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NEGOTIABLE NON-NEGOTIABLES
Kentucky County Road and Bridge Bonds Reconsidered

GEORGE W. PEAK*

Kentucky municipal debts have furnished problems which provide a unique chapter in the history of court decisions. It is extremely doubtful that any one subject has ever resulted in so many reversals of opinions.

In 1906, the Kentucky Court of Appeals (the highest state tribunal) held that the state constitution allowed municipalities to incur indebtedness during a given year up to the amount of the maximum permissible levy, regardless of the amount of the actual levy. In 1938, however, this decision was reversed and the amount of the actual levy became the governing figure. Indebtedness incurred under the former decision and not paid from current revenues could not be funded into bonds without a vote of the people, according to a 1917 ruling. But ten years later, in 1927, the court held that such indebtedness might be funded without a vote of the people. The 1938 case mentioned above probably again denies this funding authority. The maximum tax rate specified in section 157 of the Constitution might not be exceeded to pay indebtedness voted thereunder, according to a decision in 1904. This doctrine was reversed in 1917, however, and indebtedness voted under section 157 of the Constitution became authority for tax rates in excess of those specified in that section. These are some of the better known examples of the court's attempts to solve the perplexing problems presented by Kentucky municipal debts.

Until recently, Kentucky county road and bridge bonds

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1 Assume obligation representing expenditures, whether or not paid currently.


3 Payne v. City of Covington, 276 Ky. 330.

4 McCrocklin v. Nelson County Fiscal Court, 174 Ky. 308.

5 Vaughan v. City of Corbin, 217 Ky. 521.

6 Payne v. City of Covington, 276 Ky. 380.

7 Town of Bardwell v. Harlin, 113 Ky. 232.

8 City of Winchester v. Nelson, 175 Ky. 63.
issued under the authority of section 157a of the Constitution have not been the subject of such violent shifts in precedent. But Pulaski County, Kentucky v. Ben Hur Life Association of Crawfordsville, Indiana, handed down on January 21, 1941, as a reconsidered decision originally dated October 8, 1940, may well mark the beginning of changes in the precedent governing such issues. The original decision of October 8, 1940, held that county road and bridge bonds were non-negotiable under the Kentucky negotiable instruments act and that, hence, present holders could have no better title than the original purchasers. A petition for rehearing and request for withdrawal of the original opinion was filed and granted, and on January 21, 1941, the court handed down a decision in which the bonds were declared to be negotiable instruments.

A case which results in such an unusual turn of events is well worth considerable study. Not only does it present a singular item in judicial annals, but it may also furnish some clue as to what can be expected from the court in future decisions involving county road and bridge bonds. The facts of the case will be outlined here, and the two opposing opinions will be analyzed in some detail. An effort will be made to set forth the probable effects of the original opinion, had it been allowed to stand, and the probable effects of the final decision on the counties and their creditors. An injudicious procedure will be followed in predicting the course of future decisions on such bonds.

The Facts of the Case

The question of overissue. In 1930, Pulaski County, Kentucky, under the authority of an election held in 1928, issued bonds amounting to $280,000. The election was held and the bonds were issued pursuant to section 157a of the Constitution. This section places a limitation on the amount of bonds which may be issued under its authority, but the original opinion found it unnecessary to determine whether or not there had been an overissue.

The bond sale. The whole issue of $280,000 was sold to Caldwell and Company, a brokerage firm of Nashville, Tennessee. As a part of its bid, the firm proposed that upon delivery of the bonds the proceeds should be deposited with the company, to be withdrawn by the county from time to time as road con-
struction progressed. Caldwell and Company agreed to pay the same interest rate on the deposit (four and three-fourths percent) as that borne by the bonds. As security it offered the county a good indemnifying bond and collateral securities, to be placed with the Bank of Tennessee, in an amount at least equal to the balance of the deposit. This offer was accepted by the fiscal court (governing body) of Pulaski County on September 30, 1930.

Results of the bond sale. The bonds were delivered to Caldwell and Company in October, 1930, and it issued to the county a passbook evidencing the deposit. Collateral was placed with the Bank of Tennessee to a face amount of $600,000. By November, 1930, without the county having drawn on its deposit, both Caldwell and Company and the Bank of Tennessee had been closed as insolvent. Creditors received approximately one-half cent on the dollar. The $600,000 collateral was turned over to the county by order of the United States District Court at an appraised value of $15,000. Most of the securities proved to be issues of concerns promoted or financed by Caldwell and Company. The Bank of Tennessee, it developed, was practically a subsidiary of Caldwell and Company, being almost entirely under its control. The Pulaski County bonds had been promptly sold and put into the hands of the public by Caldwell and Company before its fiasco.

The county paid interest on the bonds for three years but then ceased such payments. No principal payments have ever been made. The plaintiffs in the lower court sued to collect seven matured bonds and interest coupons on these and others. They proved innocence of actual notice of the manner in which bonds were obtained by Caldwell and Company.

Non-Negotiable

There seems to be no doubt "that fraud vitiated the contract and that the title of Caldwell and Company to the bonds was defective." This conclusion the Court reached after examining all the evidence surrounding the sale. Since the plaintiffs were "innocent holders" in due course, however, the defective

*Original opinion of the court as copied in Appellees' Petition for Rehearing to the Court of Appeals of Kentucky, Pulaski County v. Ben Hur Life Association of Crawfordsville, Indiana (Westerfield-Bonte Co., Incorporated, Louisville, Kentucky, no date), at 110.
title of the original purchaser would have no effect on their title, unless the bonds were not negotiable instruments. Upon this qualification the opinion of the court hinged.

The Kentucky negotiable instruments law. The Kentucky law requires that an instrument to be negotiable must contain an unconditional promise or order to pay a sum certain in money. An unconditional promise or order to pay is further defined as follows:

"An unqualified order or promise to pay is unconditional within the meaning of this Act, though coupled with it:

"(1) An indication of a particular fund, out of which reimbursement is to be made, or a particular account to be debited with the amount; or

"(2) A statement of the transaction which gives rise to the instrument.

"But an order or promise to pay out of a particular fund is not unconditional."

Thus, if the Pulaski County bonds were payable exclusively from a particular fund, they could not be termed negotiable instruments; hence, those purchasing the bonds from Caldwell and Company would have only the same defective title thereto as possessed by the company. The court turned to this question.

The problem is complicated by the peculiar nature of governmental funds. If a bond contains only an indication of a particular fund out of which payment is to be made, the instrument is nevertheless negotiable. For example, a statute may provide for a special tax from which bonds are to be paid, and the bond may indicate such source of funds or security; but the bonds may also be general obligations of the government, payable in all events. Many special assessment bonds are of this character. If, however, the bond contains a promise to pay it only out of a particular fund, the instrument is non-negotiable (unless, of course, the bond statute expressly makes it negotiable). Revenue bonds on government utilities are usually of this character, although statutes under which they are issued generally contain express provisions as to negotiability.

The Pulaski County bonds contained a statement to the effect that the full faith, credit, and resources of the county were irrevocably pledged for their payment. But they also contained a statement to the effect that they were issued in full

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\[a\] Carroll's Kentucky Statutes (1936) section 3720b-1.

\[b\] Id., section 3720b-3.
compliance with section 157a of the constitution and all other 
laws of the state. Thus, the court reasoned, "no transferee can 
claim to be an innocent holder because of the ignorance of those 
requirements."\(^{12}\)

**Legal provisions governing payment.** Section 157a of the 
constitution reads in part as follows:

"... when any such indebtedness is incurred by any county 
said county may levy, in addition to the tax rate allowed under 
section 157 of the Constitution of Kentucky, an amount not exceeding 
twenty cents (20c) on the one hundred dollars ($100.00) of the as-
sessed valuation of said county for the purpose of paying the in-
terest on said indebtedness and providing a sinking fund for the 
payment of said indebtedness."

In *Bird v. Asher*,\(^{13}\) the court stated that "there is no con-
stitutional or statutory obligation imposed on the fiscal court\(^{14}\) 
to set aside or appropriate for the purpose of paying either the 
interest or the principal sum of road bonds issued under section 
157a any part of the state aid fund or any part of the 50 cent 
tax authorized by section 157." It went on to say in plain lan-
guage that the governing body of a county might apply any 
funds to the payment of such bonds but that it was discretionary 
whether or not funds other than receipts from the tax of twenty 
cents per $100 were applied to such payments.

From this decision, the court now reasoned that the bonds 
of Pulaski County issued under the authority of section 157a of 
the Constitution were payable out of a special restricted fund, 
*viz.*, a fund composed of the proceeds of the twenty cents per 
$100 tax levy. They, therefore, did not conform to the require-
ments of Kentucky law on negotiable instruments. The bonds 
were non-negotiable, the court opined, in its original pronounce-
ment.

**Effects of Non-Negotiability**

*Pulaski County relieved of payment.* The immediate effect 
of this original opinion, had it been allowed to stand, would have 
been to relieve Pulaski County from payment of principal and 
interest on $280,000 of its obligations. Instead of the county 
having to pay bonds, the proceeds of which it never received, the 
present holders of the bonds who had obtained them by paying 
valuable consideration would have had to stand the loss. This

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\(^{12}\) Appellees' Petition for Rehearing, op. cit. supra Note 9, at 113.

\(^{13}\) 170 Ky. 726 (1916).

\(^{14}\) The governing body of the county in Kentucky.
immediate effect the court of a certainty foresaw. It was willing to shift the burden, so to speak, in this isolated case, since the bonds were non-negotiable in any event. In fact, the opinion stated that "perhaps as a matter of economic policy the legislature should have made county bonds issued for road improvement negotiable, it has not done so, and we must construe and apply the law as enacted."

Other county bonds fraudulently purchased. At least two other counties (and probably more) have outstanding road and bridge bonds sold under circumstances almost identical with those surrounding the Pulaski County sale. Webster County attempted to recover the amount of its uncollected bond proceeds in 1938 by suing the officials in office at the time of the sale. The Court of Appeals held the purchase contract to be equivalent to a sale on credit and beyond the authority of the fiscal court to make. The case was remanded on a technical point after an intimation that the officials would be liable for the loss if the statute of limitations had not run. The question of negotiability, however, was not before the court for decision. Breckinridge County, which had lost the proceeds of a $250,000 bond issue in the Caldwell and Company debacle, lost no time in attempting to take advantage of the original opinion in the Pulaski case. By October 28, 1940, twenty days after the opinion was announced, the Breckinridge County governing body had voted to refuse payment of such bonds and had employed counsel to defend it against the collection of such bonds. Had the Pulaski opinion remained unchanged, Webster and Breckinridge Counties would have been relieved of obligations in excess of $400,000.

Other county bonds non-negotiable. The effects of the decision were not limited to the bonds of three counties, however. Approximately 100 other counties have outstanding bonds issued under the provisions of section 157 of the constitution. It had been generally assumed by all parties concerned that these bonds were negotiable, and they had entered into market

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Footnotes:

15 Far be it from the author to suggest that the court might be influenced by the probable effects of its decision.
16 Appellees' Petition for Rehearing, op. cit. supra note 9, at 118.
17 Webster County v. Hall, 275 Ky. 54 (1938).
18 Orders of the Breckinridge County Fiscal Court as copied on October 28, 1940, in a mimeograph circular prepared by The Bankers Bond Company, Louisville, Kentucky.
transactions on that basis. Suddenly, these bonds totalling about $20,000,000 were to have an important feature of their marketability destroyed.

Market disrupted. Prior to the announcement of the Pulaski opinion, road and bridge bonds of many Kentucky counties had been selling considerably above par.¹⁹ Five percent bonds, for example, were being sold in many cases on a two percent (or less) yield basis. After the opinion was announced, the market for such bonds folded completely. One source reported that the asked price for par bonds dropped around thirty points with no takers.²⁰ When or to what extent the market would have recovered is problematical, but it is certain that the bonds could never have re-entered the market on their former basis.

Impact on refunding. Several counties were in default on their road and bridge bonds as of the date of the Pulaski opinion, and several others faced default at later dates. Even though such bonds might not be negotiable, it is probable that no fraud was perpetrated in their sale. They would be valid obligations of the various counties in spite of their lack of negotiability. The 1938 legislature set up machinery to aid in the refinancing of such bonds by passing a county debt act. Who wants a refunding bond when it is non-negotiable, however? The counties already in default could have had little hope of removing the default by refunding, nor could the counties facing almost certain default have avoided the situation by refunding.

New issues prohibited and outstanding general obligations weakened. At least one reason for paying debts is that the need for borrowing again may present itself. The relief granted to three counties would have undoubtedly been reflected in the marketability of any new issues by other counties—if, indeed, such bonds could be sold at all. In fact, the sale of any new issues of road and bridge bonds would have become a virtual impossibility. Since 1909, when section 157a was added to the Constitution, there has never been a market which would take five per cent, non-negotiable municipals at a figure as much as the par sale required by law. And since the interest rate by law may not exceed five per cent, Kentucky county road and

¹⁹ Other counties, of course, had issues selling considerably below par as a result of the insufficiency of revenues from declining assessed valuations.
²⁰ The Louisville Courier-Journal, January 15, 1941.
bridge bonds could never have been sold, had it been known that their negotiability was restricted. Kentucky might still have been "in the mud." Furthermore, the market could not be presumed to take any such bonds in the predictable future. The court in declaring that road and bridge bonds were non-negotiable had in effect declared that section 157a of the Constitution was no longer operative!

Nor could general obligation bonds of the counties issued under section 157 of the Constitution have escaped the consequences of the original Pulaski opinion. Investors would tend to associate and to confuse such issues with the non-negotiable bonds, and the former's price would have been adversely affected. Perhaps, too, investors would have reasoned that this type of bond might also have its negotiability destroyed by some court decision. Refunding of general obligation bonds would likewise have been impeded.

**Credit of state and other municipalities impaired.** The opinion might have resulted in some perceptible impairment of the credit of the state government and its other units of local government. This would have been most noticeable in sales of new issues shortly after the opinion was announced, but conceivably could have been reflected in new issues for many years to come. The market for outstanding issues might also have been affected adversely.

**Federal court decision nullified.** The original opinion in the Pulaski case was reached despite a decision to the opposite in the federal courts in *Pulaski County v. Eichstaedt.* The Kentucky court justified its step by assuming that "the particular and special character and nature of the 20 cent levy, as limited and defined by this court in construing the sections of the Kentucky Constitution and Statutes" was not called to the attention of the federal court. Thus, had the Kentucky court's original opinion been allowed to stand, Pulaski County would have been placed in the strange position of having both negotiable and non-negotiable bonds of the same issue. The particular bonds in litigation in the *Eichstaedt* case are now negotiable, regardless of Kentucky court decision concerning any other particular bonds. But, presumably, the federal courts in future decisions would have followed the Kentucky court.

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21 110 F. (2d) 79 (1940).
opinion in the Pulaski case, and all county road and bridge bonds, except the particular ones involved in the Eichstaedt case, would have been non-negotiable.

Petition for rehearing filed. In December, 1940, an imposing array of counsel for various interested parties joined with the appellee in presenting to the court a petition for rehearing and a request that the opinion rendered on October 8, 1940, be withdrawn.

NEGOTIABLE

The arguments presented in the petition for rehearing may be summarized into the three most important contentions:

(1) The bonds are not payable exclusively from the tax levy of twenty cents per $100 assessed valuation, since other funds might be applied by a fiscal court to the payment of such bonds.

(2) The decisions of the court in Bird v. Asher and other cases following the doctrine announced therein set limitations on the issuance of bonds authorized by section 157a of the Constitution, but in no case did the court set limitations on the payment of such bonds, once issued.

(3) The bonds, in fact, are additional obligations of the county similar to indebtedness authorized by sections 157 and 158 of the Constitution and, like such indebtedness, are payable from funds derived by unlimited tax rates.

These contentions deserve further examination.

Bonds not payable exclusively from twenty cent levy. This argument relied on Mitchell v. Knox County Fiscal Court^{22} and a long line of cases which hold that a county may use any funds to pay road and bridge bonds, although the use of funds other than the tax levy of twenty cents per $100 assessed valuation is discretionary. Since funds other than the twenty cent levy might be used, the petition argued that the bonds were not payable exclusively from a special fund such as to destroy their negotiability under the Kentucky negotiable instruments act.

Previous decisions limit issuance, not payment of bonds. The petition pointed out that in all cases in which the court had limited payment of road and bridge bonds to the funds derived from the twenty cent tax levy, the question before the court had been one of limitation on issuance, not limitation on payment. Thus, the petition reasoned that the court in the original Pulaski opinion was following a dictum which should not necessarily apply to a question of payment. It is perfectly proper, the peti-
tion contended, to limit the issuance of road and bridge bonds to the amount which can be paid on the basis of the existing assessed valuation from a tax levy of twenty cents per $100 assessed valuation. But to apply this limitation on issuance to payment of bonds once issued is to follow an untenable dictum, the argument went on, since obligations once legally incurred should be paid. This is especially true, the argument continued, since the leading case itself contains the following language:

"... no municipality should be permitted under any circumstances to create an indebtedness without also being under an authorized and enforceable duty to provide for its payment in such manner as that it might be compelled to pay it."

**Bonds negotiable because payable, in fact, from unlimited tax rates.** Section 157a of the Constitution refers to the indebtedness authorized as additional indebtedness. If it is additional, the petition contended, it must be additional to some particular type of indebtedness. It can only be additional to the type of indebtedness authorized by section 157 of the Constitution, the argument continued. Since this type of indebtedness is a general obligation of the county and taxes to pay it are unlimited, the petition reasoned, any additional indebtedness must also be a general obligation and payable from funds derived by unlimited tax rates. Thus, county road and bridge bonds are payable from unlimited funds, the contention went, and are negotiable under the Kentucky negotiable instruments law.

**Original opinion withdrawn.** The court withdrew its original opinion and on January 21, 1941, announced its decision that the bonds are negotiable. The decision was based in part on the foregoing arguments, and in part on a point presented to the court in oral argument. This latter argument was a contention that the bonds are not payable from a limited fund because the twenty cent tax can be levied indefinitely.

**Precedent applies to limit on issuance, not payment.** The court fully accepted the argument that *Bird v. Asher, supra*, applied only to limitations governing issuance of bonds under section 157a of the Constitution. It stated this proposition and the question to be decided in the Pulaski case in the following manner:

"Hitherto the consideration of these provisions of the constitution and statute has been in relation to the creation of a debt and its

*Bird v. Asher, 170 Ky. 726 (1916).*
validity. They must be now viewed in relation to the character of the bonds evidencing the debt. If the obligation of a county assumed under them is confined strictly to levying only the limited tax of twenty cents during the life of the bonds to collecting it and to disbursing the proceeds to the holders of the bonds—if that be the extent of the obligation—they are but promises to pay the bonds out of a particular fund and this makes them non-negotiable. If the right exists to require the county to extend the time of special levy and perform the concomitant duties until the bonds are paid, or to require the county to exercise its general taxing power in order to get the money with which to pay, then the instruments are negotiable—the operation of the law makes them unconditional promises.  

Bonds not payable from a limited fund and therefore negotiable. After examining the Constitution, and the statutes and decisions thereunder, in the light of the above quotation, the court announced its decision in the following language:

"Since Pulaski County could renew the bonds if not paid at maturity, could use other available resources—at least at its option—and could because of the requirements of Section 159 of the Constitution be mandatorily required to continue the special levy beyond the life of the bonds, we are of opinion that the payment of the bonds cannot be said to be confined to a particular fund, hence that they are negotiable instruments."  

Evidently the court, having decided that the levy could be continued indefinitely, found it unnecessary to decide the question of whether or not the county could be required to exercise its general taxing power to pay the bonds.

Effects of Negotiability Decision

Pulaski County liable for payment. The immediate effect of the final decision (assuming that the bonds were issued within the governing limitations) is that Pulaski County will be required to pay these bonds on which the proceeds were only partially realized. Other counties having outstanding bonds issued under similar circumstances will also be required to pay them in full. In general, the effects of the final decision will offset any results which might have been brought about by the original opinion.

Restriction on payment possibly removed. As suggested above, the question of whether or not the county could be required to exercise its general taxing power to pay the bonds was not before the court for decision. In reaching the decision as to

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4 Emphasis mine.

25 The case was remanded to the lower court for determination of the question of overissue, but the important question as to negotiability had been decided.
negotiability, however, the court did make certain statements indicative of what might be expected in respect to the exercise of a county's general taxing power. For example, the following excerpts from the decision indicate that the indebtedness authorized by section 157a is to be considered a general obligation, the same as that authorized by section 157:

"The concept of a general obligation is implicit in the constitutional amendment (section 157a) . . . for it authorizes a county 'to incur an indebtedness'. It is referred to as 'an additional indebtedness'. The 20-cent tax is permitted 'in addition to the tax rate allowed under Section 157 of the Constitution of Kentucky', but it is not mandatorily required. Manifestly, the indebtedness to which this is additional, payable out of the general tax-levy to which the 20 cents is additional, is free from suspicion of being payable out of particular funds or otherwise being conditional.

"As we have heretofore pointed out, the terms of Section 157a contemplate a general indebtedness and not a conditional one payable exclusively out of the special tax levy therein permitted to be made. The limitations of that section determine the extent but not the nature of the debt to be incurred. The declaration that it should be in addition to the county's general indebtedness implies that it is of the same kind, for if the payment were restricted to a special non-recurring tax levy it would be of a kind different from that to which it is added."

A county may be required to levy taxes in excess of the rates specified in the constitution to pay valid general obligation debts. It is entirely possible, therefore, that in a case asking mandamus to require a county to levy more than twenty cents per $100, the court may hold that road and bridge bonds require unlimited taxes as do other general obligations. Such a decision would mean that speculative holders of defaulted county road and bridge bonds would be immensely benefited.

**CONCLUSION**

County road and bridge bonds have furnished another field for reversals in the history of Kentucky's municipal debt decisions. Pulaski County was relieved of paying a bond issue, for which it only received insignificant proceeds, as a result of the original opinion declaring such bonds to be non-negotiable. Other widespread effects of the opinion and able arguments in a petition for rehearing then resulted in a decision holding the bonds to be negotiable. This final decision appears to have paved the way for holding that county road and bridge bonds are

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*See City of Winchester v. Nelson, et al., 175 Ky. 63 (1917).*
general obligations payable from unlimited taxes. The fact that such bonds have all been issued without any such general understanding, however, and the fact that speculative holders of defaulted bonds would reap unwarranted returns, may spur the court to find a method of paying general obligation bonds from funds other than the proceeds of unlimited tax rates.