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"LEASE AND OPTION" DEVICE FOR AVOIDING CONSTITUTIONAL LIMITATIONS ON THE INDEBTEDNESS OF SCHOOL DISTRICTS IN KENTUCKY

By John C. Lovett

The Constitution of Kentucky forbids a county, city or other taxing district from becoming indebted "for any purpose in any manner" for an amount exceeding in one year the income and revenue provided for that year without the assent of two-thirds of the voters. That city and county school districts are "taxing districts" within the meaning of this section is apparently well settled. The provision in the constitution suspending the limitations in emergencies has been of little assistance to school districts who desired new buildings either because the old buildings were destroyed by fire, or because the existing facilities and equipment were inadequate for an expanding school. These are not "emergencies" within the meaning of the constitution, such as will permit a non-conformity with the above requirements.

When fire has destroyed existing buildings, where swelling enrollments made additional equipment imperative, and where

1 B. A. at Western Kentucky State Teachers' College 1937; LL. B. at Harvard University 1940; Member of Marshall County, Western Kentucky, and Kentucky State Bar Associations.

2 Kentucky Constitution, Sec. 157.

3 Brown v. Board of Education, 108 Ky. 783, 575 S. W. 612 (1900); Board of Trustees v. Postell, 121 Ky. 67, 88 S. W. 1065 (1905).

Query whether this view would be open to attack on the basis of a statement in the case of Hackensmith v. Co. Bd. of Edu. of Franklin County, 240 Ky. 76, 41 S. W. (2nd) 656 (1931). In that case the court said at page 82, "in other words, it is our conclusion that a board of education of a school district, such as in the defendant, under the law as it now exists, is only an administrative body with no power to levy or collect taxes."

The conclusion that the district is not a "taxing district" probably would not be accepted by the court. While the board itself does not levy taxes, it can require the fiscal court, or municipal governing body, to levy taxes for its benefit, and this power is sufficient to bring it within the meaning of Section 157. See: City of Newport, Ex Parte, 141 Ky. 329, 332, 132 S. W. 550, 551 (1910).

4 Supra, n. 2 at Sec. 158.

old delapidated buildings have become dangerous fire-traps, the problem of providing adequate facilities arises. As the floating indebtedness of the district increases, and the general wealth of the community decreases, the problem becomes more acute. How that problem has been solved is the basis of this discussion. In it we run the gauntlet of subterfuge, unwise public expenditures, careless decisions, and puzzling judicial double-talk.

In 1923, the County Board of Education of Davies County was confronted with the task of providing a new school building at a cost of $40,000. For some unexplained reason, it was “not thought best to submit the question to the voters” in accordance with the constitution. A plan was devised whereby the board should convey to Hagen and Potts, a construction firm, nine acres of land. The firm agreed to erect the building on the land, lease the completed building to the board for school purposes, the board in return promising to pay 13 semi-annual rentals of $3,500 each and 2 of $2,500 each. After all the payments had been made, the firm promised to reconvey the premises to the board.

A taxpayer’s suit contesting the validity of the proposed agreement brought the case before the Court of Appeals. It was there held that the plan was invalid because it created an indebtedness of $51,000 and this exceeded the anticipated revenue for 1923. Many cases had held that promising to pay a large sum in small annual installments is incurring a debt for the entire sum.

The real basis of the court’s opinion seems to be that if this plan, ingenious as it is, were approved, the protection given the voters by the constitution against “excesses and extravagancies” would be stricken from the fundamental law. The court seemed to think that the constitution provided an adequate method of meeting the situation, and it would be unwise to substitute a

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This court in the principal case took this view disregarding the possible effects of a clause in the contract providing that in case of default in the annual payments, the whole sum would become due, but all above the constitutional limitation would be void. Thus it would appear that the maximum legal obligation at any given time was within the limitation.
new device simply because it was "not thought best to submit
the question to the voters."

How the court changed its mind as to the importance of
protecting the people against unwise and extravagant spending
by public officials is seen in the decision in the case of Waller v.
Georgetown Board of Education.8 That case is the father of a
line of cases, each of which, as it was born, bore increasingly less
resemblance to its ancestor. Most of them are legitimate; a few
are bastards.

The plan in the Waller case demonstrated remarkable legal
ingenuity. There the trustees agreed to convey land on which
building had been begun to a private non-stock, non-profit
corporation, the incorporation of which was a part of the scheme.
The corporation agreed to pay $100,000 for the land (to raise the
sum bonds were issued) and the trustees agreed to use the money
in completing the building. The corporation would lease the
premises to the trustees for one year with option on the trustees
to renew for one year with option on the trustees to renew at
the end of each year. When all the bonds were paid, the corpora-
tion agreed to reconvey the premises to the trustees.

A taxpayer sought a declaration of rights under the
Declaratory Judgment Act. The court held that the contract
was valid because the debt created was only that of one year's
rental, and this was less than the anticipated revenue for that
year. The conveyance was an outright sale for full considera-
tion, and the trustees are not obligated to the bondholders nor
obligated to lease the premises for more than one year.

The court relied on the case of Overall v. City of Madison-
ville9 in which it was held that a city could erect a light plant
on a lot it did not own if the contract provided for the plant to be
erected piecemeal, so that the annual obligation would not exceed
the annual income. The court said as to the ownership of the
lot, that a lease to the city for one year with an option to renew
from year to year is not violative of the constitution.

The school district in the Waller case was a city school dis-
trict. The building had been begun and the scheme was invoked
to complete the building. The value of the property conveyed
was much less than the amount paid, thus the trustees made a

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8 209 Ky. 726, 273 S. W. 498 (1925).
9 125 Ky. 684, 102 S. W. 278 (1907).
good bargain. The bonds had been oversubscribed by the citizens of the community, thus assuring an ample local market. These characteristics of the father must be noted in order to ascertain the peculiarities of the progeny.

The first extension of the doctrine arose in the next case in which the plan was employed. There the court had little difficulty in approving the use of the scheme by a county as distinguished from a city board of education.

Later the plan was approved in a case in which it did not appear the bonds had been oversubscribed, nor did the corporation pay the money to the board, but rather paid for the construction of the building itself. The court asked three questions. (1) Has the board been given power to convey land for these purposes? (2) May the corporation legally hold and incumber the property? (3) Will the debt incurred be under the constitution limitation? All three questions were answered by the court in the affirmative.

The plan received the summary approval of the Court of Appeals in a case where the money desired could have been secured by the board of education merely by asking the fiscal court to increase the tax levy for one year. And where city and county boards jointly owned property, the city board conveyed its share to the county board and it in turn conveyed to the private corporation. This alteration in the facts does not preclude approval by the court.

These extensions in the application of the plan resulted from the court's careless approval of plans "substantially" the same as that employed in the Waller case. In reading the cases, one begins to wonder whether the idea in the case of Billings v. Bankers Bond Co., supra, condemning the attempt to strike the "prohibitions from our fundamental law" because it would lead to "excesses and extravagancies", has not been abandoned

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\[^{29}\text{Whitworth v. Breckinridge County Bd. of Edu., 225 Ky. 222, 7 S. W. (2nd) 1070 (1928).}\]
\[^{30}\text{Kirkpatrick v. City Bd. of Edu. of Russellville, 234 Ky. 336, 29 S. W. (2nd) 565 (1930).}\]
\[^{31}\text{This question is discussed more fully on page 7.}\]
\[^{33}\text{Button v. Trimble Co. Bd. of Edu., 235 Ky. 771, 32 S. W. (2nd) 345 (1930).}\]
entirely by the court. The court speaking through Judge
Thomas said,

"The school authorities of such districts in discharging their admin-
istrative duties have the right to adopt such methods for the successful
conducting of the school that are not expressly or by necessary implica-
tion prohibited by the constitution or a statute, and it is not for the
courts to determine whether in a given case they have pursued the
wisest and most prudent course."

The court has held that using the "lease and option" device for the purpose of paying an existing floating indebted-
ness is invalid. The court considered this scheme to be in sub-
stance a mortgage of the school property, and a school board
is not authorized by statute to mortgage school property. It is
submitted that the sale is just as complete in the cases where
the proceeds are to be used to pay existing debts, as where they
are to be used to pay for new buildings. The "mortgage" view,
it is submitted, is equally applicable to both. However, or other
factors in the case makes the result reached by the court seem
proper.

The court appears to have deviated from the course
thus established, however, in the case of Speer v. Ky. Children's
Home. There the children's home had become unable to
secure sufficient financial aid from private endowments. The
Department of Welfare wished to take the home under its wing,
but was prevented from doing so because the home owed a
$100,000 debt. The plan was used here, the property was con-
veyed to the newly formed corporation which issued bonds, and
paid off the debt. Then the corporation leased the property to
the Department of Welfare. Was this not substantially as much
a mortgage as that in the Hardin case? It is submitted that no
substantial distinction justifying opposite results is present.

The application of the principal was further extended in
Reneer v. Centertown Educational Corporation. There it did

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16 Holman v. Glasgow Graded Common School District, 237 Ky. 7,
at page 9, 34 S. W. (2nd) 733, 734 (1931).
17 Hardin v. Owensboro Educational Association, 244 Ky. 390, 50
S. W. (2nd) 86 (1932).
18 A statute then provided that in a sale of school property, the pro-
cceeds must be invested in other lots and buildings to be used for school
purposes, "and to be diverted to no other fund." This case involved a
city of the third class, and the statute applied only to third class cities.
Rothchild v. Shelbyville Bd. of Edu., 254 Ky. 467, 71 S. W. (2nd) 1033
(1934).
not appear that fair value was received for the property sold, and the money was used to "improve" existing buildings and equipment, not to erect a new building, nor to complete a partially constructed building. The court said,

"Even if we entertained greater doubt as to their soundness, we would not be inclined now to overrule (the cases) and thus undo what has been done in this case and in numerous other cases."

When federal funds became freely available for use in the construction of public works, the Kentucky General Assembly, as the legislative bodies in many other states, provided means for schools to benefit from those funds. This statutory device, which is essentially the same as the plan used in the Waller case with the county or city substituted in the place of a private corporation, was used in Davis v. Bd. of Edu. Newport.

Under the statutory plan, the city or county is a mere holding company and the bonds, which are in the nature of revenue bonds, are not obligations of the city or county within the meaning of the constitution. The board of education submits plans and specifications for the building, selects the site, and has general administrative control over the construction of the building. There must be a "lease and option," and if the lease calls for rentals "continuing from year to year," the aggregate of which is in excess of the constitutional limitations, the contract is invalid. An act passed by the General Assembly in 1934 declared that title to all property owned by school districts and held for school purposes shall be vested in the Commonwealth, and be controlled by the Department of Public Property, a newly created body consisting of the Governor and other state officers.

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22 Indeed it appears that fair value was not given. The price paid was $8,000 which was to be used in improving existing inadequate building and equipment. It is unlikely that the improvements would cost more than the value of the existing building plus the value of the land on which it was situated.
23 Supra, n. 19 at page 329.
24 Carroll's Kentucky Statutes, Baldwin's 1936 Revision, Sec. 4421-1 to 4421-19.
26 Davis v. Bd. of Edu. of Newport, supra.
officials. This raised the question: Can a school board convey property title to which is vested in the Commonwealth? It was held in *Bellamy v. Bd. of Edu. of Ohio Co.* that the statute did not qualify the power of the school board to convey their property. The decision in that case said the board could buy, sell and control real estate for school sites, manage school property, and use school funds in such ways as it should in the judgment and discretion deem necessary and proper. This a far cry indeed from the process of the vigilant court protecting the taxpayers from "excesses and extravagancies."

The first volley was fired at the plan by Judge Thomas in a dissenting opinion in *Scott County Bd. of Edu. v. McMillen.* In this case many improvements in school property were desired. Instead of conveying one piece of land and letting it bear the burden of improvements on it, the board conveyed three lots, without direction as to what part of the proceeds of the sale should be used to improve each lot, or indeed whether any of the proceeds should be used on some of the lots. It was held that this did not render the contract invalid, but Judge Thomas in his dissenting opinion set out some appealing objections. He first objected to expanding further the applicability of the plan. He forcefully argued that each lot of land should bear its own burden, and no piece of property be encumbered under a plan to secure funds with which to improve a separate and distinct piece of property. If this is allowed, it will "open the door for an ambitious board to engage in the erection of a building or other improvements * * * for beyond the necessities of the case," and is against public policy. He thought it should be declared against public policy for the board to encumber any piece of property for any amount over and above the cost of the improvements made to and upon it.

Certainly the conservatives will respect Judge Thomas' point of view.

Another interesting point was involved in that case. The contract provided that the private corporation would refund any taxes paid by the bondholder on the bonds. The provision included federal and state income and ad valorem taxes.

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27 Carroll's Kentucky Statutes, Baldwin's 1936 Revision, Sections 4399-19, 4618-44, 4618-47.
Obviously the purpose of the provision was to make the bonds more attractive to investors. This provision was held not to invalidate the scheme, because the broad powers vested in the board would include the power to make this kind of agreement. Here again Judge Thomas disagreed. His argument was that the provision made uncertain the amount of liability the corporation had on the bonds, which in turn rendered the amount of the annual payments uncertain and indefinite. Such uncertainty probably will lead to an increased rental payment which either the board must pay, or refuse to renew the lease, and in the latter case, the bondholders are left in a very precarious position.

It seems that Judge Thomas has foreseen the difficulties and has tried before it is too late to prevent the encroachment of the sea by holding his finger in the dike. Summary disposition of cases in which the facts are "substantially" the same as those in the Waller case merely by citing the Waller case has resulted in the present situation where the words "lease and option" are on open sesame to ambitions, extravagant, thoughtless boards.

The show is not over. It could not have been long until someone would seek to extend the plan to apply to a county which wished to replace a burned courthouse. The county had statutory authority to sell property and the plan was approved. One city wished to build a new hospital, and employed the "lease and option" device to obtain its construction. This plan was approved. And counties can use to secure funds for building a hospital. The Department of Welfare used the scheme in purchasing a children's home which was encumbered by a debt. The plan provided funds to pay the debt.

As the cases stand, it appears that almost any application of the "lease and option" device will receive the approval of the

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Two cases from the same county decided the same day employing the plan in improving two different lots by erecting school buildings. In both cases, the contracts were approved.
court. Few effective limitations remain, and the barriers erected by the framers of the Constitution to prevent maladministration have been swept away. An orgy of waste of public funds and of the accumulation of ruinous indebtedness, and the spectacle of school superintendents engineering the construction of a building "to be a monument to himself" seem in the offing.

"Pay as you go" is a sound business policy, but a bad political policy for ambitious officers. The framers of the Constitution intended that the taxpayers be protected, and be consulted in the incurring of large indebtednesses. This protection the court has swept away. Before the well becomes deeper and more harm is done, the policy should be ended. Actually one of two things must happen. Either the taxpayers must continue paying the rent and renewing the option, or the bondholders must seek what they can from the mortgaged premises. And such premises as schoolhouses and courthouses do not generally bring a high return on a forced sale.

It is submitted that this is an excellent field for remedial legislation. In absence of this, it appears desirable that the court follow the method employed in the case of Payne v. City of Covington, and overrule the previous cases, but with the reservation that the rights of all parties in those cases be preserved.

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* An actual happening.

* 276 Ky. 380, 123 S. W. (2nd) 1045 (1938).
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