Opin. Bk.

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ATTORNEY GENERAL OPINION NO. 85-4

TO: Mr. William G. Hepp
Investment Manager
Endowment Fund Investment Board

STATEHOUSE MAIL

PER REQUEST FOR ATTORNEY GENERAL'S OPINION

Regarding: Idaho Code § 57-722(3)(b)

QUESTIONS PRESENTED:

1. Whether Idaho Code § 57-722(3)(b) is constitutional?

2. What authority does the State Treasurer have as custodian of the public school fund to: (a) question the investments made by the Board through its Investment Manager who has been granted discretionary authority regarding investments; and (b) to refuse to open accounts as instructed by the Investment Manager for securities which clearly qualify for investment pursuant to Idaho Code § 57-722, specifically subsections (3)(b) and (8)?

CONCLUSIONS:

1. Idaho Code § 57-722(3)(b) authorizes investment in money market mutual funds whose assets are limited to obligations of the United States or any agency or instrumentality thereof. Such investments are constitutionally permitted, provided that the money market mutual fund meets two requirements. First, it must unconditionally guarantee full repayment of principal and interest as required by Idaho Const. art. IX, § 11. Second, the state must not directly or indirectly become a stockholder in any association or corporation. These determinations must be made on a case-by-case basis following review of the particular investment agreement and prospectus.

2. Responsibility for choice of legally permissible investments is vested in the board. The state treasurer has a custodial responsibility to safeguard fund assets entrusted to her care. This responsibility is broad enough, at a minimum, to refuse to open accounts or transfer funds for clearly illegal investments. As to investments which the treasurer believes are possibly illegal, we recommend that the transaction be completed and that legal resistance, if any, to a board request for investment be limited to judicial review of the question.

ANALYSIS:

Question 1

The question presented is whether Idaho Code § 57-722(3)(b) violates the Idaho Constitution. Idaho Code § 57-722(3)(b) provides:

> The board or its investment manager(s) may, and they are hereby authorized to, invest the permanent endowment funds of the state of Idaho in the following manner and in the following investments or securities and none other:
>
> * * * *
>
> (b) Money market mutual funds whose assets are limited to obligations of the

> United States or any agency or instrumentality thereof.

Idaho Constitution art. IX, § 11, sets forth the primary constitutional limitation upon permissible investments of the permanent endowment funds. That section provides:

> The permanent endowment funds other than funds arising from the disposition of university lands belonging to the state, shall be loaned on United States, state, county, city, village, or school district bonds or state warrants or on such other investments as may be permitted by law under such regulations as the legislature may provide. (Emphasis added)

The leading case construing this section's limitations upon investments is Engelking v. Investment Board, 93 Idaho 217, 458 P.2d 213 (1969). In that case, the Idaho Supreme Court held that §§ 9(6) and 9(8) of S. B. 1277 (S. L., 1969), which permitted purchase of stock and conversion of convertible bonds, violated Idaho Const. art. VIII, § 2, and art. IX, § 11.

In construing Idaho Const. art. IX, § 11, the court found that the legislature was limited to authorizing loans of endowment funds in view of the operative verb "shall be loaned" which is used in that section. In defining loan, the court held:

> In this situation we believe the important word "loan" must not be loosely construed to include all types of "investment." Instead, the word "loan," as used in Idaho Const., art. IX, § 11 and as extended in scope by the 1968 amendment, must carry the meaning that there must be a guarantee of full repayment of principal as well as interest. There must be an unconditional promise to repay the principal sum originally lent. (emphasis added)

93 Idaho at 223.

The court in Engelking also held that the statute authorizing purchases of stock and conversion of convertible bonds violated the express provision of art. VIII, § 2, that the state shall not "directly or indirectly become a stockholder in any association or corporation."

Thus, the court has established two requirements which must be met by any investment of the Idaho Endowment Fund Investment board. First, the investment must be a "loan," i. e., there must be an unconditional guarantee of full repayment of principal as well as interest. Second, the board must not directly or indirectly become a stockholder in any association or corporation.

In Engelking, supra, the court permitted investment in convertible bonds provided that they were not converted into common stock by the board. Thus, the fact that a security includes a potential for appreciation measured by the increase in value of equity interests is not fatal, provided that the security also unconditionally guarantees the full repayment of principal and interest.

In view of the numerous and varying provisions included in financial instruments offered to investors, it is necessary to determine compliance with Idaho's constitutional limitations upon endowment investments on a case-by-case basis. This necessarily requires a review of the particular security being considered as defined by the terms of the security agreement and prospectus.

Applying the Engelking decision to money market mutual fund investments, we begin with a definition of money market mutual fund drawn from the Dictionary of Banking and Finance, John Wiley & Sons, New York, 1982. Therein, "money market fund" is defined in the finance context as:

> ... [a]n investment vehicle whose primary objective is to make higher-interest securities available to the average investor who wants immediate income and high investment safety. This is accomplished through the purchase of high-yield money market instruments, such as U. S. Government

> securities, bank certificates of deposit, and commercial paper.

pp. 335-335.

"Mutual fund" is defined as:

> ... [a]n investment company which ordinarily stands ready to buy back (redeem) its shares at their current net asset value; the value of the shares depends on the market value of the fund's portfolio securities at the time. Also, mutual funds generally continuously offer new shares to investors.

p. 342.

"Investment company" is defined as including "a company or trust that uses its capital to invest in other companies ..." p. 288. In the context of Idaho Code § 57-722(3)(b), such a company or trust would be limited to investment in federal obligations.

Thus, a money market mutual fund is an investment company, utilizing a corporation or trust form of organization, which invests in high-yield money market instruments such as U. S. goverment securities and will redeem its shares at their current net asset value.

The definition of money market mutual fund neither includes nor excludes from the definition funds which do or do not guarantee repayment of principal and interest. It would not be contrary to the definition to provide a guarantee of repayment of principal and some amount of interest over a given period.

As an example, assume that a money market mutual fund invests in federal obligations with an average maturity of 30 days and an average annual interest rate of 8%. Also assume that the fund guarantees full repayment of principal plus interest at a minimum rate of 4% per annum if the security is held for 30 days. The fund further agrees that the investment can be redeemed at the net asset value per share at stated times.

Such an investment would meet the definition of money market mutual fund. It would also meet the definition of "loan" as interpreted by the Idaho Supreme Court in Engelking, supra. Such an investment would be comparable to convertible bonds which the court found permissible in Engelking. Like convertible bonds, there is an unconditional promise to repay principal and interest if held to a particular date in the future. Like convertible bonds, such an investment would include a right to convert the investment in the event of appreciation above the guaranteed return. In the case of convertible bonds, the court held that conversion to common stock would not be permitted since the state would upon conversion own stock in a corporation in violation of Idaho Const. art. VIII, § 2. This problem is not presented in the above example since upon redemption the state would receive cash rather than stock. Such a money market mutual fund investment would be constitutional.

In view of the ingenuity of the securities industry in developing various investment instruments, the above example is not intended to indicate that only money market mutual funds so structured meet constitutional requirements. Rather, it is intended to point out that money market mutual fund investments are constitutionally permitted vehicles for endowment fund investments if structured so that the state receives an unconditional promise to repay principal and interest.

When a statute is susceptible to a constitutional construction, that construction must be adopted. Matter of 1979 Valuation of Parcel No. R23487550330, 104 Idaho 681, 662 P.2d 1125 (1983); State ex rel. Kidwell v. U.S. Marketing, Inc., 102 Idaho 451, 631 P.2d 662 (1981); Nelson v. Marshall, 94 Idaho 726, 497 P.2d 47 (1972); Leonardson v. Moon, 92 Idaho 796, 451 P.2d 542 (1969). Accordingly, it is our opinion that a court faced with a challenge to Idaho Code § 57-722(3)(b) would read that section to preserve its constitutionality.

The court would construe Idaho Code § 57-722(3)(b) as authorizing investment in money market mutual funds which unconditionally guarantee repayment of principal and interest and which invest in federal obligations.

We have also considered the question whether the form of business organization chosen by an investment company affects the above analysis. As noted earlier, investment companies include both companies and trusts which use their capital to invest in other companies or federal obligations. In practice, money market mutual funds utilize either the corporate or business trust form of organization. Business trusts are also referred to as Massachusetts trusts and common law trusts. It is our opinion that the requirement of an unconditional promise to repay principal and interest must be provided whether the money market mutual fund is organized as a corporation or a Massachusetts or business trust.

There is a great deal of case law describing the nature and attributes of Massachusetts or business trusts (See, e. g., Modern Status of the Massachusetts or Business Trust, 88 ALR3d 704. The ALR annotation discusses the Massuchusetts or business trust in substantially more detail than can be covered herein. However, the following points are pertinent to the questions involved in this opinion. Summarizing the cases defining such trusts the annotation states:

> From the following illustrative cases which have undertaken to define a Massachusetts or business trust (also known as common-law trust), it may be said that a business trust is an unincorporated business organization created by an instrument by which property is to be held and managed by trustees for the benefit and profit of such persons as may be or may become the holders of transferable certificates evidencing the beneficial interests in the trust estate.

In addition to general agreement as to the basic definition of Massachusetts or business trusts, there is also general agreement that such trusts are very different from traditional trusts. For example, in Morrissey v. Commissioner, 296 U.S. 344, 56 S.Ct. 289, 80 L.Ed. 263 (1935), the U. S. Supreme Court pointed out that in business trusts the object is not to hold and conserve particular property with incidental powers as in the traditional trust. Rather, the business trust is created to provide a medium for the conduct of business and the sharing of gains.

Similarly, in Jim Walter Investors v. Empire Madison, Inc., 401 F.Supp. 425 (D.C. Ga. 1975), the court noted the following associational characteristics of a real estate investment trust organized under the business trust provisions of Florida law. The associational characteristics found included centralized control, beneficial shares, a distinct legal existence provided by its declaration of trust, limited liability, profit motivation, and the ability of shareholders to remove trustees and to merge, terminate, or amend the trust. The court concluded that the organization displayed no indicia of a traditional trust.

We are aware of no states which treat Massachusetts or business trusts in the same manner as traditional trusts. This apparently results from the associational nature of such organizations and the basic differences in purposes. The associational nature of such organizations has led courts to classify Massachussetts or business trusts as corporations, partnerships, or unincorporated associations. 88 ALR 722-729. States which do not view Massachusetts or business trusts as corporations frequently regulate them as corporations. For example, in Swartz v. Sher, 344 Mass. 636, 184 NE2d 51 (1962), it was held that, although a Massachusetts trust with transferable shares was not a corporation or an entity apart from the trustees, the trust was subject to regulation as a corporation and, as a practical matter, business trusts closely resemble corporations.

The cases also hold that the indenture or declaration of trust is determinative of the nature of the organization and of the details of its operation. 88 ALR3d 730. This underscores the importance of reviewing the declarations of trust on a case-by-case basis in determining the nature of a trust in a particular case. For example, in Koenig v. Johnson, 71 Cal.App.2d 739, 163 P.2d 746 (1945), it was held that the declaration of trust is to be looked to in determining whether the organization thereby created is an ordinary trust or a business trust.

Similarly, once it is determined that a money market mutual fund is a business trust rather than an ordinary trust, the question whether the securities it offers carry an unconditional promise to repay principal and interest should be determined with reference to the specific terms of the actual offering which are included in the offering's prospectus.

In Idaho, there have been three supreme court cases which have considered business trusts. Spotswood v. Morris, 12 Idaho

360, 85 P. 1094 (1906); State v. Cosgrove, 36 Idaho 278, 210 P. 393 (1922); Edwards v. Belknap, 66 Idaho 639, 166 P.2d 451 (1946).

Spotswood, supra, was an action to recover commissions for procuring a purchase for an alleged sale of real estate. The property involved had been conveyed in trust for a business association or syndicate called the Denver Townsite Company. One of the issues raised was whether two of the members of the business association or syndicate could bind the syndicate other than as set forth in the articles of agreement.

After reviewing the agreement, the court concluded that the association was a form of partnership unlike a normal partnership. In its opinion, the court reproduced virtually the entire agreement which reflects the importance of reviewing the actual agreements involved in determining the nature of such organizations and the legal effects resulting therefrom.

In Cosgrove, supra, the court considered the question whether a business trust of the state of Montana which sold one unit of its capital stock in Idaho was subject to Idaho's Blue Sky Law. The court determined that the business trust was an "association" and was, therefore, subject to the Blue Sky Law.

In Edwards, supra, the court considered whether grantors of a quitclaim deed to a business trust were entitled to cancellation of the deed as a result of the failure of the business trust to file articles of incorporation or to comply with reporting requirements upon corporations. The case was decided on grounds of estoppel rather than the nature of the organization. As to the nature of business trusts, the decision is somewhat confusing. Only Justice Budge stated that the trust is not technically an association or legal entity. Justices Givens and Koelsch found that the business trust was an unincorporated association which is a legal entity. Justices Holden and Miller (Dissenting) argued that since the trust exercised powers and privileges of corporations, it was required to file articles of incorporation and conduct its affairs in Idaho as a corporation.

The Idaho cases make it clear that the nature and legal effect of such trusts must be determined with reference to the particular agreements involved. It is also clear from the

Idaho cases that a business trust will be treated in Idaho as a form of business organization and not as a traditional trust. This is consistent with the normal view of business trusts as discussed in the ALR annotation cited previously.

The distinction bears emphasizing. Traditional trusts are not viewed as legal entities. Consequently, investment in a federal security by a traditional trustee of endowment funds would be viewed as a direct investment of the endowment fund in federal securities. However, a business trust is viewed by Idaho and virtually all other states as a business entity. As such, Idaho would follow the general rule that certificate holders in a conventional business trust stand in relation to the trust much as do stockholders to a corporation in that they are not creditors of the trust but are rather equitable owners of proportional interests in trust assets and liabilities. 88 ALR3d 737-739; Selected Investment Corp. v. Duncan, 260 F.2d 918 (Ca. 10 Okl. 1958), cert.den. 359 U.S. 914, 79 S.Ct. 584, 3 L.Ed.2d 576.

The same rule has even been found in Massachusetts, one of the jurisdictions following the minority view that business trusts are not legal entities. In Kennedy v. Hodges, 215 Mass. 112, 102 N.E. 432 (1913), it was held:

> ... [t]he shares in the Western Real Estate Trust, come within the same rule. The trustees are resident in this commonwealth and their home business office is here, where only can the certificates be transferred upon surrender and new certificates issued. The certificate holder is at least the owner of an undivided equitable interest in the property held by the trustees. There is on principle in this respect no distinction between such certificate and a certificate for shares of stock in a domestic corporation. This is virtually decided by Kinney v. Treasurer and Receiver Gen., 207 Mass. 368, 371, 93 N.E. 586, 35 L.R.A. (N.S.) 784, Ann.Cas. 1912A, 902; Peabody v. Stevens, 102 N.E. 435.

In summary, the form of business organization chosen by a money market mutual fund will not affect the application of

Idaho's constitutional provisions regarding investment of endowment funds. Idaho, as most other states, will look to the substance rather than form of business organization to determine the essential nature thereof. If organized as a business trust, an organization will be treated as a business organization and not as a normal trust. This determination will be made by reviewing the declaration of trust to determine the essence of the arrangement. Rights and obligations of shareholders and the trust will be determined from the agreements and documents defining those rights and obligations, including the declaration of trust and prospectus. To satisfy Idaho's constitutional requirements for endowment investments, such documents must unconditionally guarantee repayment of principal and interest upon the endowment investments.

Question 2

The second question posed concerns the authority of the state treasurer to question investments made by the board or to refuse to open accounts or transfer funds for investments chosen by the board.

The Idaho Supreme Court considered the responsibilities of the treasurer and the legislature as to the public school fund in Moon v. Investment Board, 96 Idaho 140, 525 P.2d 335 II (1974), and its conclusions therein were reaffirmed in Moon v. Investment Board, 97 Idaho 595, 548 P.2d 861 (1976). In interpreting Idaho Const. art. IX, § 3, in the initial case, the court reviewed the reported debate at the Idaho Constitutional Convention and held:

> Such language indicates that the Constitutional Convention intended that the legislative branch of the government should have control over the investment of the school endowment fund. ... This does not conflict with the provision that the state treasurer should be the custodian of the fund, but bifurcates the responsibilities between the executive and legislative branches of government. The treasurer is the custodian of the fund[2] and the legislature directs by law how the fund shall be invested, which, in this case, was

> accomplished by the creation of an investment board.
>
> * * * *
>
> Article IX, § 11, as amended, further indicates the constitutional mandate that the legislature is responsible for the investment of permanent endowment funds.

96 Idaho at 144.

The court did not define in detail the bifurcation of responsibilities between the treasurer and the board. However, the court's citation of 72 Am.Jur.2d, States, § 64 in footnote 2 of its discussion lends further insight into its thinking as to the intended division of responsibilities.

The Am.Jur. section cited states in pertinent part:

> Generally speaking, the duty of a state treasurer is to keep the moneys of the state and to pay them out only on regular warrants or requisitions for legal claims. He is not a trustee of moneys in the state treasury, but holds them only as the agent of the state. If there is any trust, the state is the trustee, and unless it can be sued the trustee cannot be enjoined. Ordinarily, it is not intended that payments out of the public funds should be made on the judgment of the public treasurer alone or the auditor alone. The auditor examines as to the amounts and the performance of the work, and it would seem that as to the facts his finding is sufficient protection, in the absence of any collusion or notice of fraud to the treasurer. However, the auditor's conclusion as to whether a claim is authorized or provided for by law is not binding on, nor is it a protection to, the treasurer. The state treasurer may refuse to obey a statute commanding him to indorse [sic] warrants when the constitutional debt

> limit is reached, although the statute is in other respects in its general provisions constitutional.

With regard to the public school fund, it is a trust fund of the state and the endowment fund investment board is trustee. The treasurer is the custodian of the fund. Generally speaking, principles of trust law would apply to the duties of the custodian and the trustee of the trust. The trustee is responsible for the management of the trust fund. The treasurer is responsible as custodian for the safekeeping of the assets of the trust fund.

The citation points out, in the analogous situation of warrant payments, that it is ordinarily not intended that payments out of public funds should be made on the judgment of the treasurer alone or the auditor alone. As to factual questions such as the amount of a claim or the performance of work, the treasurer is entitled to rely on the auditor absent notice of collusion or fraud involving the claim.

However, as to the question of whether a claim is authorized or provided for by law, the auditor's determination is not binding on the treasurer. The treasurer is to pay out state funds "only on regular warrants or requisitions for legal claims" and is not required to make statutorily authorized payments that would violate constitutional provisions. By analogy, the treasurer's custodial responsibilities should not be so narrowly construed as to eliminate all safeguards for the fund. Neither should the treasurer's custodial responsibilities be so broadly construed as to frustrate the board's control over the investment of the fund. Likewise, the board's authority should be interpreted broadly enough to provide for effective investment of funds but not so broadly as to eliminate the safekeeping responsibilities of the custodian.

The Am.Jur. citation indicates that the treasurer, as custodian of the fund, has some authority to refuse to open accounts or to transfer funds for illegal investments. At a minimum, the treasurer may refuse to permit investments that are clearly unconstitutional. On the other hand, refusal to permit clearly legal investments would frustrate the board's constitutional control over investments. Between these extremes, existing case law does not definitively answer the question of the treasurer's responsibility when faced with a request to open an account the treasurer believes is unauthorized by the constitution.

A procedure along the following lines would appear to provide a reasonable approach to the problem. The treasurer should notify the board of legal questions she has regarding any particular investment. The board should review the questions and notify the treasurer whether the board wishes to proceed with the investment. Such a procedure should resolve most problems, assuming substantial discussion with the legal advisors to the treasurer and the board. In those cases in which there remains a substantial doubt as to the legality of an investment, the parties could submit the quesion to the attorney general for a formal opinion. Alternatively, the treasurer might wish to seek judicial clarification of the question when she has substantial doubts as to the legality of an investment which the board decides to make.

We would recommend that the treasurer refuse to open an account or transfer funds for an investment only in extreme cases in which it appears clear to her on the basis of legal advice that the investment is unauthorized. This recommendation is made for several reasons. It is clear that the responsibility for the choice of investments is vested in the legislature and the board. Liability for losses upon statutorily unauthorized investments would be the responsibility of the board rather than the treasurer (Attorney General Opinion 79-8). Liability for losses upon authorized investments and presumably upon statutorily authorized but unconstitutional investments would impose a constitutional liability which the legislature would be required to satisfy pursuant to Idaho Const. art. IX, § 3, and Idaho Code § 57-724.

If a procedure such as that recommended above is implemented by the treasurer and the board, we would recommend that the board give the treasurer some advance notice of proposed money market fund investments or other new investments differing significantly from those previously utilized. For example, when the board requests legal advice from its counsel as to the legality of a proposed investment, it could notify the treasurer that the board will be considering the investment. Such notice would facilitate the review process.

The above procedural recommendations are intended only as one possible outline of procedures to advance common interests in safeguarding the fund and in providing for the maintenance of the public schools. The board and the treasurer are in the best position to determine whether other procedures will be more responsive to the needs of the parties or more conducive to improved long-term working relationships.

SUMMARY:

Public school endowment funds may constitutionally be invested in money market mutual funds which invest exclusively in federal obligations, provided the money market mutual fund unconditionally guarantees full repayment of principal and interest and provided the state does not directly or indirectly become a stockholder in any association or corporation. The determination must be made on a case-by-case basis following review of the particular investment agreement and prospectus.

Responsibility for choice of investments is vested in the board and the board is responsible for making investments which are legally permitted. The state treasurer has a custodial responsibility to safeguard fund assets entrusted to her care. This responsibility is broad enough, at a minimum, to refuse to open accounts or transfer funds for clearly illegal investments. As to investments which the treasurer believes are possibly illegal, we would recommend that the transaction be completed and that legal resistance, if any, to a board request for investment be limited to judicial review of the question.

Finally, we recommend that the board and the treasurer jointly develop procedures designed to promote the ability of both the board and the treasurer to effectively carry out their responsibilities.

AUTHORITIES CONSIDERED:

Idaho Constitution art. VIII, § 2
Idaho Constitution art. IX, § 3
Idaho Constitution art. IX, § 11

Idaho Code § 57-724

§§ 9(6) and 9(8) of S. B. 1277 (S. L., 1969)

72 Am.Jur.2d, States, § 64

Modern Status of the Massachusetts or Business Trust, 88 ALR3d 704

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Moon v. Investment Board, 96 Idaho 140, 525 P.2d 335(1974)
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DATED this 20th day of June, 1985.

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