STATE OF NEBRASKA
Office of the Attorney General
2115 STATE CAPITOL BUILDING
LINCOLN, NEBRASKA 68509-8920
(402) 471-2682
TDD (402) 471-2682
CAPITOL FAX (402) 471-3297
1235 K ST. FAX (402) 471-4725

DON STENBERG
ATTORNEY GENERAL

STEVE GRASZ
LAURIE SMITH CAMP
DEPUTY ATTORNEYS GENERAL

#95041

NO.
STATE OF NEBRASKA
OFFICIAL
MAY 17 1995
DEPT. OF JUSTICE

DATE: May 15, 1995

SUBJECT: Investing County Hospital Surplus Funds in Mutual Funds Comprised of U.S. Government Obligations

REQUESTED BY: Senator Curt Bromm
Nebraska State Legislature

WRITTEN BY: Don Stenberg, Attorney General
Timothy J. Texel, Assistant Attorney General

You have requested this office's opinion regarding the following issue: "Whether a county hospital may invest surplus funds in mutual funds comprised of U.S. Government securities and obligations?"

Due to legal considerations, it is the longstanding policy of this office to limit its formal opinions provided to the Legislature to topics which pertain to pending or possible legislation. As it was unclear from your request whether the topic about which you inquired dealt with pending or possible legislation, we contacted your office. In a telephone conversation on March 30, 1995, Mr. Perre Neilan indicated that if it is determined counties cannot invest surplus funds in U.S. Government securities mutual funds, you plan to initiate legislation to address that topic.

Although in general we believe it is permissible for counties to invest surplus funds in mutual funds comprised solely of U.S. Government obligations, before a definite answer could be given regarding any such particular investment, the mutual fund's organization and prospectus would have to be carefully examined.

David K. Arterburn
L. Jay Bartel
J. Kirk Brown
David T. Bydalek
Delores N. Coe-Barbee
Dale A. Comer
James A. Elworth
Lynne R. Fritz
Royce N. Harper
Lauren Lee Hill
Jay C. Hinsley
Amy Hollenbeck
William L. Howland
Marilyn B. Hutchinson
Kimberly A. Klein
Joseph P. Loudon
Charles E. Lowe
Lisa D. Martin-Price
Lynn A. Melson
Ronald D. Moravec
Fredrick F. Neid
Marie C. Pawol
Kenneth W. Payne
Alan E. Pedersen
Paul N. Potadle
Hobert B. Rupe
James D. Smith
James H. Spears
Mark D. Starr
Timothy J. Texel
John R. Thompson
Barry Wald
Terri M. Weeks
Alfonza Whitaker
Melanie J. Whittamore-Mantzios
Linda L. Willard

Printed with soy ink on recycled paper

Probably the most important variable which must be addressed on a case-by-case basis is how the mutual fund is organized. The issue is by no means a clearly settled point of law in Nebraska, and other jurisdictions have arrived at differing conclusions.

There are several statutes affecting the determination of this issue. Neb. Rev. Stat. § 77-2315 (1990) controls the investment of county funds and allows for investment in U.S. Government bonds and U.S. Treasury notes. It states, in pertinent part:

> A county treasurer may by and with the consent of the county board invest in United States Government bonds, bonds and debentures issued either singly or collectively by any of the twelve federal land banks, the twelve intermediate credit banks, or the thirteen banks for cooperatives under the supervision of the Farm Credit Administration, United States Treasury notes, bills, or certificates of indebtedness maturing within two years from the date of purchase, or in certificates of deposit.

Another is Neb. Rev. Stat. § 77-2341(1) (Cum. Supp. 1994). The statute states:

> (1) Whenever any county, city, village, or other governmental subdivision, other than a school district, of the State of Nebraska has accumulated a surplus of any fund in excess of its current needs or has accumulated a sinking fund for the payment of its bonds and the money in such sinking fund exceeds the amount necessary to pay the principal and interest of any such bonds which become due during the current year, the governing body of such county, city, village, or other governmental subdivision may invest any such surplus in excess of current needs or such excess in its sinking fund in certificates of deposit, in time deposits, and in any securities in which the state investment officer is authorized to invest pursuant to the Nebraska Capital Expansion Act and the Nebraska State Funds Investment Act and as provided in the authorized investment guidelines of the Nebraska Investment Council in effect on the date the investment is made. The state investment officer shall upon request furnish a copy of current authorized investment guidelines of the Nebraska Investment Council.

The Nebraska Capital Expansion Act neither authorizes nor prohibits investment in mutual funds. It deals with bank investments and related matters such as assuring all Nebraska banks and savings and loans are provided an equal opportunity to obtain state deposits. The Nebraska State Funds Investment Act's stated purpose is to formulate and establish policies to govern the

practices to be followed by the state investment officer for investment of state funds. It likewise fails to specifically address mutual funds, but Neb. Rev. Stat. § 72-1246 (1990) directs that "The state investment officer shall invest in investments the nature of which individuals of prudence, discretion, and intelligence acquire or retain in dealing with the property of another . . . ."

Section 77-2341 allows state political subdivisions to invest in securities which the Nebraska Investment Council's investment guidelines authorize. The Investment Council's guidelines authorize direct investment in U.S. Government obligations (paragraph 1), U.S. Government obligations held under repurchase agreements (paragraph 6), and in investment trusts and/or companies investing in U.S. Government, government agency, and money market securities (paragraph 15). ***See "Nebraska Investment Council Authorized Investments"*** amended as of June 5, 1991.

It appears well-established that investment trusts and/or companies, referred to in Neb. Rev. Stat. § 77-2341, are mutual funds. In a footnote, the U.S. Supreme Court stated succinctly "A mutual fund is an open-end investment company" in ***Investment Company Institute v. Camp***, 401 U.S. 617 at 625, 91 S. Ct. 1091 at 1096, (1971). ***See also The Mutual Fund Industry: A Legal Survey***, 44 Notre Dame Law. 732 (1969); L. Loss, ***Fundamentals of Securities Regulation***, 2d Ed. (1988); and ***Organization of a Mutual Fund***, 49 Business Lawyer 107 (1993). Therefore, Nebraska statutes and the Investment Council's guidelines would allow county hospitals to invest in mutual funds investing in U.S. Government obligations.

The overriding control of this issue, however, necessarily resides in the Nebraska Constitution. Article XI, Section 1, of the Nebraska Constitution states:

> No City, county, town, precinct, municipality, or other sub-division of the state, shall ever become a subscriber to the capital stock, or owner of such stock, or any portion or interest therein of any railroad, or private corporation, or association.

The Constitution's language certainly prohibits a county from investing in a mutual fund when the portfolio includes stock, but it does not specifically address the issue of mutual funds solely comprised of U.S. Government obligations.

Before we can answer whether a county could invest in a mutual fund, we must first address the issue of precisely what interests an investor acquires by investing in a non-stock mutual fund. The question then becomes "Do investors in a mutual fund limited to U.S. Government obligations obtain any interest in the underlying

investment trust company which operates the fund, similar to corporate stockholders?" If the courts would answer the question in the affirmative, the investment of surplus funds would be unconstitutional. If the courts would find mutual fund investors do not acquire any interest in the investment company itself, then we believe the investment would be permissible.

Most case law and other authorities which address the topic of ownership interests in mutual funds deal with stock mutual funds. They do not distinguish between diversified funds and those comprised solely of U.S. Government securities. Research failed to discover any Nebraska cases which were directly on point, but several related cases might provide insight into the factors a court would take into consideration.

In ***State ex rel. Johnson v. Consumers Public Power District***, 143 Neb. 753, 10 N.W.2d 784 (1943), the state of Nebraska sued the Defendant power district to determine whether the public power district acted beyond its authority when it purchased all the stock of another electric company (Western Public Service Company) in order to obtain the other company's facilities and equipment. Nebraska claimed Consumers Public Power District was prohibited from purchasing Western Public Service Company's corporate stock by Article XI, §1 of the Nebraska Constitution. The Court, in finding that the constitutional provision did not prevent the purchase, stated:

> This provision of our Constitution must be construed with reference to the evils it was intended to correct or prevent. It was intended to prohibit any subdivision of the state from entering into private business by being associated as a stockholder, or by being a partner, or a part owner, in a private business venture or enterprise.

Id. at 766, 10 N.W.2d at 794.

The Court looked to the purpose of the constitutional provision prohibiting the state from owning stock in private corporations in making its decision. The purpose of purchasing all of Western Public Service Company's stock was to dissolve that company and incorporate all its equipment and facilities into the Defendant's company. The Court held that Article XI, §1 of the Nebraska Constitution was intended to prohibit the state from purchasing stock and thereby owning and operating what should be private ventures, which the Court found was not Consumers Public Power District's purpose.

Other courts have decided similarly in related cases. In ***Long v. Mayo***, 111 S.W.2d 633 (Ky. App. 1937), the state of Kentucky wanted to obtain a bridge by purchasing all the stock in the bridge

company. The Kentucky Constitution, like Nebraska's, prohibited the state from becoming a stockholder in any company, association, or corporation. The Court upheld the purchase. Just as in the ***Consumers Public Power District*** case, the Kentucky Court looked closely at the purpose the constitutional provision was intended to serve. The purpose was found to be preventing the state from entering into or acquiring an ownership interest in private business enterprises. Since the stock acquisition was for a public purpose, namely cessation of tolls on the well-traveled bridge, the purchase was acceptable. ***See also People ex rel. Murphy v. Kelly***, 76 N.Y. 475 (1879), and ***Thaanum v. Bynum Irr. Dist.***, 72 Mont. 221, 232 P. 528 (1925).

The Nebraska Supreme Court also dealt with Article XI, §1 of the Nebraska Constitution in ***Nebraska League of Savings and Loan Assns. v. Mathes***, 201 Neb. 122, 266 N.W.2d 720 (1978). Regarding the constitutional provision, the Court stated:

> Approximately 40 states have similar constitutional provisions. In general, such provisions were designed to prevent the use of public funds to aid in the construction of railways, canals, and similar undertakings. The intent was to keep states and political subdivisions out of private business.

Id. at 124, N.W.2 at 722.

In ***Mathes***, the Court dealt with whether Article XI, §1 of the Nebraska Constitution prohibited political subdivisions of the state from depositing funds in mutual savings and loan associations. In particular, the Court examined whether depositors owned an interest in the association itself. The Court went on to hold that accounts in mutual savings and loan associations constituted a proprietary interest in the association. Since the depositors had a right to share in the control of the savings and loan association, as well as its profits or losses upon liquidation, deposits by political subdivisions of the state were prohibited.

The Court found that the historical context of Article XI, §1, "impels the conclusion that it was intended to prohibit any state subdivision from acquiring any proprietary or ownership interest in any private corporation or association." The Court in ***Mathes*** also looked to the purpose of Article XI, §1 in its decision. One distinction that should be drawn is that if the savings and loans in ***Mathes*** had been stock associations, as opposed to mutual associations, then the depositors would not have acquired ownership and control interests in the savings and loan association itself, and Article XI, §1 would presumably not have prohibited such investments. ***See*** Neb. Op. Att'y Gen. No. 85-132 (September 12,

1985). Thus, the particular mutual fund in which a county desired to invest would have to be examined to determine if any ownership interests in the investment trust company was being acquired. If the trust company was a stock company, the relationship depositors hold to the investment trust company operating the mutual fund might be analogous to a bank or a stock savings and loan. The state would not acquire an ownership interest in the business itself, only in the funds on deposit in the mutual fund or bank account.

When courts review constitutional provisions preventing state purchases of capital stock, the provisions' intended purpose have been examined and applied to the circumstances. Applying this reasoning to the issue of investing in mutual funds comprised of government securities indicates the Court would look to whether such investments fall into the category of activities Article XI, §1 of the Nebraska Constitution was intended to prohibit. By investing in mutual funds comprised solely of U.S. Government securities, a subdivision of the state would not normally be entering into a private business venture or enterprise. Of course, each mutual fund is different, and we emphasize that the individual mutual fund's investment agreement and prospectus be scrutinized to ensure a county would in fact not acquire any ownership interest in the investment trust company itself.

Several other state's Attorneys General have addressed issues similar to the one posed in your opinion request. The Idaho Attorney General reviewed the constitutionality of a state statute which authorized investment in money market mutual funds limited to obligations of the U.S. Government or its agencies. Idaho has a constitutional provision very similar to Nebraska's Article XI, §1. The Idaho Attorney General's opinion found investments in U.S. Government obligation mutual funds are constitutionally permitted, as long as the state did not thereby become a stockholder in any association or corporation. It was advised that investment decisions be made on a case-by-case determination based on the intended mutual fund's organization. 85 Idaho Op. Att'y Gen. 4 (1985).

Oregon likewise has a constitutional provision prohibiting the state or its political subdivisions from becoming a stockholder in any joint company, corporation, or association. In a footnote of one opinion, the Oregon Attorney General stated that a government entity's investment in a mutual fund entirely comprised of commodities, mortgages or other non-stock investment media would be permissible. 43 Or. Op. Att'y Gen. 186 (1983). However, a later Oregon Attorney General Opinion specifically qualified the earlier opinion's statement, noting that "investment in shares issued by a mutual fund may also constitute direct ownership of stock in a joint company, corporation or association in violation of the

Oregon Constitution, whether or not the mutual fund assets include stocks issued by other companies." Or. Op. Att'y Gen. (original not numbered) (March 31, 1986). The Opinion did not go on to explain why the qualification was necessary or on what it was based. Although the Oregon Attorney General concluded that cities and counties could not invest in mutual funds, it was based on an Oregon statute which did not authorize investments in mutual funds.

In comparing the two opinions, it appears the Oregon Attorney General was unable to arrive at a definite answer on the topic without having the opportunity of examining a specific mutual fund. It is not clear whether a mutual fund limited to U.S. Government obligations would be included in the later qualifying language. But on the face of the language in the second opinion, it seems the Oregon Attorney General is acknowledging the uncertainty in the area mentioned in the outset of this opinion.

Other sources have indicated that investment of state funds in U.S. Government security mutual funds may not be authorized. In a Missouri Attorney General's opinion, it was found that a public ambulance district could not invest in mutual funds, as it would violate the portion of Missouri's Constitution similar to Article XI, §1 in Nebraska's Constitution. 88 Mo. Op. Att'y Gen. 26 (1988). The Missouri Attorney General's opinion is of limited value in our discussion, though, as it did not draw any distinction between corporate stock mutual funds and any other types. Mutual funds limited to U.S. Government securities were not discussed.

In ***Baum v. Investors Diversified Services, Inc.***, 286 F. Supp. (N.D. Ill. 1968), investors claimed an investment company's policy of reducing the "load" (administrative fee) relative to the amount of money invested was discriminatory. The suit was based on the Robinson-Patman Act, which prohibited discrimination against purchasers of commodities. Some of the language dealing with descriptions of mutual funds may apply to our issue, however. The Court stated:

> **A mutual fund share is a security reflecting undivided ownership in a mutual fund company.** Such shares are not traded by shareholders but are redeemable upon their request. The shareholder need pay no commission upon redemption. The value of a share is determined by dividing the total number of shares outstanding into the market value of the securities held at any given point in time. Such value is deemed the "net asset value." Each share, therefore, represents an undivided interest in the total portfolio of the mutual fund company.

Baum at 917 (emphasis added).

The Court held the investors did not actually own the securities, but only held a right to redeem their respective portion of the portfolio, and the investors held an interest in the mutual fund company itself. If the Nebraska courts adopted a similar view, investment in mutual funds comprised entirely of U.S. Government obligations may be prohibited by Article XI, §1 of the Nebraska Constitution.

In a Louisiana Attorney General's opinion, it was concluded that Louisiana statutes allowing excess funds of political subdivisions to be invested in money market mutual funds were unconstitutional. 88 La. Op. Att'y Gen. 546 (1988) The opinion was able to examine a particular mutual fund, as the state investment officer had already invested surplus funds into that fund. Just as in your inquiry, the mutual fund involved consisted of U.S. Government obligations.

The bond resolutions controlling where the funds could be deposited specifically allowed investment in direct general obligations of the United States. The Louisiana Attorney General concluded the investments violated Article VIII, §14, subsection (A) of the Louisiana Constitution, which sets out that ". . . Neither the state nor a political subdivision shall subscribe to or purchase the stock of a corporation or association or for any private purpose."

The opinion states that "Investing in a money market mutual fund in not the same as investing in a direct general obligation of the United States." The opinion cited to the ***Baum*** decision, noting that the Court there had pointed out when investing in money market mutual funds, shares are purchased in a portfolio. The investor does not thereby purchase the actual security.

The opinion also states that mutual funds typically have Boards of Trustees or fund managers, but investors are shareholders who have voting rights. The opinion concluded that the purchase of mutual fund shares by governmental subdivisions violated the Louisiana constitution "[b]ecause an investment in a mutual fund is actually the purchase of an undivided ownership in a mutual fund company, and not a purchase of the underlying securities...."

Although this reasoning would certainly be true for mutual funds investing in private stocks, we believe the organization of a mutual fund investing solely in U.S. Government securities would have to be examined to determine whether investors were in fact acquiring voting rights.

In conclusion, the issue of whether a state or any of its political subdivisions may invest in mutual funds investing solely in U.S. Government securities is unclear. Nebraska courts have not

addressed the issue, and the authorities around the country which have addressed this or similar topics are divided. In our opinion, the central issue involved is what interest mutual fund investors acquire when they invest in a mutual fund comprised of U.S. Government securities. The purpose of Article XI, §1 of the Nebraska Constitution is arguably met when a county avoids mutual funds involved in corporate stocks and avoids taking any active role in operating any private business venture.

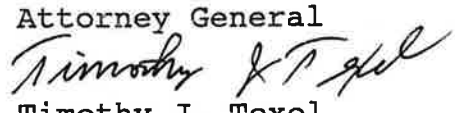
But other authorities believe investments in mutual funds, even those comprised entirely of U.S. Government securities, represent an investment in and part ownership of the mutual fund company which operates the fund. If this view would be taken by a court, then such investments would be unconstitutional in Nebraska.

We believe it is generally permissible for counties to invest surplus funds in mutual funds comprised solely of U.S. Government obligations. Before a definite answer could be given regarding investment in any particular mutual fund, its organization and prospectus would have to be carefully examined to ensure that the state or its political subdivision was not thereby acquiring an interest in the investment company.

Your office indicated that if a county could not invest in U.S. Government security mutual funds, that you would consider legislation to provide for it. Due to the constitutional basis for the potential prohibition of such investments, we believe to remove the uncertainty in the area would require a constitutional amendment to Article XI, §1, specifying that investments in management investment company portfolios limited to U.S. Government securities are permissible.

Sincerely,

DON STENBERG
Attorney General

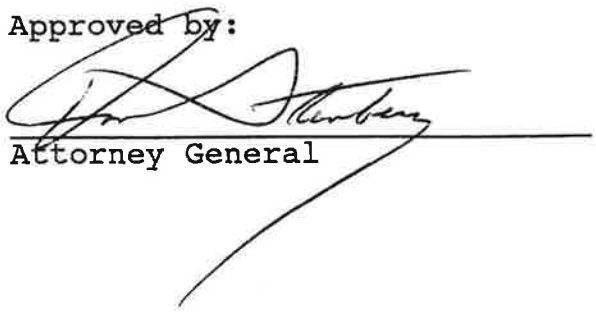


Timothy J. Texel
Assistant Attorney General

08-03-14.op

cc: Patrick J. O'Donnell
Clerk of the Legislature

Approved by:



Attorney General