STATE OF KANSAS

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November 17, 1975

ATTORNEY GENERAL OPINION NO. 75- 433

The Honorable Paul Feleciano, Jr.
State Representative
2302 North Hood
Wichita, Kansas 67204

Re: Kansas Housing Finance Authority Act--Constitutionality

Synopsis: Revenue bonds issued by the Kansas Housing Finance Authority under the proposed Kansas Housing Finance Authority Act do not constitute debts of the state or a pledge of the faith and credit of the state. Provisions for subsequent legislative appropriations to bond reserve funds of the authority are entirely permissive and import neither a legal obligation of the State to make such appropriations nor any legal claim of holders of such bonds to payment from such appropriations. In implementation of the proposed act, the proposed Authority does become a party to internal improvements in violation of Article 11, section 9 of the Kansas Constitution.

* * *

Dear Representative Feleciano:

You inquire concerning certain features of a bill which has been proposed as the Kansas Housing Finance Authority Act. Its purpose, stated in section 2 thereof, is "to provide financing for residential housing for sale or rental to persons or families of low or moderate income." Under section 4, there is created a "body politic and corporate to be known as the 'Kansas housing finance authority.'" It is constituted a "public instrumentality" and the

> "exercise by the authority of the powers conferred by this act in the financing

> of residential housing shall be deemed and held to be the performance of an essential governmental function."

The powers of the Authority are described with great breadth and particularity in the Act, *and* particularly in sections 5 through 7. Briefly, in aid of the financing of residential housing for low and moderate income families, it is empowered to purchase construction and mortgage loans, and accompanying promissory obligations, from lending institutions and to sell or otherwise dispose of such mortgages and other obligations. It is authorized to make loans to and purchase securities from lending institutions, the proceeds of such loans and purchases to be used to finance the residential construction described above.

The capital which the Authority is created to furnish to lending institutions is derived from the sale of revenue bonds. Under section 9(a), the Authority

> "shall have the power, and is hereby authorized to issue from time to time its bonds in an aggregate principal amount not exceeding one hundred million dollars ($100,000,000) to provide funds for the financing of residential housing as authorized under the provisions of this act, the payment of interest on bonds of the authority, establishment of reserves to secure such bonds including the reserve funds created pursuant to section 10 hereof . . . ."

Section 14 states that these bonds

> "shall not be deemed to constitute a debt of the state or of any political subdivision thereof or a pledge of the faith and credit of the state or of any such political subdivision thereof, but all such bonds shall be payable solely from the revenues and assets of the authority. All such revenue bonds shall contain on the face thereof a statement to the effect that neither the state nor the authority shall be obligated to pay the same or the interest thereon except from revenues

> and assets of the authority and that neither the faith and credit nor the taxing power of the state or of any political subdivision thereof is pledged to the payment of the principal of or the interest on such bonds."

Although the principal of and interest on such bonds are payable solely from revenues and assets of the Authority, those assets may very well include monies appropriated directly to it from the state treasury. Under section 10, the Authority is authorized to create one or more "bond reserve funds," to be used

> "solely for the payment of the principal of bonds secured in whole or in part by such fund or of the sinking fund payments with respect to such bonds, the purchase or redemption of such bonds, the payment of interest on such bonds or the payment of any redemption premium required to be paid . . . ."

The amount of each such bond reserve fund shall be as determined by the Authority, with respect to the bond issue for which the reserve fund is created, an amount equal to

> "not more than the greatest of the respective amounts, for the current or any single future fiscal year of the bonds of the authority, of annual debt service on the bonds of the authority secured in whole or in part of such fund, such annual debt service for any fiscal year being the amount of money equal to the aggregate of all interest and principal payable on such bonds during the fiscal year, calculated on the assumption that all such bonds are paid at maturity or if any amount of such bonds is required to be redeemed on any earlier date by operation of a sinking funds, then on the assumption that such amount of bonds is redeemed on such earlier date and that such amount is considered principal payable on such bonds during the year they are to be redeemed for purposes of this calculation."

Although section 14, as quoted above, provides that the bonds shall not be deemed a pledge of the faith and credit of the state, and that the taxing power of the state is not pledged to the payment of either principal or interest thereon, section 10(c) directs the Authority to look to the legislature each year for funds to meet the bond reserve fund requirement of each bond reserve fund:

> "To assure the continued operation and solvency of the authority for the carrying out of its corporate purposes, provision is made in paragraph (a) of this section for the accumulation in each bond reserve fund provided for therein of an amount equal to the bond reserve fund requirement for such fund. In order to assure such maintenance of the bond reserve funds, the chairman of the authority shall annually, on or before September 15 make and deliver to the governor and to the legislative coordinating council such chairman's certificate stating the amount, if any, required to restore each bond reserve fund to the bond reserve fund requirement for such fund. The governor shall submit to the legislature in the next succeeding budget the amount, if any, required to restore each bond reserve fund to the bond reserve fund requirement for such fund. Any amounts appropriated by the legislature and paid to the authority pursuant to this section shall be deposited by the authority in the applicable bond reserve fund."

This provision prompts your question whether, in the event of imminent default on payments of either principal or interest on such bonds, the legislature is obligated to appropriate general fund monies to supply deficiencies in the bond reserve funds. Each purchaser and holder of these bonds is notified, by the recital required to appear on the face of each bond by section 14, that the bond does not constitute a pledge of the faith and credit of the state, and that neither the faith and credit of the state nor its taxing power is pledge to payment of either principal or interest on these bonds. There exists, thus, no legal obligation of the State of Kansas to the bondholders to appropriate sufficient monies from the general fund to the bond reserve funds of the Authority to forestall default on payment of either principal or interest on bonds issued by it. However, bonds issued by Kansas state agencies

have long enjoyed a good reputation in the marketplace, derived in large part from decades of sound business practices, fiscal policy and timely payments. Obviously, the reputation might well be measurably diminished by a default in the payment of either principal or interest on bonds issued by the Authority. The failure of the Legislature to appropriate sufficient monies to forestall a default on bonds of the Authority would not constitute a breach of any legal or moral obligation of the State of Kansas, but a default which resulted from such failure might well entail serious and damaging consequences to the credit of the state, consequences possibly as severe as if the default were of a clearly legal obligation.

Courts in a number of jurisdictions have considered the question whether bonds issued under the authority of acts such as this one constitute debts of the state and a pledge of its faith and credit. With but one exception, each of these courts has held that such bonds do not constitute a debt of the state or a pledge of its credit, and that provisions for subsequent legislative appropriations to bond reserve funds, do not constitute binding commitments, either legal or moral, of the credit of the state. *See, e.g., Walsh Construction Co. v. Smith*, 537 P.2d 542 (Ore. 1975); *Johnson v. Pennsylvania Housing Finance Agency*, 453 P.2d 329, 309 P.2d 528 (1973); *State ex rel. Warren v. Nusbaum*, 59 Wis.2d 391, 208 N.W.2d 780 (1973); *Minnesota Housing Finance Agency v. Hatfield*, 210 N.W.2d 298 (Minn. 1973); *Maine State Housing Authority v. Depositors Trust Co.*, 278 A.2d 699 (Me. 1971); *Martin v. North Carolina Housing Corp.* 175 S.W.2d 665 (N.C. 1970); *Massachusetts Housing Finance Agency v. New England Merchants National Bank of Boston*, 356 Mass. 202, 249 N.E.2d 599 (1969). This conclusion likewise follows from cases decided by the Kansas Supreme Court. *State ex rel. Fatzer v. Kansas Armory Board*, 174 Kan. 369, 256 P.2d 143 (1953) and *State ex rel. Fatzer v. Board of Regents*, 167 Kan. 587, 207 P.2d 373 (1949).

A much more difficult question is raised by your inquiry whether implementation of the proposed act is affected in any fashion by Article 11, § 9 of the Kansas Constitution, which states thus:

> "The state shall never be a party in carrying on any work of internal improvement except that: (1) It may adopt, construct, reconstruct and maintain a separate system of highways, but no general property tax shall ever be laid nor general obligations bonds issued by the state for such highways;

> (2) it may be a party to flood control works for the conservation or development of water resources."

In two of the cases cited above, acts similar to that proposed here were challenged on the ground, *inter alia*, that the residential housing to be financed thereby constituted internal improvements prohibited by the state constitution. In *State ex rel. Warren, v. Nusbaum, supra*, this objection was raised, and rejected. First, the court referred to the elaborate legislative declaration contained in the act, reciting the serious inadequate supply and pressing need for safe and sanitary housing for families of low and moderate income, that this shortage is inimical to the safety, health, education, morals and welfare of residents of the state and to the orderly growth and prosperity of the state and its communities, that present patterns of financing were inadequate, and that local authorities alone could not meet this housing need. The court proceeded thus:

> "The interpretation and application of the internal-improvement restriction of the constitution has always presented difficult questions for this court. While each decision has precedential value, the specific facts then under consideration cannot be ignored. . . .
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> The language of sec. 10, art. VIII, was not intended by the framers of the constitution to prohibit encouragement of all internal improvements. . . . In State ex rel. Jones v. Forelich, (1902), 115 Wis. 32, 91 N.W. 115, an effort was made to define the term 'internal improvement.' The intervening years have proved, if nothing else, that the application of an abstract definition of the terms has proved difficult. An examination of the cases coming before this court over the last seventy years leads to the conclusion that both this court and the legislature have been cognizant of changing times and the ever-changing needs of the state and its people. These cases demonstrate that in considering the application of the internal improvement restriction at least two factors are considered: (1) The

> dominant governmental function, and (2) the inability of private capital to satisfy the need.
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> We have previously determined there is a valid public and state purpose for the enactment of ch. 234, and we now find and conclude the dominant purpose set forth in the enactment is a valid governmental function and that since private capital is unavailable, therefore, the proposal does not constitute an internal improvement prohibited by sec. 10, art. VIII, Wis. Const." 208 N.W.2d at 806-808. [Citations omitted.]

In *Minnesota Housing Finance Agency v. Hatfield, supra,* the identical question was also discussed and decided:

> "Historically, this provision of the Constitution has been given a fairly limited reading. First, § 5 has been held to apply only to the state, not to its political subdivisions. . . . Additionally, this court has long held that the provision does not apply to works in the state in its governmental, as opposed to proprietary functions. . . . The rationale for the latter exception was discussed in historical terms in Erickson (218 Minn. 103, 15 N.W.2d 203):
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> "'A reading of the debates in the constitutional convention or conventions which framed our constitution leads us to believe that the evil sought to be prevented by * * * art. 9, § 5, * * * was that of the state's financing railroads, toll roads, or canals, all of which lend themselves readily to operation for profit by private corporations and are not well carried on by public officers.'"

The court acknowledged that this statement might "appear to include housing in forbidden internal improvements." Notwithstanding, the court went on to observe that preservation of the

public health has long been one of the clearly accepted governmental functions, and found that the act in question "meets the accepted governmental function of protecting public health." 210 N.W.2d at 304-305.

The Kansas Supreme Court has never adopted a governmental versus proprietary test for the identification of public improvements. As originally adopted, the prohibition against internal improvements was absolute, with no exceptions for highways or water control or conservation. In *Leavenworth County v. Miller*, 7 Kan. 479 (1871), the court described the breadth of the prohibition thus:

> "The state as a State is absolutely prohibited from engaging in any works of internal improvement. We will concede that this prohibition does not extend to the building of a state-house, penitentiary, state university, and such other public improvements as are used exclusively by and for the State, as a sovereign corporation: but it does extend to every other species of public improvement. It certainly extends to the construction of every species of public improvement which is used, or may be used, by the public generally . . . such as public roads, bridges, etc. . . . [I]t is prohibited from opening up or constructing any roads, highways, bridges, ferries, streets, sidewalks, pavements, wharfs, levees, drains, water-works, gasworks, or the like. . . ." 7 Kan. at 493.

In *State ex rel. Brewster v. Knapp*, 99 Kan. 852 (1917), the court held unconstitutional an appropriation of monies for the improvement of county roads, notwithstanding the building of roads and highways is indisputably a legitimate governmental function. Moreover, the fact that the act may be found to serve a public purpose does not exempt it from the constitutional prohibition, as the court in *Knapp* pointed out:

> "We know that rivers like the Kansas and the Marias des Cygnes in times of high water change their channels and cause great destruction along their valleys by reason of their crooked courses. It would seem the most patent and plausible scheme of public welfare for the state to appropriate

> money to straighten these channels where their bends and sinuosities are so marked. After the flood of 1903, which brought such devastation along the Kansas river, it would have seemed the most natural thing imaginable for the state to enter upon the work of protecting this great valley from similar disasters in the future. But as the last situation was left to be controlled by the formation of a local drainage board, so the two other suggested situations must be left out of the category of things which the state can do, for the all-sufficient reason that in entering upon such task, beneficial as it might be, the state would become a party in carrying on a work of internal improvement." 99 Kan. at 857.

In *State ex rel. Boynton v. Atherton*, 139 Kan. 197, 30 P.2d 291 (1934), the court referred approvingly to *State ex rel. Jones v. Forelich*, 115 Wis. 32, 91 N.W. 115 (1902), which was impliedly abandoned in *State ex rel. Warren v. Nusbaum, supra*, by the Wisconsin Supreme Court, and quoted therefrom as follows:

> "'In other cases the expression 'works of internal improvement' contained in constitutional prohibitions similar to ours, has been declared to include enterprises as follows: Dredging sand flats from a river (*Ryerson v. Utley*, 16 Mich. 269) deepening and straightening river (*Anderson v. Hill*, 54 Mich. 477, 20 N.W. 549); constructing or operating street railways (*Attorney-general v. Pingree*, 120 Mich. 550, 79 N.W. 817, 46 L.R.A. 407); telephone or telegraph lines (*Northwestern Tel Exch. Co. v. Chicago, M. & St. P. R. Co.*, 76 Minn. 334, 345, 79 N.W. 315); irrigation reservoirs (*In re Senate Resolution Relating to Appropriation of Moneys Belonging to Internal Impr. Fund*, 12 Colo. 287, 21 Pac. 484); roads, highways, bridges, ferries, streets, sidewalks, pavements, wharves, levees, drains, waterworks, gas works (*obiter, Leavenworth Co. v. Miller*, 7 Kan. 479, 493, 12 Am. Rep. 425); levees (*Alcorn v. Hamer*, 38 Miss. 652); improvement of Fox river (*Sloan v. State*, 51 Wis. 623, 632, 8 N.W. 393); levees and drains (*State v. Hastings*, 11 Wis. 448, 453).'"

In *Atherton*, the court clearly implied that works pertaining to the improvement and beautification of the state's own property, such as its fish and game preserves, "may fairly be regarded as *public improvements* which the constitution does not forbid," but that the unspecified projects contemplated by the act there in question could reasonably be expected to include other and more far-reaching undertakings, beyond the scope of the prohibition. [Emphasis by the Court.]

Unlike the distinction between governmental and proprietary activities followed by the Wisconsin and Minnesota Supreme Courts in the cases cited above, the Kansas Supreme Court has looked instead to the distinction between "public improvements" and "internal improvements." In *State ex rel. Fatzer v. Board of Regents*, 167 Kan. 587, 207 P.2d 373 (1949), a case concerning the legality of revenue bonds proposed to be issued by the Board of Regents for the construction of student dormitories and facilities connected therewith, the court stated thus:

> "This distinction made in our constitution between 'public improvements' and 'internal improvements,' unlike constitutional distinctions of some other states, has been clearly recognized and emphasized in our former distinctions. . . . These cases clearly indicate the reasoning and purpose of the framers of our constitution in making the stated distinction." 167 Kan. at 598.

Under the extant decisions of the Kansas Supreme Court, the construction of residential housing cannot be excepted from the prohibition against internal improvements merely because the program might be deemed to serve a public purpose and a governmental function. Similarly, the housing in question cannot be deemed to constitute a "public improvement," for it does not involve works for the improvement of the state's own property. The conclusion is inescapable that the residential housing proposed to be financed by the proposed Authority constitutes works of internal improvement, to which the state may not be a party.

This conclusion leads to a second question, whether under the bill as proposed, the state is indeed a party to such improvements. This question was considered in *In re Advisory Opinion*, 380 Mich. 554, 158 N.W.2d 416 (1968), a case involving legislation substantially similar to that proposed here. The court found that the housing which was proposed to be constructed was a work of internal improvement, and proceeded thus:

> "The construction to be encouraged by the act is, however, a work of internal improvement, and it is therefore necessary to decide whether the State will be a party to it, financially interested in it, or engaged in carrying on such work as prohibited by article 3, section 6, Constitution 1963.
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> The act does not authorize the state housing development authority to build buildings. It does not anticipate that the state housing development authority will be a party to building contracts. It cannot be said then that the state agency will be a party to, nor engaged in carrying on the construction of housing. The state housing development authority will, however, be making advances and mortgages for the purpose of financing such construction.
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> Moneys of the state housing development authority are not moneys of the State. The funds to be established under the act are trust funds to be administered by the state housing development authority. The State has no beneficial interest in such funds, and when such funds are used to finance the construction of housing, the State cannot be said to be financially interested in such construction. The state government can neither gain nor lose by reason of such construction. We conclude, therefore, that while the construction of private housing is not a public work of internal improvement, the act does not make the State party to, financially interested in, or engaged in carrying on such work, and the act does not therefore offend against Constitution 1963, art. 3, § 6." 158 N.W.2d at 429.

Article 11, § 9 of the Kansas Constitution provides that the state "shall never be a party in carrying on any work of internal improvement." It does not provide, as was proposed during the Wyandotte Convention, that the "state shall never contract any debt for works of internal improvement." The constitutional restrictions upon state indebtedness found, *e.g.*, in Article 9, §§ 6 and 7, have been construed to apply only to indebtedness to be paid by a general property tax. *State ex rel. Fatzer v. Board of Regents*, 167 Kan. 587, 207 P.2d 373 (1949). As the

tax base of state government has shifted from property taxes to sales and income taxes, the restrictive interpretation of these constitutional protections against state indebtedness has been rendered substantially illusory. The direction of Article 11, § 9 that the state "shall never be a party in carrying on any work of internal improvement" has not been thus emasculated. Thus, the state may not be party to any internal improvement regardless of the source of funds proposed to be provided therefor by the state.

The proposed Authority is created a body politic and corporate, and *constituted* a public instrumentality empowered to perform what is designated an "essential governmental function." It is an arm of the state. Pursuant to the authority of state law, the Authority is proposed to be empowered to sell revenue bonds as a source of capital for the performance of that declared essential governmental function. It is difficult to conclude that the funds so raised are not funds of the state. It is also difficult to agree that the state is not financially interested in the residential housing for which the proposed Authority is authorized to provide funds, particularly so when the Authority takes, in exchange for the funds loaned or otherwise furnished to lending institutions, assignments of construction and mortgage loans and succeeds to the rights of the lender in the properties so financed and constructed, as it is empowered to do. In every real and practical sense, the Authority is indeed a party to the construction of residential housing which it is empowered to finance under the proposed act. I cannot but conclude that in the performance of its duties and its assigned governmental functions under the proposed act, the Authority to be created thereby is a party to the construction of residential housing thereunder, and is thereby a party to internal improvements in violation of Article 11, § 9 of the Kansas Constitution.

Yours very truly,

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cc: The Honorable Neil H. Arasmith
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