

Therefore, the municipal bank should be created in a way similar to the state's mortgage-loan program. For example, by creating a separate corporate entity for the bank, the city would likely not be securing the bank's transactions with its full faith and credit.

d) Certain procedural mechanisms could also make it more likely that a court would find that a local government's establishment of a municipal bank did not violate Washington State's constitution.

Procedural mechanisms have been used to justify public spending. Nick Beermann, in his article for the Seattle Law Review outlines some of these mechanisms:

“Procedural mechanisms, such as creating public corporations for channeling public funds to establish a public purpose for financing [see Washington Revenue Code, Section 35.21.730 (1998)], utilizing Federal Housing and Urban Development loans to avoid public scrutiny [see C.F.R. Section 570.703 (1994)], declaring development projects to be public emergencies to avoid the referendum process constitutionally guaranteed the public, and granting a wide variety of tax subsidies to private corporations.”

(“Legal Mechanisms of Public-Private Partnerships: Promoting Economic Development or Benefiting Corporate Welfare?”, Seattle University Law Review Vol. 23 (2000)).

Therefore, by creating a public entity, such as a public facilities district, a Public Utility Division, or a municipal corporation, the government is able to avoid obvious public purpose violations since channeling funds through a public entity yields a strong inference of public purpose (O'Brien, 84 Wash. 2d 64 (1974)). This would likely then avoid constitutional scrutiny by the courts.

CONCLUSION

It is likely that a court would find that Seattle and King County have the power and are not prohibited by state law from establishing a municipal bank.