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KENTUCKY'S "PAY-AS-YOU-GO" PLAN FOR MUNICIPALITIES

In the recent case of *City of Winchester* v. *Winchester Bank*,[1] decided by the Kentucky Court of Appeals, the bank instituted suit to recover on two demand notes executed by the city The city denied liability principally on the ground that the notes were renewals of former notes which had become void because not paid out of the revenues levied and collected by the city for the year in which the obligations represented by the notes were created.

This defense was based on Section 157 of the Kentucky Constitution which provides in part

> "No county city, town, taxing district, or other municipality shall be authorized or permitted to become indebted, in any manner or for any purpose, to an amount exceeding, in any year, the income and revenue provided for such year, without the assent of two-thirds of the voters thereof, voting at an election to be held for that purpose; and any indebtedness contracted in violation of this section shall be void. Nor shall such contract be enforceable by the person with whom made; nor shall any municipality ever be authorized to assume the same."[2]

McQuillin, in *The Law of Municipal Corporations,* seemed accurately to interpret such a provision when he stated that it requires "municipal corporations to adopt the safe, sane and conservative plan of pay-as-you-go, consequently each year's income and revenue must pay each year's indebtedness and liability and no indebtedness or liability incurred in any one year shall be paid out of the income or revenue of any future year."[3]

The Court, however, applied a rule which may be expressed, "Once valid always valid," and held that for an obligation to be void under the above section of the Constitution it must constitute an indebtedness, *at the time it was made,* in excess of the

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[1] 305 Ky 45, 205 S.W 2d 997 (1947) (rehearing denied December 12, 1947)

See Ky. R. S. (1946) sec. 92.360 (2) (The legislative body of any city of the second to sixth class shall not, in any year, expend any money in excess of the amount levied and collected for that year). One wonders how this provision can be enforced.

[3] 6 McQuillin, The Law of Municipal Corporations sec. 2365 (2d ed. 1937). This section was quoted with approval in Payne v. City of Covington, 276 Ky 380, 385, 123 S.W 2d 1045, 1048 (1938).

income and revenue *provided* for that year. It pointed out that in several previous cases it had held that a debt of a municipality constituted a permanently valid obligation (subject, presumably, to the statute of limitations) if at the time it was made it was valid.[4]

It seems obvious that such an interpretation, however desirable it may seem to be in a particular case from the standpoint of a creditor who has dealt with a city in good faith, is not consistent with a true "pay-as-you-go" plan. For example, it allows the officers of a city, in the early part of the city's fiscal year, to borrow money up to the amount of the city's income and revenue provided for that year, and thereafter to expend the amount so borrowed and all the income provided for that year without repaying the amount borrowed. Yet at the close of the fiscal year, although no funds would remain with which to discharge the obligation, the debt would be valid, since it was valid when made, and would thus be carried over. It should be noted, however, that even under the Court's interpretation, it seems that to constitute a debt "valid when made" the amount borrowed in any year *plus the amount of floating debt carried over* from previous years must not exceed the income and revenue provided for that year.[5]

The Constitutional provision in question has been the subject of much litigation from the time it was enacted to the present time, and the numerous cases show many conflicts in its interpretation. The purpose of the limitation has been said to

[4] Penrod v. City of Sturgis, 269 Ky. 315, 107 S.W 2d 277 (1937) Geveden, County Treasurer v. Fiscal Court of Carlisle County, 263 Ky. 465, 92 S.W 2d 746 (1936), Randolph v Shelby County, 257 Ky. 297, 77 S.W 2d 961 (1934), *accord,* Mountain Grove Bank v. Douglas County, 146 Mo. 42, 47 S.W 944 (1898), 6 MCQUILLIN, THE LAW OF MUNICIPAL CORPORATIONS sec. 2365 (2d ed. 1937), *Contra:* Weaver v. City and County of San Francisco, 111 Cal. 319, 43 Pac. 972 (1896).

[5] Fulton County Fiscal Court v. Southern Bell Telephone & Telegraph Co., 285 Ky 17, 35, 146 S.W 2d 15, 25 (1940) ("It was at all times the duty of the fiscal court to earmark enough of the legally anticipated revenue to take care of all the governmental expenses for the year and to reserve that sum. When the balance of the revenue anticipated was spent or covered by warrants or other obligations, then there was an exhaustion of revenue. Any money paid out and any obligation assumed thereafter for non-essential matters was illegally paid and assumed. And such outstanding obligations, being void cannot be funded."), Randolph v. Shelby County, 257 Ky 297, 301, 77 S.W 2d 961, 963 (1934), Hogan v. Lee Fiscal Court, 235 Ky. 100, 29 S.W 2d 611 (1930).

be to protect the people from improvident contracts.[6] The cases show that it does not refer to "necessary governmental expenses,"[7] however, or to liabilities imposed by law for what is done without right or to liabilities for what is done negligently;[8] nor was it intended to deprive the municipality of all remedy necessary to preserve its health and safety in an emergency.[9]

Thus the Kentucky Court has always tended to give a liberal construction to Section 157 Further, in construing Section 158 of the Constitution, the Court has again evidenced a desire to be liberal.[10] That section limits a municipality's indebtedness to a certain percentage of the value of the taxable property therein,[11] but contains two provisos relating expressly to debts contracted before the adoption of the Constitution and concludes with the following separate sentence "Nothing herein shall prevent the issue of renewal bonds, or bonds to fund the floating indebtedness of any city, town, county, taxing district or other municipality" The Court has held that this last provision is not confined to debts created before the adoption of the Constitution but authorizes the funding of debts subsequently incurred.[12] This holding has been frequently attacked by various members of the Court.[13]

For a while Section 157 was construed as requiring that the principal amount of a valid debt at the end of the fiscal year must be carried over and considered in the financial operations of the succeeding year.[14] However, the Court, "influenced by

[6] *See* Fulton County Fiscal Court v Southern Bell Telephone & Telegraph Co., 285 Ky. 17, 34, 146 S.W 2d 15, 24 (1940).

[7] *Ibid., See* Ballard v Adair County, 268 Ky. 347, 349, 104 S.W 2d 1100, 1102 (1937) Breathitt County v Cockrell, Jailer, 250 Ky. 743, 751, 63 S.W 2d 920, 923 (1933).

[8] Knepfle v City of Morehead, 301 Ky. 417, 192 S.W 2d 189 (1946).

[9] *See* Samuels v City of Clinton, 184 Ky. 97, 104, 211 S.W 567, 570 (1919)

[10] It is not the purpose of this note to consider in any detail the limitations on indebtedness imposed by Section 158 itself.

[11] This limitation may not be lifted even by a vote of the people, see Fulton County Fiscal Court v Southern Bell Telephone & Telegraph Co., 285 Ky 17, 26, 146 S.W 2d 15, 20 (1940).

[12] Fulton County Fiscal Court v. Southern Bell Telephone & Telegraph Co., 285 Ky. 17, 146 S.W 2d 15 (1940), Hill v City of Covington, 264 Ky 618, 95 S.W 2d 278 (1936), Hall v. Fiscal Court of Fleming County, 239 Ky. 425, 39 S.W 2d 656 (1931)

[13] See note 12 *supra.*

[14] Nelson County Fiscal Court v McCrocklin, 175 Ky. 199, 194 S.W 323 (1917) Southern Bitulithic Company v. DeTreville, 156 Ky. 513, 161 S.W 560 (1913)

the necessity of reading Sections 158 and 157 together in order to make a complete regulation, later imported into Section 157 the provision of Section 158 which authorizes the funding of a floating debt and changed the interpretation."[15] Today, therefore, *provided the city funds its floating debt,* it is required to consider and charge up against its current revenues in succeeding years *only* the amount of interest and sinking fund payable during the particular year, and thus may validly borrow new money up to the full amount of the income and revenue provided for the current year less only interest and sinking fund charges on old debt.[16] However, it would still seem that the full amount of *unfunded* floating debt must be considered when determining whether any new debt is "valid when made."[17]

In recent years, the Court had occasionally shown a tendency to tighten up its construction of Section 157.[18] In a landmark case, *Payne* v. *City of Covington,*[19] decided in 1938, the Court first indicated that tendency. Prior to that case the term "revenue provided" in Section 157 had been construed as meaning the maximum revenue allowed under the Constitution,[20] but in that decision the Court changed the interpretation to mean the amount actually provided for by the local taxing authorities. In rendering its opinion the Court said.

> "The framers of our Constitution who gave multiplied months to preparation of the instrument which was later ratified and adopted by the people, knowing the general tendency of governments and especially subordinate taxing divisions thereof and their officials to run into debt and incur liabilities that would affect

[15] Fulton County Fiscal Court v. Southern Bell Telephone & Telegraph Co., 285 Ky. 17, 28, 146 S.W. 2d 15, 21 (1940).

[16] Allen County Fiscal Court v. Allen County Farm Bureau, 298 Ky. 220, 182 S.W. 2d 660 (1944), Hogan v. Lee Fiscal Court, 235 Ky. 100, 29 S.W. 2d 611 (1930). However, the entire funded debt is to be considered in applying the limitation set out in Section 158, Fulton County Fiscal Court v. Southern Bell Telephone & Telegraph Co., 285 Ky. 17, 146 S.W. 2d 15 (1940).

For cases upholding a device to escape the debt limitation, known as the "holding company plan" see Sizemore v. Clay County, 268 Ky. 712, 105 S.W. 2d 841 (1937). Waller v. Georgetown Board of Education, 209 Ky. 726, 273 S.W. 498 (1925).

[17] See note 5 *supra.*

[18] *See* Griffin v. Clay County, 304 Ky. 592, 598-599, 201 S.W. 2d 733, 737 (1947).

[19] 276 Ky. 380, 123 S.W. 2d 1045 (1938).

[20] Carter v. Krueger & Son, 175 Ky. 399, 194 S.W. 553 (1917). City of Providence v. Providence Electric Light Co., 122 Ky. 237, 91 S.W. 664 (1906).

> their faith and credit and impose onerous burdens upon the tax paying public placed these positive and wise limitations upon the powers of the counties, towns, etc., to incur debts or impose liabilities upon themselves beyond the limitations prescribed in the quoted provisions without referring the proposition to the voters for approval.
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> "The undoubted purpose of the makers of the Constitution and of the people in adopting the inserted language, supra, of section 157 and its limiting language found in section 158 was to require counties, municipal corporations and other tax levying political units to conduct their affairs on the 'pay as you go' plan, as is not only clearly evidenced by the language itself, but which has also been interpreted by all courts before which questions arising thereunder have been presented, and by recognized law-writers on the subject as the declared and undeviating interpretation that should be given such limiting language.
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> " it is the duty of all persons dealing with political subdivisions of the government to do so at their peril and to take notice of the limitations of their powers and authority. if his transaction creates a debt exceeding that authority he must suffer the consequences. Such political units speak by their records which are always open to the public and anyone contemplating dealing with them may easily inform himself as to the status of the affairs of the particular unit with which he proposes to deal."[21]

Yet, notwithstanding the strong language used in the *Payne* case, the decision in the present case is liberal enough to permit municipal officers easily to avoid a strict "pay-as-you-go" plan, as already pointed out herein.

The Court seems to justify its liberal construction on the ground that any other theory would practically destroy the ability of municipalities to obtain credit necessary to carry on their governmental functions.[22]

In answer to this it may be stated that for long-term financing the municipality could raise funds by a vote of the people. It is they who must pay the debts and who should authorize obligations that cannot be met by the income and revenue provided for the year in question. For short-term financing the municipality could execute a valid and binding pledge of some specific municipal fund set apart, out of the general municipal revenues for that year, for the repayment of such short term

[21] 276 Ky. 380, 383–388, 123 S.W 2d 1045, 1047–1049 (1938).

[22] City of Winchester v. Winchester Bank, 306 Ky. 45, 48, 205 S.W 2d 997, 999 (1947).

obligations.[23] It should also be pointed out that the non-availability of the suggested methods would not handicap a municipality in the exercise of its "necessary governmental functions" or in emergencies because, as stated above, these situations are held not to be within the purview of the constitutional limitation —the limitation only applies to improvident contracts.

In conclusion it may be stated that Section 157 of the Kentucky Constitution requires a municipality to obtain the assent of its voters before becoming indebted in any amount exceeding the income and revenue provided for that year. This should force the municipality to operate on a "pay-as-you-go" plan. The doctrine that a municipal debt is valid if valid when made, as that doctrine has been applied by the Kentucky Court thus far, strays further than is reasonably necessary from a strict "pay-as-you-go" plan, since under that doctrine the municipality is able to borrow money up to the amount of income and revenue provided for the particular year, and then expend the amount borrowed plus all the income provided for that year. Thus it would still end up the fiscal year with a valid debt, while under strict "pay-as-you-go", no floating debt could be carried over. Under the decision in the present case this type of debt may be accumulated as the years go by through funding the floating debt, which may be done without a vote of the people, and then the municipality is only required to charge up against its current revenues in succeeding years the amount of interest and sinking fund payable during the year in question. The Court's contention that any other theory would destroy the ability of municipalities to obtain credit necessary to carry on their governmental functions may be met with the arguments that under previous decisions the limitation does not apply to "necessary governmental functions" or emergencies, that ample revenues may and should be *provided* by the then present taxing authorities, that if funds are needed to carry on municipal functions until collections are made, the credit may be obtained by executing a valid pledge of specific income to be received, and that if long term funds are needed the credit may be secured by obtaining the assent of the voters. It may be reasonable to modify the

[23] *See* COOLEY, MUNICIPAL CORPORATIONS sec. 131-132 (1914). This argument was presented to the Court in the petition for rehearing in the present case, apparently without success.

strict "pay-as-you-go" plan to the extent of refusing to invalidate debts valid when made in cases where the actual revenues *collected* fall below the revenues *reasonably anticipated,* but it is submitted that the modification should be extended no further. If the anticipated revenues are in fact collected, creditors of the city should take the risk of failing to obtain and enforce a pledge of those revenues. The Court of Appeals, however, has refused to place any such risk upon creditors of municipalities and has permitted a key prop to be cut from under the protective barrier of Section 157 Mandatory "pay-as-you-go" in Kentucky seems to exist chiefly as a pious hope.

FRANK K. WARNOCK

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