

35 Cal. Bankr. J. 241

California Bankruptcy Journal

2020

Special Health Care Issue

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ULTRA VIRES--MEAN LIEN FIGHTING MACHINE

I. Introduction

As healthcare districts² continue to face economic challenges in an industry plagued by not only perpetual reimbursement rate uncertainty but a pandemic that will continue to wreak havoc on their financial viability for years to come, it is inevitable that seeking the protection that chapter 9 of the Bankruptcy Code has to offer will become the solution of choice for many such entities. In order to avail itself of the protection that a chapter 9 bankruptcy proceeding has to offer, healthcare districts (as with all hopeful chapter 9 debtors) must overcome not insignificant obstacles in order to demonstrate that they are eligible to proceed under chapter 9.³

However, if and when this initial hurdle has been cleared, the arsenal available to a healthcare district is likely to contain unique, powerful and woefully underutilized weapons, particularly when it comes to the readjustment of debts and obligations vis-à-vis creditors purporting to be secured by real and/or personal property of the healthcare district. Although the concept is certainly not one that is unique to a chapter 9 debtor, the ability of a healthcare district to readjust the debts of its secured creditors in a chapter 9 bankruptcy proceeding is likely to be far more expansive than the options available to a typical chapter 11 debtor. *Ultra vires* is perhaps the most powerful of these options, as the successful application of this doctrine can result in the disallowance of an ostensibly secured claim in its entirety, the discharge of any and all equitable obligations potentially arising from such disallowance, and the invalidation of any and all liens otherwise accompanying such a claim.

Given the gravity inherent in such a doctrine--for both debtors and creditors alike--understanding the nature and extent of the applicability of this doctrine as it ***242** pertains to a particular entity (e.g. private corporation vs. public/governmental entity) is imperative to successfully navigating the quagmire that has become of *ultra vires*.

This article will provide both healthcare and restructuring practitioners with a fundamental framework that will enable them to evaluate the potential benefit that pursuing an *ultra vires* action as part of an overall readjustment can provide. Armed with this analysis, the decision on whether to embark down the chapter 9 path will be at the very least a more informed one.

II. The Evolution of the *Ultra Vires* Doctrine

Ultra vires is a Latin phrase meaning “beyond the powers,” which generally manifests itself in the legal proposition that if a corporation (or governmental or quasi-governmental entity, including a municipality) enters into a contract that is beyond the scope of its corporate or statutory/constitutional powers, respectively, the contract is void and of no force and effect.⁴

As aptly stated by William Herbert Page in his book “The Law of Contracts,” the “real difficulty of [*ultra vires*] is that there was practically no foundation for it at Common Law, since no business corporations existed; and that, without such foundation and without opportunity to observe the practical working of the rules that they were laying down, the courts were forced, by reasons of the sudden growth of manufacturing, trading and transportation corporations, to develop new rules, and to elaborate

a subject whose fundamental principles were not understood. Early precedents, hastily decided, present difficulties in many jurisdictions, as they do not harmonize with the modern trend of judicial decision; and the courts, unwilling to overrule them, follow them blindly, or distinguish them in cases often undistinguishable. The modern cases are therefore in hopeless confusion. There are conflicting views, not only upon isolated rules, but upon the whole theory of the subject; upon the question of what facts are operative as well as upon the question of what decision is to be rendered upon the facts given. *No general statement can therefore be made of the present scope of the doctrine of ultra vires, except that ultra vires contracts do not, under some circumstances, have* *243 *the validity of contracts entered into within the limits of corporate power.*⁵ [Italics added].

If one accepts this premise as true (which most scholars and judicial officers in the United States seem to have done), the skillful practitioner must focus strictly on the precise source(s) from which their client derives its authority in order to truly evaluate the likely result of advancing the doctrine of *ultra vires*. In the example of a healthcare district in California, such authority is strictly statutory, and embodied primarily in the California Health and Safety Code and the California Government Code. Moreover, “certain general principles have become well established with respect to municipal contracts ... [t]he most important one is that contracts wholly beyond the powers of a municipality are void. They cannot be ratified; no estoppel to deny their validity can be invoked against the municipality; and ordinarily no recovery in *quasi* contract can be had for work performed under them. It is also settled that the mode of contracting, as prescribed by the municipal charter, is the measure of the power to contract; and a contract made in disregard of the prescribed mode is unenforceable. And even though the person with whom the contract was made has supplied labor and materials in the performance of the contract and the public agency has received the benefits thereof, he has not right of action to recover in quantum meruit the reasonable value thereof.”⁶

These principles have been evolving in California courts for over a century,⁷ with the doctrine of *ultra vires* first being applied in *The San Francisco Gas Company v. The City of San Francisco*⁸ in 1858. In that case, the Plaintiff, a municipal corporation, had furnished gas to the Defendant, and then brought suit when the Defendant refused to pay for the gas. The Defendant successfully *244 advanced the position that because no ordinance had ever been passed authorizing the Plaintiff to furnish gas to the city as required by the Plaintiff's charter, the act of so furnishing gas to the city was *ultra vires*.⁹ In ruling in favor of the Defendant, the trial court opined that “[m]unicipal corporations have no powers except those granted, or such as are necessary to carry into effect powers granted. A corporation is a creature of the charter than constitutes and gives it being, and prescribes bounds and limits to its operations, beyond which it cannot regularly proceed. Assuming this proposition to be correct, it follows that a municipal corporation can contract only in the mode, and for the objects, specified in the charter. It has no general ability, like a natural person, but having only the capacity to contract for specified objects, and in a certain specified mode, its contracts are void, unless within the powers granted, both as to the subject of the contract, and manner of its created and execution.”¹⁰

In the past 162 years, this notion has only become more pronounced, and while courts have generally been more inclined to impose an equitable remedy, such as quantum meruit, for the benefit of the contracting party against whom an *ultra vires* finding is made when dealing with a private corporate entity, courts have been much more reluctant to impose such a remedy when the subject party is a municipality, a principle founded on the reasoning originally articulated by the California Supreme Court that a “municipal government is, in fact, a part of the State government, exercising subordinate legislative powers over a certain community within a defined district; and the ends contemplated by its creation are different from those intended by other corporations. The same rule, therefore, can not [sic] be applicable to them in reference to this question ... [and a] party who deals with the officers of a municipal corporation should see that they had the authority to bind the corporation.”¹¹

Nearly a century later, courts appeared steadfast in their endorsement of this principle. As the court in *Miller v. McKinnon* noted: “Persons dealing with the public agency are presumed to know the law ... and act at their peril.”¹² Similarly, “one who makes a contract with a municipal corporation is bound to take notice of the limitations on its power to contract and also of the power of the particular officer *245 or agency to make the contract.”¹³ Thus, a contractual counterparty's lack of knowledge of the law applicable to a municipality's borrowing limits does not factor into the analysis of whether a municipality exceeded its power to borrow and, thus, whether the loan is unenforceable. As the California Supreme Court has stated: “It may sometimes seem a hardship upon a contractor that all compensation for work done, etc., should be denied him; but it should be remembered that he, no less than the officers of the corporation, when he deals in a matter expressly provided for in the charter, is bound to see to it that the charter is complied with. If he neglects this, or choose to take the hazard, he is a mere volunteer, and suffers only what he ought to have anticipated. If the statute forbids a contract which he has made, he knows it, or ought to know it, before he places his money or services at hazard.”¹⁴

In addition, numerous courts have recognized that for a governmental act to be *ultra vires*, it must be “beyond the power of a municipality to perform under any circumstances and for any purpose.”¹⁵ If the wrongful act is one which the municipality has the right to do under some circumstances or in some manner, then it is not *ultra vires*.¹⁶ Violations of statutory conditions or a mistake of judgment in the exercise of the power by such bodies does not prevent it from being the act of the city.¹⁷ In other words, in order to find that an action taken by a municipality is *ultra vires*, the court must find that the municipality was never granted the power to take such action in the first instance (as opposed to the municipality intentionally abusing the power granted to them or incorrectly interpreting--and thus applying--the power granted to them).

While it is clear that the evolution of *ultra vires* has not been synonymous with the clarification of *ultra vires*, the applicability of this doctrine in the bankruptcy context has been increasingly elucidated since the turn of the century.

*246 III. Potential Bankruptcy Applications for the *Ultra Vires* Doctrine

The doctrine of *ultra vires* appears to be an incredibly underutilized yet potentially very powerful weapon, particularly for a chapter 9 debtor, and even more particularly so for a chapter 9 debtor that is a healthcare district. Surprisingly, there appear to be only three published bankruptcy court decisions in the Ninth Circuit that substantively address *ultra vires* where the debtor is a municipality, each of which will be discussed below in turn.

In the first of three decisions of its kind, in upholding the validity of the transaction at issue, the bankruptcy court in *In re County of Orange* held that “although they may have been unwise, speculative, or unduly risky, the reverse repurchase transactions made by the Orange County Treasurer ... were not, on the theories presented [t]here, *ultra vires* and thereby void under [applicable] law.”¹⁸ However, despite an ostensibly adverse ruling for the debtor, the bankruptcy court provided significant guidance for a municipality seeking to invoke the doctrine of *ultra vires*. Of particular import, the bankruptcy court analyzed the impact of entering into a contract with a municipality that exceeded the statutory and/or constitutional debt limit established for the municipality, an issue that was directly at issue in the *Southern Inyo Healthcare District* case, which is discussed in detail below. More specifically, the court re-affirmed what the California Supreme Court had previously made clear: “that any contract entered into in violation of the Debt Limit¹⁹ would be *ultra vires* and, therefore, void.”²⁰ “[I]n giving effect to this [section] ... it will not be strange if some shall be found to suffer. But it must be remembered that all are presumed to know the law, and that whoever deals with a municipality is bound to know the extent of its powers. Those who contract with it, or furnish it supplies, do so with reference to the law, and must see that limit is *247 not exceeded. With proper care on their part and on the part of the representatives of the municipality, there is no danger of loss.”²¹

Fortunately or unfortunately (depending on your role in the transaction), the draconian responsibilities and consequences imposed on parties who contract with a municipality pronounced by the court nearly two centuries ago have not changed significantly. However, the strict liability standard that was enunciated by the California Supreme Court in 1882 and that has been solidified since then is contrary to the notion that with proper care on both sides of the transaction, there will be no danger of loss. In fact, the responsibilities are monumental for any entity that lends to a healthcare district if the lender truly wants to protect its investment. More often than not, these additional burdens on a lender to a healthcare district will be outweighed by the potential consequences and damages that may result if the healthcare district is ultimately determined not to have had the proper statutory and/or constitutional authority to borrow the funds. This dilemma undoubtedly compromises the willingness and the ability of institutional banks and investors to lend to healthcare districts, which raises public policy issues that are beyond the scope of this article.

Only a couple years later, the bankruptcy court in the Northern District of California in the case of *In re Southern Humboldt Community Healthcare District* opined that “[r]estrictions on the borrowing of public entities are common in California and other states. They may apply to counties, municipalities, quasi-municipal corporations, and special assessment districts. They may include a limitation on debt as a percentage of revenue, a restriction on the fiscal year from which loans may be repaid, or both. They are intended to prohibit the accumulation of public debt without the consent of the taxpayers, and require governmental agencies to carry on their operations on a cash basis.”²² “Claims made on loans in excess of borrowing limitations are unenforceable.”²³

In estimating the value of the claim asserted by a bank that had lent funds to the healthcare district at \$0 (thus prohibiting them from voting on the debtor's plan of adjustment), the *Southern Humboldt* court held, after discussing [California Health](#)

and Safety Code § 32130,²⁴ that: “[i]t appears to the court an inescapable *248 conclusion that the Bank's claims against the District are completely unenforceable. This is not a conclusion the court enjoys reaching, as money from the Bank not only allowed the District to keep operating but also allowed its employees to fatten their retirement accounts. This situation appears to fall squarely within the legal maxim that no good deed goes unpunished. Nonetheless, the law appears clear and must be followed.”²⁵

In the most recent and most comprehensive of the three California Bankruptcy Court decisions regarding the *ultra vires* doctrine, the bankruptcy court in *In re Southern Inyo Healthcare District*²⁶ issued a lengthy memorandum of decision on cross-motions for summary judgment, in which it ultimately held that “[i]f Southern Inyo's Board of Directors acted without statutory authority when it took the Optum Bank loan, the bank is presumptively without remedy and the objection to the bank's Proof of Claim must be sustained.”²⁷

In reaching this conclusion, the bankruptcy court provided a thorough and well-reasoned analysis of not only the underlying statutory schemes at issue, but on the potential impact of the *ultra vires* doctrine on the rights of a purportedly secured lender in a chapter 9 bankruptcy proceeding of a healthcare district.

After identifying and analyzing the provisions of the California Health and Safety Code that authorize the formation of rural hospital districts,²⁸ authorize the establishment and operation of healthcare facilities,²⁹ and authorize the purchase and encumbrance of district property,³⁰ the bankruptcy court turned to the specific provisions of the California Health and Safety Code that governed the loan(s) taken *249 by the healthcare district--§ 32130³¹ and § 32130.2.³² After so doing, the bankruptcy court reaffirmed the principles set forth by its predecessors in holding that “[g]overnmental boards of directors and officials only possess those powers ‘which are (1) expressly granted by the state constitution or by state statute or (2) necessarily implied by such express grants.’ ‘Any fair, reasonable doubt concerning the existence of the power’ should be resolved against the municipality. California restricts the amount of debt a public entity may incur and the manner in which the public entity may incur the debt. ‘The validity of a [public entity's] transaction, whether it creates indebtedness or liabilities, is measured at the time the transaction is entered into.’ Actions that are wholly beyond the powers of a governmental entity are *ultra vires* and void.”³³

IV. Practical Considerations and Applications

Perhaps one of the most valuable weapons *ultra vires* has to offer a healthcare district is the ability to render void a transaction in which the healthcare district has already received the benefit and for which the healthcare district will not need to make the counterparty whole, and this is the result irrespective of whether the healthcare district held itself out as having the requisite authority to engage in the transaction and the counter-party reasonably relied on that apparent authority. Accordingly, when counseling a healthcare district through a chapter 9 bankruptcy proceeding, it is imperative that the nature of any and all transactions resulting in large obligations and/or obligations purporting to be secured by real and/or personal property of the healthcare district be carefully scrutinized in order to assess whether the healthcare district possessed the requisite authority to engage *250 in the transaction at issue at the time it did so. In the event that it did not act within the confines of the statutory authority proscribed, the benefit to the Debtor could be monumental. Moreover, it is likely to be the only time that the failure of the healthcare district to follow the rules may singlehandedly create the value necessary to ensure a successful exit from chapter 9.³⁴

V. Conclusion


As healthcare entities and practitioners alike continue to navigate both the unfathomable new challenges presented by the worst pandemic that most of us will ever see in our lifetime and the perpetual challenges that plague the healthcare industry, the benefit that a weapon such as *ultra vires* could provide in the context of a chapter 9 bankruptcy proceeding could be invaluable, and in many instances, could be the difference between a healthcare entity not only surviving, but flourishing, and a healthcare entity shutting its doors.

Footnotes

- 1 Ashley M. McDow is a restructuring and insolvency partner in the Los Angeles office of Foley & Lardner, LLP. Ms. McDow specializes in the representation of debtors and debtors-in-possession in Chapter 9 and Chapter 11 bankruptcy proceedings.
- 2 Although this article is focused primarily on the application of the *ultra vires* doctrine in a chapter 9 bankruptcy proceeding involving a healthcare district, the rationale, analysis, and very likely, the conclusion, will apply with the same force and effect in chapter 9 bankruptcy proceeding involving a municipality of a different type.
- 3 See generally [11 U.S.C. § 109\(c\)](#).
- 4 See also *S. Tacoma Way, LLC v. State of Washington and Sustainable Urban Dev. #1, LLC* (June 24, 2010) (ultra vires acts are those “performed with no legal authority and are characterized as void on the basis that no power to act existed, even where proper procedural requirements are followed. Ultra vires act cannot be validated by later ratification or events”) and Black’s Law Dictionary (defining an ultra vires act as one “beyond the scope of power allowed or granted by a corporate charter or by law”). Black’s Law Dictionary (10th ed. 2014).
- 5 2 WILLIAM HERBERT PAGE, THE LAW OF CONTRACTS § 1082, *The Origin of The Doctrine of Ultra Vires*. (emphasis added).
- 6 [Miller v. McKinnon](#), 20 Cal. 2d 83, 88 (1942) (citations omitted); see also *Cty. of Orange v. Fuji Sec., Inc. (In re Cty. of Orange)*, 31 F. Supp. 2d 768, 774 (C.D. Cal.1998) (citations omitted).
- 7 See, e.g., *The Stockton Morris Plan Company v. Cal. Tractor and Equip. Corp.*, 112 Cal. App. 2d 684, 689 (1952) (holding that “[a] contract against public policy or against the mandate of a statute, may not be made the foundation of any action, either at law or in equity”) (quoting [Hooper v. Barranti](#), 81 Cal. App. 2d 570, 574 (1947)); [Smith v. Broderick](#), 107 Cal. 644, 653-54 (1895) (holding that “[i]f, at the time of entering into the obligation, there is a limitation upon the extent to which a municipality may enter into such obligation ... there is not violation of any provision of the constitution, or any obligation of the municipality, in insisting that the person dealing with it shall be bound by the terms of the law, as they existed when he entered into his dealings with the municipality”).
- 8 *The San Francisco Gas Co. v. The City of San Francisco*, 9 Cal. 453 (1858).
- 9 Robert L. McWilliams, *Ultra Vires Corporate Acts under the California Decisions*, CAL. L. REV., Vol. 6, No. 5 (July 1918).
- 10 *The San Francisco Gas Company*, 9 Cal. at 464 (1858).
- 11 *Id.* at 466.
- 12 [Miller](#), 20 Cal. 2d at 89 (1942).
- 13 [G.G. Mezzetta, Inc. v. City of Am. Canyon](#), 78 Cal. App. 4th 1087, 1092 (2000).
- 14 [Reams v. Cooley](#), 171 Cal. 150, 157 (1915) (quoting [Zottman v. San Francisco](#), 20 Cal. 96, 104-05 (1862)).
- 15 [San Antonio River Auth. v. Garrett Bros.](#), 528 S.W.2d 266, 271 (Tex. App. 1975); see also *Grove v. Sugar Hill Inv. Assocs., Inc.*, 466 S.E.2d 901, 905 (Ga. App 1995); [Haslund v. City of Seattle](#), 547 P.2d 1221, 1230-31 (Wash. 1976); [Bator v. Ford Motor Co.](#), 257 N.W. 906, 913 (Mich. 1934).
- 16 See generally [Bator v. Ford Motor Co.](#), 257 N.W. at 913 (Mich. 1934).

17 *Id.*

18 *In re County of Orange*, 31 F. Supp. 2d at 771 (C.D. Cal.1998).

19 The Constitutional Debt Limit provides that: “No county, city, town, township, board of education, or school district, shall incur any indebtedness or liability in any manner or for any purpose exceeding in any year the income and revenue provided for such year, without the assent of two-thirds of the qualified electors thereof, voting at an election to be held for that purpose.”  Cal. Const., art. XVI, § 18. This provision is “meant to establish the ‘pay as you go’ principle as a cardinal rule of municipal finance.” Additionally, the provision seeks to ensure the actual costs of municipal government is closely reflected in the tax rate and give the people the ultimate power of approving or rejecting projects requiring long-term expenditures. *In re County of Orange*, 31 F. Supp. 2d at 776-77 (C.D. Cal. 1998) (internal citations and quotations omitted).

20 *Id.* at 775.

21 *Id.* at 775-76 (citing  *San Francisco Gas Co. v. Brickwedel*, 62 Cal. 641, 642-43 (1882)).

22 *In re S. Humboldt Cmty. Healthcare Dist.*, 254 B.R. 758, 760 (Bankr. N.D. Cal. 2000).

23 *Id.* (citations omitted).

24 CAL. HEALTH & SAFETY CODE § 32130 provides as follows: “A district may borrow money and incur indebtedness in an amount not to exceed 85 percent of all estimated income and revenue for the current fiscal year, including, but not limited to, tax revenues, operating income, and any other miscellaneous income received by the district, from whatever source derived. The money borrowed and indebtedness incurred under this section shall be repaid within the same fiscal year.” CAL. HEALTH & SAFETY CODE § 32130.

25 *Id.* at 760-61.

26 By way of disclosure, the author was counsel for the Southern Inyo Healthcare District in this matter.

27 *In re S. Inyo Healthcare Dist.*, 612 B.R. 750, 769 (E.D. Cal. 2020).

28 *See* CAL. HEALTH & SAFETY CODE § 32000 et seq.

29 CAL. HEALTH & SAFETY CODE § 32121(c) (j).

30 CAL. HEALTH & SAFETY CODE § 32122.

31 *See infra* note 24.

32 CAL. HEALTH & SAFETY CODE § 32130.2 provides that: “(a) A district may, by resolution adopted by a majority of the district board, issue negotiable promissory notes to acquire funds for any district purposes subject to the restrictions and requirements imposed by this section. The maturity of the promissory notes shall not be later than 10 years from the date thereof. The total aggregate amount of the notes outstanding at any one time shall not exceed 85 percent of all estimated income and revenue for the current fiscal year, including, but not limited to, tax revenues, operating income, and any other miscellaneous income of the district. Indebtedness incurred pursuant to any other provision of law shall be disregarded in computing the aggregate amount of notes that may be issued pursuant to this section. (b) Negotiable promissory notes may be issued pursuant to this section for any capital outlay facility, equipment, or item which has a useful life equal to, or longer than, the term of the notes, as determined by the board of directors. (c) The maximum annual interest rate which may be paid on the negotiable note shall at no time exceed the amount authorized under Section 53531 of the Government Code.” CAL. HEALTH & SAFETY CODE § 32130.2.

33 *In re S. Inyo Healthcare Dist.*, 612 B.R. at 760 (E.D. Cal. 2020).

34 To be clear, the author is in no way encouraging any entity to engage in a transaction that they know exceeds their authority (whether statutory or otherwise) by misrepresenting or omitting material facts of which they are aware, because

although such action/inaction is not likely to alter the result in an *ultra vires* action, separate torts (such as fraud) may be implicated by such tactics.

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