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THE DEVELOPMENT OF FINANCING PUBLIC IMPROVEMENTS BY KENTUCKY MUNICIPALITIES

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Under the American system, a municipality is a governmental unit, subservient to the state, performing certain definite functions delegated to it by the legislative body of the state, within prescribed constitutional restrictions.[1] A student of municipal law is primarily concerned with the authority and duties of the municipality as delegated to it by the parent government. The starting point of each municipal question is: the constitution of the state in which the municipality is located for the purpose of determining whether or not the vested authority falls within one of the restrictions written into the organic law. In the absence of constitutional restrictions, the next step is to consult statutes for the purpose of determining whether or not the municipality has specific and clearly-defined authority to accomplish the end it desires. If the student stays close to these two fundamental propositions, he will not go far afield.

True, a municipality has certain implied powers, but those implied powers grow out of specific delegated powers. To illustrate, a Kentucky municipality of the fourth class has specific statutory power to construct and maintain a gas plant and distribution system.[2] Having this power, there is impliedly granted to such municipalities the authority to select the means by which they will accomplish this end, if the method selected is not prohibited by the constitution.[3]

The delegated authority to municipalities was first governmental in its character, that is, the central government vested in municipalities within its jurisdiction certain governmental au-

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[1] 43 C. J., Sec. 1, 19 R. C. L. 388, City of Louisville v. Commonwealth, 62 Ky. 295 (1864); 1 Dill. Mun. Corp., Sec. 20; Mayor v. Roy, 86 U. S. 468 (1873); Green County v. Shortell, 116 Ky. 108 (1903), 75 S. W. 251; City of Covington v. Commonwealth of Kentucky, 173 U. S. 231 (1899).

[2] Section 3490-36, Carroll's Kentucky Statutes, 1936 Edition.

[3] R. F. C. v. City of Richmond, 249 Ky. 789, 61 S. W. (2d) 631 (1933).

thority and prerogatives, the exercise of which were not susceptible to satisfactory or efficient central control. The proprietory functions of municipalities are the outgrowth of the first governmental authorities granted them. It was soon found that to maintain order, it was necessary to light municipal streets and in order to protect the health of a community, adequate water and sewerage facilities must be established. The lighting of the streets was an accepted governmental function; however, if the municipality, in connection with the lighting of its streets produced a surplus, that surplus was usually disposed of to inhabitants within its corporate limits and by so doing, the municipality entered into the proprietory field.

The establishment and maintenance of sewer systems was, generally, an accepted governmental function;[4] likewise the providing of fire protection has, from its inauguration, been considered governmental;[5] however, if a municipality in providing such service, produced a surplus of water, such water was sold to its inhabitants and by such sale performed a proprietory function.[6]

Under legislative authority, municipalities, as now constituted generally have the specific authority by constructing and operating the necessary facilities, to furnish themselves, together with their inhabitants, light, heat, power, water and other utilities. The furnishing of these utility services to their inhabitants represents the performance of a purely proprietory function.[7]

Originally the entire burden of educating the youth was accepted by the church and other private institutions. However, as a result of the teachings of Spencer, of Mann and many others, the duty of educating the youth was accepted as a state and municipal function. The establishment, operation and maintenance of adequate educational facilities is one of the cardinal functions of local and state governments.

[4] Johnson's Admr. v. Commissioners of Sewerage of Louisville, 160 Ky. 356, 169 S. W. 827 (1914); Smith v. Louisville, 146 Ky. 562, 143 S. W. 3 (1912).

[5] City of Louisville v. Bridwell, 150 Ky. 589, 150 S. W. 672 (1912).

[6] Phillips v. Kentucky Utilities Co., 206 Ky. 151, 266 S. W. 1064 (1924); Phillips v. City of Elizabethtown, 218 Ky. 428, 291 S. W. 358 (1927).

[7] Flutmus v. City of Newport, 175 Ky. 817; 194 S. W. 1039 (1917); Dillon on Mun. Corp., Section 1670.

The law is not a static thing. The ancient principles of law are capable of development and have been developed for the purpose of meeting and solving the problems of and for the advancement of civilization. It is the lawyer who points the way to achieve human development. It is the lawyer who has made possible the development of local governments classified in the broader sense as municipalities. He defends, protects and guides them. In order to illustrate the contributions of the lawyer to municipal government, we will consider the development of Kentucky municipalities from the adoption of the last constitution of the Commonwealth. But, due to lack of space only the following: The development of the functions of municipalities in connection with the building and lighting of streets, the furnishing of heat, light and electric energy to consumers within the municipal corporate limits and, in order to protect the health of the community, the furnishing of pure water and sewer facilities, and finally, the furnishing of educational facilities.

The General Assembly of the Commonwealth has, from time to time, granted certain powers to municipalities concerning the foregoing, all of which are subject to constitutional restrictions.

Kentucky has had four Constitutions, the Constitution of 1783, the Constitution of 1799, the Constitution of 1850 and the present Constitution adopted September 28, 1891. Time will not permit reference to the first three, nor will it permit a discussion of each restriction applicable to municipalities contained in the present Constitution; however, for our purpose it is necessary to consider the restrictive provisions applicable to organization, taxation and indebtednesses of municipalities.[8]

In 1893, the General Assembly of the Commonwealth divided the cities and towns of the Commonwealth into six classes pursuant to existing constitutional provisions, and proceeded to adopt charters for cities of each class. During this session charters were adopted for cities and towns of the first, third, fourth, fifth and sixth class.[9] The charter for cities of the second class

[8] Sections 156, 157, 158 and 159 of the Constitution of the Commonwealth of Kentucky.

[9] Chapters 244, 222, 250 and 196 of the 1893 Acts of the General Assembly of the Commonwealth of Kentucky, Extraordinary Session.

was adopted by the General Assembly of 1894.[10] These charters defined the powers, duties and functions of the cities and towns of the Commonwealth so classified. The foregoing charters, among other things, vested in cities and towns of the Commonwealth the following powers:

(1) To construct and maintain streets, alleys, public ways and sidewalks.

a. The original construction of public ways by cities of the first class was to be at the exclusive cost of the property owners, which cost was evidenced by apportionment warrants.

b. The construction of public ways by cities of the second and third class under the special assessment plan was not mandatory. If constructed on the special assessment plan, property owners were given the privilege of electing to pay the cost assessed their property in ten equal annual installments.

c. The original construction of public ways by cities of the fourth class was to be at the exclusive cost of the property owners; such cost to be evidenced by apportionment warrants.

d. The construction of public ways by cities of the fifth and sixth class was to be at the cost of the city. The maintenance of such improvements, however, was to be at the cost of abutting property owners.

(2) With the exception of cities of the sixth class, each class was vested with the authority to make necessary contracts to light streets and public buildings.

a. Cities of the third class were given the authority to provide light for streets and public buildings either by contract or by facilities acquired or constructed and were given the further authority to furnish light, heat and power to consumers located within their corporate limits.

(3) Each class city was given the authority to provide water for municipal purposes by contract. Cities of the first four classes were given the authority to maintain fire departments.

a. Cities of the third and fourth class were given the authority to acquire or construct waterworks systems for the purpose of supplying themselves and their inhabitants with water.

[10] Chapter 100 of the 1894 Acts of the General Assembly of the Commonwealth of Kentucky.

(4) Each class of cities was given the authority to construct, operate and maintain sewer systems. Certain classes were given the authority to construct such systems on the special assessment plan. The assessment was usually limited as in the charters of cities of the second class wherein such assessments were limited to one dollar per abutting foot of property located adjacent to the sewer line.

(5) The charters of cities of the first four classes, in order to provide for the maintenance and operation of public school systems, created a Board of Education as a separate and distinct corporate entity from the city.

a. In that the school districts serving cities of the fifth and sixth class were not coterminous with the corporate limits of such cities, the control, operation and maintenance of such school systems was vested in the existing boards of education.

(6) Each class of cities was given authority to borrow money and to levy taxes for the purpose of carrying out the authority, powers and functions delegated to them by the legislative authority of the Commonwealth.

Kentucky is a conservative state. Because of the restrictions contained in its Constitution, municipalities are required to keep expenditures within their income, which income is limited by fixed constitutional limits from 50 cents to $1.50 per $100 of the value of taxable property located within their corporate limits. No county, city, town or taxing district or other municipality is permitted, under the Constitution 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. Any indebtedness contracted in violation of the Constitution is void.[11] The borrowing capacity of cities, towns, counties, taxing districts and other municipalities is further restricted to an amount, including existing indebtedness, ranging from two per centum to ten per centum of the value of the taxable property located within their corporate limits as estimated by the assessment next before the last assessment previous to the incurring of the indebtedness.[12]

[11] Section 157 of the Constitution of the Commonwealth of Kentucky.
[12] Section 158 of the Constitution of the Commonwealth of Kentucky.

Cities, towns, counties, taxing districts or other municipalities when authorized to contract an indebtedness are required, at the same time, to provide for the collection of an annual tax sufficient to pay the interest on such indebtedness and to create a sinking fund for the payment of the principal thereof within not more than forty years from the time of contracting the same.[13]

One of the first questions presented to the courts following the adoption of the last Constitution was whether or not an indebtedness authorized pursuant to the restrictions therein contained, was payable from a portion of the proceeds of taxes levied pursuant to the restrictions of Section 157. It was contended that a municipality could not levy a tax in excess of the permissible limits of this section and that municipal bonds were payable from a limited tax. The Court of Appeals in considering this question for the purpose of arriving at the constitutional intent, construed the section of the Constitution applicable to indebtedness together.[14] It was held that the restrictions recited in Section 157 were applicable to general governmental expenses of the municipality. That if a municipality incurred an indebtedness within, and subject to constitutional restrictions, that such indebtedness was payable from an ad valorem tax which may be levied without limit as to rate or amount.[15]

Municipal problems are not always solved by the enactment of legislation granting authority to the municipality authorizing the accomplishment of the desired end. The legislative authority is subservient to the constitutional restrictions some of which we have above noted. A municipality in connection with the exercise of its delegated authority must operate within the restrictions contained in the organic law.[16] The exercise of such municipal authority often necessitates the incurrence of indebtednesses, some of which are classified within the prohibitive constitutional restrictions unless incurred in the manner pre-

[13] Section 159 of the Constitution of the Commonwealth of Kentucky.

[14] Nall v. City of Elizabethtown, 200 Ky. 321, 254 S. W. 893 (1923); City of Winchester v. Nelson, 175 Ky. 63, 193 S. W. 1040 (1917).

[15] Ballard v. City of Shelbyville, 180 Ky. 135, 201 S. W. 452 (1918); Phelps v. City of Lexington, 167 Ky. 449, 180 S. W. 786 (1915); Benjamin v. City of Mayfield, 170 Ky. 726, 186 S. W. 169 (1916).

[16] Bird v. Asher, 170 Ky. 726, 186 S. W. 663 (1916); Jones v. Rutherford, 225 Ky. 773, 10 S. W. (2d) 296 (1928).

scribed by such restrictions. The cost incurred in exercising the authority granted in the foregoing charters, with few exceptions as to constructing streets and sewers, under the then existing statutory and constitutional limitations, had to be financed from the proceeds of taxes or by contracting indebtednesses within the restrictions of the organic law.

We have noted that pursuant to the statutory method provided, certain cities were authorized to construct streets and, to a limited extent, sanitary sewers and apportion the cost of such construction against the property benefited; and that other cities were permitted to issue bonds payable solely from the proceeds of such assessment taxes duly apportioned and levied. This authority presents the question as to whether or not an indebtedness so incurred is a debt within the meaning of constitutional limitations or restrictions.

This question was duly presented to the court and it was definitely established that Kentucky municipalities having the proper legislative authority may construct streets and sewer systems, assess the cost of such construction against the benefited property and issue bonds to pay for such costs, payable solely from the proceeds of such assessments.[17] Bonds payable solely from the proceeds of special assessments duly levied against the benefited property do not constitute an indebtedness within the meaning of constitutional restrictions for the reason that such bonds are payable as to interest and principal from a special fund pledged for that purpose.[18] The municipality issuing such bonds cannot use its general funds, or pledge its full faith, credit and taxing power for the payment thereof.[19]

Prior to the development of the special fund theory as pertaining to the issuance of special obligation bonds payable from the proceeds of the revenues of self-liquidating projects and the enactment of legislation vesting municipalities with the authority to issue such bonds to pay for the cost of such construction, with the exception of the construction of sewers and to a limited

[17] Adams v. City of Ashland, 26 Ky. L. Rep. 184, 80 S. W. 1105 (1904); Shaw v. City of Mayfield, 204 Ky. 618, 265 S. W. 13 (1924); Gosnell v. City, 104 Ky. 201, 46 S. W. 722 (1898).

[18] Adams v. City of Ashland, *Id.*

[19] German Nat. Bank v. City of Covington, 164 Ky. 292, 179 S. W 330 (1915).

extent the construction of streets, all municipal construction in Kentucky authorized by general charter provisions was financed either from the proceeds of taxes or by the issuance of general obligation bonds. It was soon found that in numerous instances municipalities exhausted their bonding capacity, and in numerous other instances the proposed bond issues were not approved by the requisite number of voters, voting on the question at an election duly held for that purpose pursuant to constitutional requirements. In some few instances, municipalities constructed waterworks systems, electric light, heat and power plants and financed the cost of such construction by the issuance of general obligation bonds.

There appear to be two exceptions to the acquisition of a water supply by means other than the financing of such construction by the issuance of general obligation bonds, or contracting with a private company for such services. The City of Lebanon at an early date, secured legislative authority to construct a cistern in the court house yard to contain water for public use and to pay for the cost of such construction from the proceeds of fines and penalties collected by the municipality.[20] Thirty-five years after the construction of its cistern, the municipality secured the authority to acquire the stock of a private water company and by so doing, secured control of the local water company.[21]

Water is furnished to the city of Louisville by the Louisville Water Company. The stock of this company has been acquired by the Louisville Sinking Fund Commission and the control and management of the system is vested in a board, the appointment of which is controlled by the City of Louisville. By this method the City of Louisville enjoys the advantages of a waterworks system which for all practical purposes may be considered as municipal in character.

The General Assembly of 1926 authorized cities of the second, third and fourth class to construct waterworks systems and to pay for the cost of such construction by the issuance and sale of special obligation bonds, generally referred to as revenue

[20] Chapter 99 of the 1851 Acts of the General Assembly of the Commonwealth of Kentucky.

[21] Chapter 117 of the 1886 Acts of the General Assembly of the Commonwealth of Kentucky.

bonds.[22] Under this method of financing, a municipality pledges a portion of the revenues of the system to retire the bonds.

The bonds when issued pursuant to legislative authority are special obligations of the obligor, payable as to both principal and interest from a fixed amount of the gross income and revenues to be derived from the operation of the waterworks system of said obligor, which amount must be fixed and pledged and be paid into a special fund identified as the "Bond and Interest Redemption Fund" and must be sufficient to pay and be used only for the payment of the interest on and the principal of the bonds as and when they mature, and are further secured by a statutory mortgage lien on the system. This lien is not a foreclosable lien. It gives to the holder of said bonds or any of the coupons, the right to enforce the statutory mortgage lien on the system conferred by suit, action, mandamus or other proceeding to compel the performance of all duties required by the Act, including the making and collecting of sufficient rates, the segregation of income and revenues and the application thereof.

In case of default in the payment of the principal or interest of any of such bonds, any court having jurisdiction of the action may appoint a receiver to administer said waterworks on behalf of the municipality with the power to collect rates sufficient to provide for the payment of any bonds or any obligations outstanding against said waterworks, for the payment of operating expenses, and to apply the income and revenues in conformity with the Act and the ordinance authorizing the issuance of such bonds.

The first municipality offering special obligation waterworks bonds, pursuant to the legislative authority of 1926 was the City of Bowling Green. The City, by ordinance duly adopted, authorized the construction of improvements and extensions to the existing municipal waterworks system and by its provisions pledged the entire revenues of the system to be so improved for the purpose of paying the interest and principal of the bonds authorized, the maintenance and operation of the system and for the purpose of creating a depreciation fund.

[22] Chapter 133 of the 1926 Acts of the General Assembly of the Commonwealth of Kentucky.

All questions as to the constitutionality of the Act were presented to, and decided by the Court of Appeals. In a well considered opinion it was held that the bonds authorized pursuant to the provisions of the Act were not debts within the meaning of constitutional restrictions or limitations. That a City owning its waterworks facilities may improve such facilities and pledge the revenue of the entire system as improved for the purpose of retiring the bonds authorized for the purpose of financing such improvements.[23] The Court by the proper application of the special fund theory made possible the acquisition or improvement of an essential municipal utility.

In 1930 the General Assembly extended the authority pertaining to the construction or improvements of waterworks systems to cities of the fifth and sixth class and authorized the issuance by such cities of special obligation bonds to pay the cost of such improvements.[24] Under the existing law of the Commonwealth, cities of the second, third, fourth, fifth and sixth class may now acquire or construct waterworks systems from the proceeds of special obligation bonds payable from revenues of the system and secured in the manner hereinabove discussed.

The General Assembly of 1932 amended the waterworks revenue bond law by authorizing cities of the second, third and fourth class to acquire or construct sewer systems and pay for the cost of such construction by the issuance of bonds payable from the revenues of the project.[25] This Act was presented to, and approved by the Court of Appeals.[26]

Following the enactment of this amendment it was necessary to present to, and have determined by a decision of, the Court of Appeals, the question whether its enactment repealed the authority of cities of the fifth and sixth class to acquire or construct waterworks systems and pay for the cost of such construction by the issuance of revenue bonds. This litigation was necessary due to the fact that the Act as amended gave cities of

[23] City of Bowling Green v. Kirby, 220 Ky. 829, 295 S. W. 1004 (1927).

[24] Chapter 92 of the 1930 Acts of the General Assembly of the Commonwealth of Kentucky.

[25] Chapter 109 of the 1932 Acts of the General Assembly of the Commonwealth of Kentucky.

[26] Wheeler v. City of Hopkinsville, 245 Ky. 388, 53 S. W. (2d) 740 (1932).

the second, third and fourth class the authority to acquire, operate and maintain waterworks and/or sewer systems by the use of the revenue bond method without reciting the authority of cities of the fifth or sixth class as to the construction of either waterworks or sewers, thereby creating a grave doubt as to whether by the enactment of this legislation, the General Assembly repealed the authority of fifth and sixth class cities authorizing the construction of waterworks systems. The Court held that the amendment to the waterworks Act did not repeal the authority vested in cities of the fifth and sixth class by the 1930 Act.[27]

In 1932 the General Assembly authorized cities of the third, class to acquire, construct, operate and maintain electric light, heat and power plants and to issue special obligation revenue bonds to pay for the cost of such construction.[28] The bonds authorized by this authority are similar in character to waterworks revenue bonds. The 1932 Act has been further amended by extending the authority therein contained to cities of the second, third, fourth, fifth and sixth class, subject to a restriction not contained in the original act, making mandatory the submission of the question as to the acquisition of the system and the issuance of revenue bonds to a vote of the qualified voters within the corporate limits of the City.[29] The system cannot be constructed or bonds issued to pay for the cost of such construction unless approved by a majority of the voters voting on the question at an election duly held as required by the Act.[30]

[27] Williams v. City of Raceland, 245 Ky. 212, 53 S. W. (2d) 370 (1932).

[28] Chapter 119 of the 1932 Acts of the General Assembly of the Commonwealth of Kentucky.

[29] Chapter 77 of the 1936 Acts of the General Assembly of the Commonwealth of Kentucky.

[30] It is not the intention of the writer to discuss generally the procedure of municipal governing bodies. However, the restrictions contained in the 1932 light, heat, and power act as amended present a rather difficult and important question. A reading of the act would indicate that a municipality vested with the authority to acquire or construct an electric light, heat or power plant and distribution system and to pay for the cost of such construction by the issuance of special obligation bonds, may submit such question at any time, at a special election called for that purpose. This is not the law. The Court of Appeals has held that such special election may be held only on the same day on which regular elections are held. Ginsberg v. Giles, 254 Ky. 720, 72 S. W. (2d) 438 (1934). A municipality desiring to take advantage of the Act must, before so doing, wait for the sub-

The determination of charges to be made for services in connection with the operation of waterworks systems and electric light, heat or power plants together with regulations enforcing collection is comparatively simple. In the event that either of these utilities is constructed from the proceeds of revenue bonds which are to be retired from a portion of the revenue of such utility, if there are sufficient consumers to warrant the charge of a reasonable rental which will provide funds sufficient to pay the interest on and the principal requirements of the bonds, and to create an adequate operation and maintenance fund and an adequate depreciation fund, there will be no difficulties encountered by the municipality in meeting its obligations. Furthermore there should be no difficulty encountered in collecting for services rendered due to the fact that such service may be adequately determined by meters, and in the event of non-payment, the service may be discontinued until all sums in arrears have been paid together with a proper charge for reinstating the service.

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mission of the question until a regular election is held. This question is of no particular consequence in connection with the subject matter involved; however, all cities of the Commonwealth having a Commission form of Government are required, upon the filing of a petition by the requisite number of voters located within the corporate limits of the City, to submit an ordinance calling for the expenditure of funds ranging from $100 to $1,000 to the voters at a special election. Sections 3235 c-14, 3840 b-14, and 3606 b-14, Carroll's Kentucky Statutes, 1936 Edition. If a petition is filed meeting the statutory requirements, such ordinance has no effect until it is approved by a majority of the voters voting on such question at an election held for that purpose. Sections 3235 c-23, 3840 b-23, and 3606 b-23, Carroll's Kentucky Statutes, 1936 Edition. In view of the decision requiring that such election be held on the same day on which a regular election is held, you may readily visualize the possible hindrance to municipal functions resulting from this provision in the charters of cities having the Commission form of Government. In addition to holding that the election must be held on the same day on which a regular election is held, the Court of Appeals has also held that an ordinance authorizing the construction of a revenue-producing project, the cost of which is to be financed by the issuance of special obligation bonds payable as to principal and interest solely from the revenues of the project, is an ordinance calling for the expenditure of money, and comes within the restrictions of the applicable sections of the Statutes. Kentucky Utilities v. Ginsberg, 255 Ky. 148, 72 S. W. (2d) 738 (1934); Board of Commissioners of the City of Middlesborough v. Kentucky Utilities Co., dated June 16, 1936. (Not yet reported.) This is contrary to the rule in other jurisdictions. Collins v. City of Phoenix, 26 F. (2d) 753 (1928); Peck v. Birch, 139 N. E. (Ind.) 696; Globe v. Willis, 146 Pac. (Ariz.) 544 (1915); Chitwood v. Lanning, 257 N. W. 345 (1934); Short v. City of Seattle, 164 Pac. (Wash.) 531 (1917); Short v. City of Seattle, 164 Pac. (Wash.) 239 (1917).

The fixation of rentals or charges for the use of a sewer system sufficient to create revenues in an amount equal to the interest and principal requirements of the bonds issued to pay for the cost of constructing such system, to maintain and operate the system, and to create a depreciation fund, presents a more complicated question for the reason that it is not possible, by the use of meters to gauge the value of the services rendered, and in case of failure to pay, it is not practicable to discontinue the service.

Sewer revenue bonds have developed within the past few years. Prior to the issuance of such bonds sewer systems were constructed either from the proceeds of general obligation bonds or special assessment bonds. In the case of general obligation bonds, the bonds were retired from ad valorem taxes duly levied in the corporate limits of the municipality in which such system was constructed; and in case of special assessment bonds, the bonds were retired solely from the proceeds of assessments duly levied against the abutting property as hereinabove noted. In each case the general public considered the use of such systems as being a free governmental service furnished by the municipality. In a few isolated cases private interests constructed sewer systems and charged for the use of the service furnished by the system. This practice was an exception, there being a few such systems established, two of which were in Kentucky—one in the City of Hopkinsville and the other in the City of Murray. The Murray system has been acquired by the city and developed as a municipal utility.

The primary question in the operation of a self-liquidating utility by a municipality in connection with the rates to be charged for the use of such utility, is to determine a fair and equitable rate, taking into consideration the total cost of such project, the operation and maintenance cost and the creation of an adequate and reasonable depreciation fund. It is singular to note that in a vast majority of sewer systems privately owned, a monthly fee is charged each person whose property is connected with such system. This is, obviously, an inequitable method of charging for the use of the system. There are two elements which should be considered:

1. A ready to serve charge; and
2. The value of the service to the individual user.

It will, therefore, follow that in a rate schedule, fixing and determining the fees to be charged for the use of a sewer system, there should be a minimum fee, and that the total fee to be charged should be based upon the extent of the use made of the system by the user. In the absence of a metering system to determine the extent of such use, it is considered that the best method to be used is to base the charge for sewerage service largely upon the amount of water used in the premises served by the system.

In arriving at an equitable sewerage charge after analyzing methods used by private companies and other available information on the subject, the following is considered as the most acceptable.

1. A division of the fees to be charged into the following classifications:

a. Residential.
b. Commercial.
c. Industrial.

For each classification, the establishment of a fee should be based upon the following:

a. A minimum fee to all consumers according to class.

b. A fee to be charged on a graduated scale, based upon the number of thousands of gallons of water metered by the waterworks system to the premises.

c. An additional fee for residential property based upon the number of rooms in excess of six, contained in each residence.

All fees should be charged and collected monthly, and in instances where water is used for yard sprinkling purposes, the water used for such purposes should be metered to the consumer on a separate meter so as to avoid an excessive sewerage service charge in such instances.

It is entirely doubtful as to whether or not a municipality may successfully operate a sewer system and pay for such system out of its revenues, unless it owns and operates a waterworks system, for the obvious reason that one is indispensable to the other. In some jurisdictions bonds may be issued to pay

for the cost of constructing a sewer system and retired from the proceeds of the municipal waterworks system; or combined sewer and waterworks revenue bonds may be issued for the purpose of constructing the two systems or for the purpose of improving and extending the existing systems.[31]

In addition to the sewerage service charge problem, in all issues of sewer revenue bonds, there is the problem of assuring the maximum number of connections to the system. In that, the municipality constructing the sewer system has before it the problem of preserving public health, and unless each piece of property abutting on such system is connected therewith, the general purpose is defeated. In order to protect the public health and at the same time to assure the maximum number of connections to the system, in the event such system is constructed by the issuance of revenue bonds, the municipality should adopt appropriate health regulative ordinances requiring connection with the system of each piece of property located within the limits served by the system. Such ordinances have been presented to and have been approved by the Court of Appeals even though, in the language of the Court, "the result may be the loss of many ancient landmarks."[32]

In order to operate economically a waterworks and sewer system, the water and sewerage departments of the municipality should be consolidated into one department and the charges to the consumers should be presented and collected at the same time. In order to prevent any possible default in the revenue bonds issued to pay the cost of constructing the system, there should be deposited monthly one-twelfth of the annual principal and interest requirements into a bond fund maintained for that purpose; in some instances there is a contingency fund created in the bond fund equal to one or two years bond requirement so as to assure at all times, the prompt payment, when due, of interest and principal of the bonds authorized; and the balance of the revenue should be segregated into the Operation and Maintenance Account and the Depreciation Account as required by the Statutes and the ordinance authorizing the issuance of such bonds.

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[31] Act 299 of the 1933 South Carolina Legislature as amended.

[32] Nourse v. City of Russellville, 257 Ky. 525, 78 S. W. (2d) 497 (1935).

Prior to the enactment of legislation vesting municipalities with the authority to issue and sell special obligation bonds to finance the cost of acquiring or constructing waterworks systems and light, heat and power plants, there had been acquired or constructed by cities and towns of the Commonwealth forty-eight waterworks systems and ten light, heat and power plants. The sewer systems had generally been constructed from the proceeds of general obligation bonds or by the special assessment plan, however, since the enactment of the sewer revenue bond legislation there have been constructed five sewer systems in cities and towns of the Commonwealth, ranging in population from 2,500 to 18,000 and there is now under construction a system in a town of 12,000 population. The construction of numerous waterworks systems has been financed by the issuance and sale of waterworks revenue bonds, as will be hereinafter noted. With possibly two exceptions the construction of electric light, heat and power plants or distribution systems have been financed by the issuance of general obligation bonds. Before the enactment of the revenue bond legislation a city proposed to acquire an electric distribution system by a series of contracts. Each contract provided for the construction of a portion of the system. The contractual obligations being within the anticipated revenues for the years in which they were created, the Court of Appeals sustained the plan.[33]

A casual examination of the financial affairs of municipalities of the Commonwealth, with possibly a few exceptions, develops the fact that because of constitutional limitations, only comparatively few of the larger cities have sufficient bonding capacity to authorize the issuance and sale of general obligation bonds to pay for the cost of constructing the utilities hereinabove discussed. Cities of the fourth, fifth and sixth class having a population of less than 5,000, assuming that such cities are entirely free from indebtedness, in view of constitutional limitation, with few exceptions do not have sufficient borrowing capacity to authorize the incurring of an indebtedness classified as a general obligation, sufficient to pay the entire construction cost of waterworks systems, sewer systems or light, heat or power plants.

Without the adoption of the special fund theory by the

[33] Overall v. City of Madisonville, 125 Ky. 684, 102 S. W. 278 (1907).

Court of Appeals permitting the issuance of bonds payable from project revenues or special assessments and classifying such bonds as special obligations of municipalities, little development would have been possible in bringing forward the construction of essential utilities such as waterworks and sewers necessary to promote public health and the general welfare of those living within their corporate limits. This illustrates the imperative necessity for the establishment of a sane and sensible definition of the term "indebtedness" as used in the Constitution. By so doing the mandate of the Constitution has not been abrogated, but, upon the other hand, constitutional government by such reasonable interpretations has been protected, for, after all, when Government becomes static and stands in the way of human progress it is in danger of being discarded.

The Reconstruction Finance Corporation by an Act of Congress was given the authority to make loans to municipalities for the purpose of constructing public works in order to relieve unemployment. A number of Kentucky cities by meeting the requirements of the corporation, were able to finance the construction of waterworks systems by the sale of special obligation bonds to the corporation and one city financed the construction of a sewer system by the issuance and sale of sewer revenue bonds to the corporation.

Under Title 2 of the National Industrial Recovery Act, the authority of the Reconstruction Finance Corporation in making loans to municipalities and other political subdivisions was transferred to the Federal Emergency Administration of Public Works, an agency created for that purpose. This agency was authorized to make grants as well as loans to municipalities to be used in connection with the construction of public works. The interest rate on such loans was established at four per centum and the amount of the grant was established as being equal to 30% of the cost of labor and material used upon the project. By subsequent amendments the Administration is now authorized to make loans and grants equal to the total cost of the project. The amount of the grant has now been determined by Executive Order of the President as equal to 45% of such cost and the interest rate on the bonds purchased remained at four per centum.

Hundreds of applications were received by the Administration from various Kentucky municipalities requesting allot-

ments for the construction of necessary public works, which consisted in the main of waterworks systems, sewer systems, schools and other municipal buildings. With the exception of applications covering waterworks and sewer systems, there were only a few cases in which the applicant was in a position to finance its portion of the cost by offering the government legal, valid and binding bonds equal to its percentage of such cost.

In this group of applications three were filed for the construction of major improvements to the State Educational Institutions of higher learning. An examination of such applications disclosed the fact that such institutions did not have the authority to issue any type of securities to finance their portion of the construction cost.

Because of constitutional restrictions, in order to obviate the curtailment of the public works program in the Commonwealth, it became necessary to present a solution which would authorize the financing of the construction of school building facilities for common school purposes as well as the necessary improvements and buildings for the State University and State Colleges of the Commonwealth. The writer acting in his capacity as Counsel for the Federal Emergency Administration of Public Works, drafted legislation authorizing the issuance of securities in the form of special obligation bonds so as to make possible the financing of the construction of graded and high school buildings and appurtenances thereto, as well as the construction of the necessary buildings and improvements to the University of Kentucky and the Colleges of the Commonwealth.

The foregoing legislation was presented to the 1934 General Assembly of the Commonwealth and was duly enacted.[34] The authority to construct graded and high school buildings, together with appurtenances thereto and to issue special obligation bonds to pay for the cost of such construction was vested in the municipalities of the Commonwealth. In that this method of financing was the first of its character used in the history of municipal financing, it would not be out of place to review specifically the difficulties encountered, as well as the solution of these difficulties.

[34] Chapters 68, 69, and 72 of the 1934 Acts of the General Assembly of the Commonwealth of Kentucky and Chapters 14 and 15 of the 1934 Acts of the General Assembly of the Commonwealth of Kentucky, first extraordinary session.

Before the adoption of the Acts there was no statutory method for the construction of graded and high school buildings in the Commonwealth, unless such construction was financed out of taxes duly levied or the issuance of general obligation bonds for that purpose. Because of the constitutional and statutory limitations relative to the levy of taxes, no municipality of the Commonwealth could create, out of a tax levy for one year, a sum sufficient to construct the necessary school building facilities to accommodate the educational needs of the municipality. Because of constitutional restrictions limiting the borrowing capacity of Boards of Education, no municipality could finance the construction of the necessary school building facilities to meet the modern needs of education by the issuance of such bonds. From this analysis of the situation, insofar as school buildings were concerned, such construction may be carried out only to a limited extent, and the Commonwealth, from the standpoint of per capita value of school buildings would not only remain in the 42nd place as compared with other states of the nation, but would in all probability, soon shift nearer to the 48th place. In working out the problem there were four elements to consider:

1. Boards of Education of the Commonwealth under the restrictions of Section 157 of the Constitution, may become indebted in any sum so long as such sum does not exceed the unencumbered revenues for the year in which such indebtedness was created.

2. Boards of Education of the Commonwealth were separate and distinct municipal corporate entities, as compared with the City or County in which they were located.

3. Boards of Education of the Commonwealth operated through a system of budgetary control.

4. The annual budget of Boards of Education of the Commonwealth is certified to the governing body of the City or County in which such Board is located and when so certified, it becomes the mandatory duty of such governing body to levy and collect a tax sufficient to meet the budgetary requirements.

If it were possible to devise special obligation bonds to finance the construction of graded and high school building facilities, such bonds should be based upon the foundation contained

in the Constitution and statutory law of the Commonwealth set out above.

In order to come within the constitutional restrictions in connection with financing the construction of school buildings by methods other than the issuance of general obligation bonds of the Board of Education or the municipality in which such Board is located, it was necessary to create a special fund, which may be classified as "project revenues" sufficient to pay the principal and interest of the bonds so issued and to maintain and insure the project. In order to meet the foregoing requirements an agency other than Boards of Education must be made the construction agency, and, for reasons which are entirely obvious, such agency should be an existing governmental unit, primarily or secondarily concerned with public education. The logical agency to construct the project and issue bonds to pay for the cost of such construction is the municipality. In the event the project to be constructed is a part of the educational system of the city, which under the laws of the Commonwealth is a separate and distinct entity from the Board of Education, the city should be the construction agency and the obligor of the bonds. In case the project to be constructed is to be a part of the educational plants of a Board of Education of a County, the agency to construct the project and issue special obligation bonds to pay for the cost of such construction should be the County, which, like the City, is a separate and distinct entity from the County Board of Education. The method devised by the legislation enacted is as follows:

(1) Boards of Education of the Commonwealth must first convey to the City or County as the case may be, a fee simple title to a site to be used by such City or County in connection with the construction of the desired school building improvements.

(2) The City or County as the case may be, after accepting the conveyance of a site, orders the preparation of the necessary plans and specifications for the construction of the proposed project and agrees to construct the project in the event the Board of Education offers to lease, upon acceptable terms, the project when completed, at annual rentals sufficient to meet the amortization requirements of the bonds, to maintain the

project and to pay the cost of insurance thereof against loss by windstorm, fire or other hazard.

(3) The plans and specifications are to be submitted to the Board of Education and to the Superintendent of Public Instruction of the Commonwealth for approval.

(4) Following the approval of the plans and specifications the Board of Education formally offers to lease the project when completed at annual rentals sufficient to amortize the bonds to be authorized and sold to finance the construction cost and to maintain and insure the project.

The lease offered by the Board of Education is for an extended period of years equal to the maturity of the bonds and for a fixed period of years equal to the unencumbered revenues of the Board for the year in which such lease is executed, and is subject to automatic renewals for a like term of years at the end of each fixed term until it has been renewed for a number of years equal to the extended term.

The obligation of the Board of Education is to pay rentals for a fixed term of years, which rentals are not in excess of its unencumbered revenue for the year in which such lease is executed. The Board may terminate the lease by giving notice of its intention so to do ninety days before the expiration of any fixed term. If the lease is terminated, or in the event the Board of Education fails to pay its rentals, it forfeits all equity in the property, and must forthwith give possession. If the Board of Education pays rentals sufficient to amortize the bonds, the title to the property reverts to the Board.

(5) Following the presentation, the acceptance of and the execution of the lease and approval of the plans and specifications for the construction of the project by the Board of Education and the Superintendent of Public Instruction, the municipality may construct the project and issue special obligation bonds to pay the cost of such construction.

The bonds are special obligations, payable solely from and secured by an exclusive pledge of and a first lien on a fixed amount of the revenues of the school building facilities, which revenues are to be derived, and payment made under a lease agreement between the Board of Education and the municipality constructing the building facilities, for an extended period

of years equal to the total maturities of the bonds, by which lease, the Board of Education agrees to pay annually as the services accrue, in accordance with its terms and conditions, rentals in an amount sufficient to pay the principal of and the interest on the bonds as and when they mature and the annual maintenance and insurance cost of the project, which said rentals are to be included in the annual budget of the Board of Education as a part of the operating expenses of the school system of the City or County issuing the bonds, and when so included and presented to the governing body of such City or County, such governing body shall produce a sum sufficient, by the levy of a tax within the limits prescribed by law, to pay such rentals and said bonds are additionally secured by a statutory mortgage lien upon the project.

There were presented to the Court of Appeals two types of contracts of lease and rent to be entered into between a Board of Education and a municipality, in connection with the construction of a school building and the issuance of bonds to pay for the cost of such construction. The plans presented were as follows:

PLAN A.—A contract of lease and rent to extend over a period of thirty years, beginning upon the date when the building to be erected shall have been completed and ready for occupancy. The annual rental to be equal to the principal and interest requirements of the bonds, plus the cost of maintaining and insuring the building. Upon the payment of all rental charges during the thirty year period, the property is to be conveyed to the Board of Education by the City.

PLAN B.—The annual rental to be paid by the Board of Education to be equal to the principal and interest requirements of the bonds, plus the cost of maintaining and insuring the building. The fixed term of years to be not in excess of the number of years for which the unencumbered revenues of the Board of Education for the year in which the lease was entered into will pay; the Board of Education to have the exclusive right and option of extending the lease for a like term of years, computed in the same manner in which the original term was computed and determined upon, with the exclusive right and option of extending the term or terms upon the same basis for a period

of not in excess of thirty years; the extension of any term to be automatic if the Board of Education fails to give affirmative notice to the city that it will not renew the lease. Upon payment in full of all the rentals for a consecutive term of thirty years, the city is to convey the property to the Board of Education.

Plan A was rejected because of constitutional limitations. Plan B was approved for the reason that it is a contract permissible under the restrictive provisions of the Constitution, in that it does not exceed the unencumbered revenues for the year in which it was executed.[35]

When considering the security for City or County special obligation school bonds, it is of prime importance to visualize the necessity for the construction of the project and the relationship between the Board of Education and the municipality issuing the bonds. Ample safeguards are assured as to the determination of the necessity for the construction of the project, in that the project, before it may be constructed, must have the approval of the Board of Education and in addition thereto, must be approved by the Superintendent of Public Instruction Likewise, in that such construction, originates with the educational authorities, this procedure gives reasonable assurance that the project is necessary and will, after construction, be used for the purpose for which it was intended and rentals paid for such use over a period of years equal to the maturities of the bonds.

The relationship of the constructing agency and the Board of Education is of prime importance; both are separate and distinct corporate units, each having the authority to contract one with the other, and each is instrumentally concerned in the maintenance of adequate school facilities. Each has specific duties to perform in connection with the maintenance of school facilities and in the performance of these duties they produce a sum sufficient to meet the interest and principal payments of the bonds. The school budget is presented to the municipality issuing the bonds and when the rental charges are included therein, it becomes the duty of the municipality to produce, in manner and form prescribed by law, a sum sufficient to meet the

[35] Davis v. Board of Education of Newport, 260 Ky. 294, 83 S. W. (2d) 34 (1935).

budgetary requirements which include the rental charges therein contained.

The two essential elements necessary to assure the payment of any type of special obligation bonds payable from the revenues of a self-liquidating project are present: that is, the necessity for the services rendered by the project, and the ability of those availing themselves of the use of the project to pay for the services rendered. This method of financing has made possible the construction of numerous school plants in Kentucky to date, as will be hereinafter noted.

In preparing a special obligation bond act for State Educational Institutions of higher learning of Kentucky, the difficulties encountered were not as complicated as those in the Acts authorizing the issuance of such bonds to finance the cost of constructing school buildings to be used for common school purposes. The Act gives the governing bodies of each State Educational Institution, the authority to construct college building projects and to issue special obligation bonds payable from the revenues of such projects to finance the construction costs.[36] The problem involved, in connection with such financing, is the determination of project revenues. Under the terms of the Act, before the issuance of bonds, the governing body of the Institution is required to fix the rental, tolls, fees and other charges to be imposed in connection with the operation of the services to be thereby furnished by the project and to provide that the institution shall pay into a separate special fund, established in the bond resolution, a reasonable cost and value of any services rendered by the project on account of classroom, laboratory facilities, assembly halls or any other educational facilities furnished by the project necessary for the operation of the institution and that such reasonable cost and value of any such services rendered to the institution shall be paid into such special fund monthly as such services accrue.

Under the provisions of this Act there have been issued bonds to pay for the cost of constructing gymnasiums, dormitories, libraries, classroom buildings, light, heat and power plants, and a waterworks system.[37] In each case it is necessary

[36] Chapter 72, *supra*, note 38.

[37] Clay v. Board of Regents of Morehead State Teachers College, 255 Ky. 846, 75 S. W. (2d) 550 (1934).

to fix and determine, within the limits of constitutional restrictions, and the provisions of the Act, project fees or rentals to be charged those availing themselves of the facilities furnished by the project, which must produce a sum sufficient to pay the interest on and the principal of the bonds as they mature and to operate and maintain the project.

In the case of dormitories, in that they furnish a specific service to the occupants, the nature of the project simplifies the determination of the rate structure. In case of a general program for construction, it is necessary to analyze specifically the use to be made of each of the projects to be constructed. This may be specifically illustrated by a study of the rate structure of the University of Kentucky project. There will be constructed under this project a student union building, an engineering building, a law building and a general heating plant. After an analysis of the use of each of the subprojects, a rate structure was prepared and adopted by the Board of Trustees of the University, which makes specific charges for educational facilities furnished the institution by each of the subprojects, and in addition thereto, a charge paid by the institution for the furnishing of heat to the institution by the general heating plant. In addition to the foregoing, there is a classroom fee charged for the facilities furnished the students enrolled in the College of Engineering by the Engineering Building; a classroom fee is charged each student enrolled in the College of Law for the facilities furnished by the Law Building; also there is a fee charged for the use of the facilities furnished by the Student Union Building, which fee is chargeable against all of the students attending the institution. These fees are payable by the student each semester upon matriculating in the University, and are not a part of the enrollment or matriculation fee of the Institution, but are separate from all other fees charged by the Institution. The sum paid by the University for educational facilities furnished by the project and for heating the plant of the University are payable monthly as such services accrue. All sums paid, either by the University or the students represent the income of the project and must be used solely for the purpose of paying the interest and principal requirements of the bonds and in maintaining and operating the project.

It is to be noted from the foregoing that in building a rate structure in connection with the issuance of revenue bonds, it is essential that a proper determination be had of the facilities furnished by the project and that the rents and fees fixed and collected have a distinct relation to the furnishing of such facilities, that is, the bonds are not payable from the general fund of the borrower, but are payable solely from the revenues of the project, a fixed portion being specifically pledged for that purpose, thereby distinguishing such bonds from general obligations of the borrower.

The foregoing theory as to the fixation of project revenues was approved by the Court of Appeals; the Court specifically holding that the bonds are special obligations, payable solely from the revenues of the project constructed, and are not debts within the meaning of any constitutional restrictions or limitations.[38]

As a result of the enactment of the Institutional Bond Act, there have been constructed and are now in the process of construction, major improvements to the University of Kentucky and five of the six colleges of the Commonwealth.

In conclusion, it may be observed, that the enactment of legislation authorizing municipalities and state institutions to finance the construction of public improvements by the issuance and sale of special obligation (revenue) bonds has made possible a substantial development in connection with the acquisition of necessary public improvements. This may be illustrated by noting that before the enactment of special obligation bond legislation, there were constructed by cities and towns of the Commonwealth, 48 waterworks systems, and that since the enactment of this legislation, there have been constructed 54 waterworks systems, which covers a period of less than ten years.

As a further illustration it is here noted, that since the enactment of special obligation bond legislation applicable to graded and high schools, and improvements to the University of Kentucky and the colleges of the Commonwealth, there have been constructed 91 graded and high schools, and major improvements to the University of Kentucky and five of the six colleges of the Commonwealth.

[38] J. D. Van Hooser & Co. v. University of Kentucky, 262 Ky. 581, 90 S. W. (2d) 1029 (1936).

A reflection of the special obligation bond theory may be further illustrated by the Public Works Program in Kentucky, which program as to projects completed or under construction amounts to the sum of $22,155,992.00. Of this sum, applicants have financed their portion of the construction cost by the issuance of special obligation bonds, as follows:

Waterworks systems	$3,423,421.00
Sewer systems	$1,673,272.00
Streets	$4,629,000.00
Graded and common schools	$3,923,394.00
University of Kentucky and Colleges of the Commonwealth	$3,222,678.00
A State tuberculosis sanitorium	$ 294,545.00

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