MEMORANDUM

State of Alaska
Department of Law

TO: The Honorable Wilson Condon
Commissioner
Department of Revenue

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SUBJECT: Validity of Method of Crediting Interest on Exxon Valdez Oil Spill Trust Funds and Other Funds Participating in the General Investment Account (Reissued)

You requested our advice on questions posed concerning the administration of the general investment fund of the state.[1] The primary question focuses on the propriety of a former policy for allocating interest earned by the general investment fund to certain funds in state custody. The question arose when there was objection to the method adopted by the Hickel administration for accrual of interest income on amounts attributed to the Exxon Valdez Oil Spill Trust (EVOS trust). You also asked us to interpret provisions in court documents which may apply to the management of the EVOS trust to determine if there should be an adjustment made in investment earnings credited to the trust for a specific period. Finally, you asked if other funds in the custody of the state might be entitled to a similar adjustment.

I. **FACTS**:

The executive director of the Exxon Valdez Oil Spill Trustee Council (Trustee Council) questioned the validity of an interest-crediting policy established under interdepartmental memoranda of understanding covering the period July 1993 through June 1997. The memoranda were used to record policy determinations made jointly by the division of finance

[1] This entity is also known as the "General Fund and Other Non-segregated Investments Fund."

in the Department of Administration and the treasury division in the Department of Revenue concerning the investment of public funds which are pooled for investment purposes. Specifically, the memoranda formalized responsibilities for crediting investment income earned by the general investment fund and methods for valuing assets in case of transfer of amounts out of the fund.[2] The agencies have been using this method to set interest allocation procedures since 1986.

From state fiscal year 1986 through 1993 a series of memoranda adopted a method of allocating investment income based on a pro-rata share of the income earned each month multiplied by the month-end balance of the funds held in trust.[3] The memoranda covering fiscal years 1994 - 1997 stipulated a daily rate of return derived from a representational fixed investment instrument.[4] After fiscal year 1997 and continuing to the present, the policy changed yet again to credit funds in the investment pool with the total daily rate of return actually earned on invested assets. There is no dispute that the EVOS settlement fund would have been credited with more interest if the total daily return method had been used during the fiscal periods July 1994 - June 1997 rather than the method then in effect.

The EVOS Trustee Council decides if trust funds will be used for a restoration project. The council also decides if the expenditure will be made through a state agency. During the relevant period, to implement that decision, amounts were transferred from the EVOS Joint Trust Fund managed by the federal court system to a state fund known as the Exxon Valdez Settlement Fund.[5] The settlement fund is classified by the division of finance as a trust fund and invested in the general investment fund pending expenditure. By this classification, the division of finance acknowledged that there are express restrictions on the purposes for which the money may be expended.

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[2] According to the Department of Revenue, surplus money from 128 funds and accounts are pooled and invested in the general investment fund.

[3] The memoranda contain detailed provisions for the calculation of investment return on and market value of marketable securities purchased with pooled funds. For purposes of brevity and clarity, we have summarized the terms of the memoranda to only those which are relevant to distinguish their effect on the legal issues under consideration.

[4] A proxy measure of actual income was stipulated: the weekly auction rate for the 180-day Treasury bill.

[5] The Exxon Valdez Settlement Fund is not created by statute. Effective October 5, 2000, the EVOS principal was transferred from the federal court system to the custody of the State of Alaska.

The legislature provided that "[the EVOS trust] shall be managed as provided in the Memorandum of Agreement and Consent Decree that established it." AS 37.14.400 (hereinafter "the Consent Decree").6 The Consent Decree provides that the "natural resource damage recovery" shall be used by the state and the federal government "for the purposes of restoring, replacing, enhancing, rehabilitating or acquiring the equivalent of natural resources injured as a result of the oil spill. . . ". Consent Decree at VI, A. The Consent Decree defines "natural resource damage recovery" to include not only the amounts paid by Exxon to settle the claims of the affected governments but also "all interest accrued on any such recoveries." Consent Decree at II, G.

The Consent Decree expressly designates the state as a co-trustee in the collection and joint use of the natural resource damage recoveries. Consent Decree at IV, A. However, the Consent Decree does not expressly provide for the investment of EVOS trust funds that are in the custody of the state pending their use. Thus, it appears that the money in the settlement fund is subject to the provisions of the EVOS trust but that it is left to the state to determine how to satisfy the requirements imposed by the trust arrangement. According to the Consent Decree, all interest earned on the settlement fund must be deposited in the joint trust fund. Consent Decree at VI, A.

There is authority in state law for the Department of Revenue and other fiduciaries to invest. AS 37.10. Broad powers are granted for the investment of "a state fund." AS 37.10.071. In exercising these investment powers, the department may exercise the powers of "an owner with respect to the assets." AS 37.10.071(a)(6). While the term "state fund" is not expressly defined, the relevant statute establishes a fairly clear implication that a "state fund" includes trust and custodial receipts. *See* AS 37.10.071(b)(7), (c), and (f)(3). Under the investment powers conferred, the "fiduciary of a state fund" is granted the power to "acquire or dispose of investments either directly, indirectly, or through investment pools or trusts . . .". AS 37.10.071(b)(2). Based on this authority, we conclude that the Department of Revenue properly pooled trust receipts in the general investment fund.

II. **THE GENERAL RULE CONCERNING THE PAYMENT OF INTEREST**:

As a general rule, the state is not obligated to pay interest on amounts it holds for others unless it is expressly authorized by statute or contract. *Danco Exploration Inc. v.*

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6 *United States v. Alaska*, Civil Action No. A91-081 (D.C. Alaska).

State, Dept. of Natural Resources, 924 P.2d 266 (Alaska 1996). This rule is an application of the doctrine of sovereign immunity. Restated, the state is not liable for interest unless it has consented to be liable for interest either by the enactment of legislation or, being compelled by federal laws or by contractual agreement. In at least one other jurisdiction, the general rule has been modified to a certain extent. Under the modified formulation of the general rule, even in the absence of a statute "a legislative purpose to allow interest . . . may be found in the nature of the burden imposed and the relative equities between the beneficiaries. . . ." *Consolidated Police, Etc., Pension Fund v. Passaic*, 130 A.2d 377 (N.J. 1957).

The investment powers granted by statute for a fiduciary of a state fund include the requirement that the department collect and deposit the principal and income for owned or acquired investments. AS 37.10.071(a)(3). We believe this creates an obligation to pay interest on trust or custodial funds. However, the statute gives no guidance as to the proper method for allocating investment income among the participants in a pooled investment.

III. IS THE EVOS TRUST ENTITLED TO AN ADJUSTMENT TO COMPENSATE FOR THE FORMER METHOD OF ACCOUNTING FOR INVESTMENT RETURN ON THE GENERAL INVESTMENT FUND?

The EVOS trust is similar to a public or charitable trust. The beneficiaries are not separately identifiable persons but are the governments acting on behalf of the public at large. The trust instrument of the EVOS trust is principally the Consent Decree and any federal or state statutes expressly applicable. The Consent Decree is not as complete as a private trust agreement but would probably be considered the equivalent by a court. As mentioned earlier, the Consent Decree is silent concerning the methods or limits on the joint trustees. As a result, their powers and duties are determined in part by general trust law and other statutes in *pari material*. *See e.g. State v. Weiss*, 706 P.2d 681 at 683 n.3 (precedent involving school trust land supported court's reliance on "basic trust law principles").

A. Is the State Excused from Liability Because Its Agents Acted in Good Faith?

In analyzing the issues, we have considered whether the state might avoid liability because the officials involved acted in good faith in determining the method for calculating the rate of return on investment. As a matter of general trust law, a trustee does not commit a breach if it does not intentionally or negligently perform an act. *Restatement (Second) Trusts*, § 201a. There is no evidence that the Hickel administration officials responsible for formulating the accounting methods in question here acted in bad faith or as a product of

negligence. They formally recorded the basis for imposing the new policy in a detailed memorandum.[7] However, the defense of good faith is not effective to prevent liability for a mistake in law as to the existence of a power to act with regard to trust property. *Restatement (Second) Trusts*, §201b. According to the Restatement:

> The extent of [the trustee's] duties and powers is determined by the trust instrument and the rules of law which are applicable, and not by [the trustee's] own interpretation of the instrument, or his own belief as to the rules of law.

Id. If there is a legitimate question as to the extent of the trustee's powers, the most effective way to obtain insulation from a claim of breach would have been to seek instructions from the Superior Court as to the appropriate interpretation to be given to the trust instrument and applicable law. Id. Based on our review of the matter, there is no record that the responsible officials either sought legal advice or instructions from a court before the former interest accounting method was adopted. There is no record that the change in policy was communicated to the Trustee Council.

B. Interpretation of the Consent Decree's Requirement to Pay Interest.

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[7] In the memorandum, the comptroller justified the change in policy on the following grounds:

(1) the use of the month-end balance to compute earnings for the period did not take into account fluctuations in the balance during the period;
(2) it ended confusion over the allocation of unrealized gains and losses;
(3) the new method provided an independent method for predicting interest allocations;
(4) the old method was cumbersome and time consuming; and
(5) federal law required that "systematic methodology" be developed and that the old policy did not meet this requirements.

In defining "natural resource recovery" the Consent Decree provides that "[t]he term also includes *all* interest accrued on any such recoveries." Consent Decree at II, G (emphasis added). We believe that a court would not apply a technical or narrow interpretation to these words. *See e.g. Island Homes, Inc. v. City of Fairbanks*, 421 P.2d 759 (Alaska 1966) (Trustee may exercise power conferred on him by specific terms and those powers necessary or appropriate to carry out purposes of trust). We could not in good faith argue that the Consent Decree modified the state's duty to pay the actual amount of interest earned. This is not to say that the wording of the Consent Decree would prevent adjustments to investment returns on EVOS trust receipts which properly reflect the pro rata expense of managing the investment pool. However, the power to deduct the cost of management is discretionary and may be exercised prospectively only.

C. Did the Method of Allocating Interest Earned on EVOS Trust Receipts Constitute a Breach of Trust?

We must next determine whether the method of allocating the return on investment of trust receipts used by the Department of Revenue amounted to a breach of trust. This is a necessary determination because a trustee has no liability unless there is a breach. *Restatement (Second) Trusts*, § 201.

For approximately four years the state used a method to allocate interest which rendered a smaller return on EVOS trust receipts than was actually realized by the general investment fund. The state applied this method to a pooled investment strategy under which the EVOS trust receipts were commingled with other trust receipts and unrestricted state receipts.[8] According to the department,

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[8] The general investment fund has consistently held approximately $1 billion in assets. Approximately one-third of these receipts were purchased with unrestricted state revenues. Another third of the assets is attributed to receipts derived from statutory or other recognized funds established within the state treasury. The final third is attributed to a combination of segregated funds which are not considered a part of the state general fund and which may or may not be considered a part of the state treasury. The EVOS settlement trust fits within the last category as a segregated trust fund.

> Investing these funds in a single pool achieves significant savings in management and administrative costs. As well, because the time when these various funds draw down their balances differ, Treasury can invest the pooled funds with a significantly longer time horizon than if it were investing each of the funds separately. As a consequence, Treasury can increase the return on these funds over the long term by investing them in a commingled pool.

Dept. of Revenue Opinion Request at 2. The department uniformly allocated the return on investment to all trust receipts covered by the general investment fund.

In the case of the EVOS trust receipts, the department commingled trust and nontrust receipts in a single investment pool. According to the *Restatement*,

> The fact that in making investments, trust funds of one trust are combined with funds of other trusts administered by the trustee does not make the investment improper, provided that it is in other respects proper.

Restatement (Second) Trusts, § 227, cmt.j. A trustee may not commingle trust assets with money or other property of the trustee. *Restatement (Second) Trusts* § 179. However, the prohibition against commingling is not violated by a pooling arrangement if the trust interests are properly "earmarked" and are administered in a way that protects the separate nature of the trust receipts and preserves the independence of the trustee in actions regarding the trust receipts. *Restatement (Second) Trusts* § 227, cmt.m. These requirements are best satisfied by an investment pool operated like a mutual fund where each fund source is given shares in the investment determined on a pro-rata basis. Gain or loss is determined on a share-by-share basis in a way that preserves the separateness of the trusts and the independence of the trustee.

The interest allocation method applied to the pooling arrangement for the fiscal years 1994-1997 did not ensure the requisite separateness and independence, and for that reason probably constituted a breach of trust. The method for the computation of interest, while providing a uniform rate for trust and custodial receipts, provided a residual rate of return for the state general fund which was effectively a better rate for unrestricted state money in the pool. To a certain extent, the fiduciary of the general investment fund violated the requirement that "[a]mong beneficiaries of a fund, the fiduciaries shall treat beneficiaries with impartiality."

AS 37.10.070(c).[9]

Having concluded that the former interest accounting method constituted a breach of trust, we believe that the EVOS trust is entitled to an adjustment for lost interest. The adjustment should credit the EVOS trust with the actual rate of return on amounts allocated to the general investment fund during the period July 1993 - June 1997. If the actual daily rate earned during that period is not available, the Department of Revenue may use any other method of computation that approximates the rate of return earned on assets of the general investment fund. The additional balance should be carried forward to the present with compound interest. *See Restatement (Second) Trusts* § 205(b) (Trustee chargeable with the amount required to restore trust to what would have been if properly administered).

IV. IS THE STATE REQUIRED TO MAKE ADJUSTMENTS FOR OTHER FUNDS IN THE GENERAL INVESTMENT FUND?

According to the Department of Revenue, during the relevant period there were approximately 128 funds providing money that was invested in the general investment fund. These funds ranged from sources clearly owned by the state to others that are beneficially owned by persons or governmental entities other than the state. You ask whether any of these other funds would be entitled to an adjustment similar to that which we believe should be given to the EVOS trust. We have reviewed the list of funds participating in general investment fund. We examined the authority for each fund and generally confirm the conclusions reached by the Departments of Revenue and Administration concerning the entitlement to interest while in state custody.[10] We believe that in nearly all cases where you indicate that the state general fund is entitled to receive the interest, there would be no entitlement to an adjustment based

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[9] This can be compared to a corporate trustee depositing trust funds with itself. This is permitted under state law if the trustee pays the legal rate of interest on uninvested trust funds or, if there is no legal rate specified by state or federal law, then the trustee pays the same rate of interest payable on similar nontrust deposits. AS 13.36.145(a)(1). In essence, this statute requires that there be no discrimination between the rate of return granted to trust receipts and other similar receipts under management by the trustee.

[10] We suspect that the income distribution classification assigned to the following funds set out in appendix 2 to your opinion request needs to be further established: Assistive Technology Loan Guarantee Fund and the Alcoholism and Drug Abuse Revolving Loan Fund. It appears these funds are entitled to interest only because the federal agency administering the fund either permits or requires the retention and use of interest.

on the conclusions of this memorandum.[11]

A. Funds Involving a Trust or Custodial Relationship.

Our advice recommending a reallocation of investment earnings is applicable only to trust arrangements.

> "Trust" is a fiduciary relationship with respect to property, subjecting person by whom title to property is held to equitable duties to deal with property for benefit of another person, which arises as result of manifestation of intention to create it.

Alaska State Employees Ass'n v. Alaska Public Employees Ass'n, 825 P.2d 451 (Alaska 1991) (citing *Restatement (Second) Trusts* § 2). After reviewing the materials provided along with your opinion request and consulting with the state comptroller, we conclude that the following funds and accounts were invested during the relevant period under either a public trust obligation or a relationship in which a person or entity distinct from the state has an ownership interest in the funds under management by the general investment fund:

(1) Oil Restoration Fund (11140)[12]

(2) Exxon Valdez Settlement Fund (33070)

(3) Deposits, Suspense and Miscellaneous Trust Account (32010)[13]

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[11] We assume the Wage and Hour Fund (32011) is established under AS 23.05.260 to hold wage claim recoveries. The determination that interest earned on this account is payable to the general fund is incorrect because the aforementioned statute gives the employee a right to the recovery after deducting the cost of collection. Even though there is not an express statutory or contractual entitlement to interest, it is inconsistent to permit the payment of interest to the Public Advocacy Trust and to other similar funds but not to this one.

[12] By plea agreement, the Oil Restoration Fund, consisting of approximately $50 million, was established as a segregated fund. *U.S. v. Exxon*, No. A90-915 CR. (D.C. Alaska). The state was obligated to use the money for a specific purpose, and the plea agreement expressly provided for the payment of interest on the recovery after the money was placed in state custody.

[13] This general category includes a mixture of funds and accounts. Some of the sub-funds do not raise liability for income allocation decisions. Trust or custodial relationships are present in the permanent fund dividend trust accounts, the Alaska Heritage Endowment, Cooke Memorial Trust, the

(4) Public Advocacy Trust (32012)

(5) Wage and Hour Trust (32011)

(6) Alaska Aerospace Development Corp. Revolving Fund (21643)[14]

(7) Alaska Aerospace Development Corp. Federal Grant Fund (21649)

(8) Alaska Student Loan Corp. Revolving Loan Fund (82000)[15]

Department of Law Trust Account, and the Unlicensed Vessel Operators Retirement Fund.

[14] Even though the Aerospace Corporation has a separate legal existence with the power to invest its money, two of its funds are entrusted to the Department of Revenue. This arrangement appears to be consensual and there is no indication that the corporation is so closely held that the state is the real owner of the assets of these funds.

[15] This fund includes money of the Alaska Student Loan Corporation that is not covered by a bond indenture. There are other funds of the Alaska Student Loan Corporation briefly passing through the general investment fund that do not appear to cause any liability during the period in question. These funds include: Alaska Student Loan Corporation Secured Loans Fund (90600); Alaska Student Loan Corporation Proceeds / Disbursements (90650); Alaska Student Loan Corporation Proceeds Receipts (90655). The Alaska Student Loan Corporation Operations Fund (81800) does participate in the general investment fund on a sustained basis.

(9) Mental Health Trust (34045)

(10) Mental Health Trust Income Settlement (34046).

These funds should receive a reallocation of investment earnings computed in the same manner used for the EVOS trust fund.

You asked whether it might be possible to invoke some rule of reason concerning the obligation to locate beneficiaries of small amounts representing adjustments made according to our advice. We are unable to locate authority that would relieve you from this obligation, so it is our advice that you would undertake such a policy at some peril.

B. Funds Held by the State as Owner.

Some of the funds participating in the general investment fund are either owned entirely by the state or represent money from a nonstate source that has been paid into state custody for accomplishing certain public purposes.[16] We place federal funds in this category even though some of these funds are in a sense trust funds. No persons or entities other than the state have either a legal or beneficial interest in the money. Rather than a beneficial ownership interest in the property held, the rights of others are those of a third party beneficiary or a creditor. Under these circumstances, the claimant has a right to claim against the state for a breach of the agreement under which the money is held. *Restatement (Second) Trusts* § 14, cmt.a. *See also ASEA V. APEA*, 825 P.2d 451, 459 (Alaska 1991). The money is owned by the state but, if invested, is held under a fiduciary obligation that differs from a trust relationship. These funds are invested in the general investment fund under the state's power to "invest money in the state treasury above an amount sufficient to meet immediate expenditure needs." AS 37.10.070(a). The power of the state in relation to the investment of these funds is that of an owner.

To a certain extent a public official who has fiscal powers over state-owned money is a trustee for the general benefit of the public as defined by statute. The state is exposed to liability for investment of this money but only to the extent that it might be liable under the terms of the statute, or a contract that defines the obligation to invest the money. According

[16] Examples of state-owned funds include the Alaska Clean Water Fund (21640), the Fish and Game Fund, and the Power Cost Equalization Fund (11150).

to statute,

> [t]he commissioner may invest on the basis of probable total rate of return without regard to the distinction between principal and income and without regard to the generation of income.

AS 37.10.070(b). In exercising these powers, the commissioner is charged to "act only in regard to the best financial interests of the state." AS 37.10.070(a)(4).

Federal law requires that the state pay the federal treasury a rate of return for the use of federal funds while held pending expenditure for the intended purpose. 31 U.S.C. § 6503(b). Before 1990, states were permitted to retain interest earned on federal grant money pending disbursement for program purposes. After 1990, amendments enacted in the Cash Management Improvement Act, Public Law No. 101-453 (Oct. 24,1990), removed the exemption from paying interest on federal funds. These amendments provided for a stipulated interest rate tied to a rate equal to the average of the bond equivalent rates of 13-week Treasury bills.

While we have no authority on point in Alaska concerning the appropriate method for allocating interest on state-owned money, there is a federal case concerning the allocation of interest earned on federal funds before federal law was changed to stipulate the rate of interest. In *Trustees of California State University v. Riley*, 74 F.3d 960 (9th Cir. 1996), a state university contended that it was exempt from paying interest on Pell grants. These funds were placed in a pooled investment fund similar to the general investment fund. The court decided that Pell grants did not meet the definition of "grant" and therefore were not covered by the exemption provided by former law. The federal grantor agency audited the state grantee to determine the amount of interest that should have been paid to the government. The audit concluded that the government was entitled to interest for each full month in which the university had grant funds on deposit on the last day of the month. The court rejected this method and declared that the correct legal standard for determining the validity of the method of interest allocation is whether the method selected is reasonable; that is, not arbitrary, capricious, or contrary to law. *Riley*, 74 F.3d at 966. It is not required that the method used be better or more accurate than another method. In *Riley*, the Ninth Circuit Court of Appeals found that it was arbitrary to calculate interest on withheld federal funds granted to a state university based on the end of month balance. The method was found to be arbitrary because the court believed that the parties were able to calculate interest using a method that was more accurate and less vulnerable to manipulation. The court was critical of the ease with which the liability for interest could be affected by inflating the end of month balance.

We believe that the Alaska Supreme Court would adopt the standard used in *Riley* to determine the appropriateness of an income allocation method established for owned assets of the general investment fund. The interest allocation method applied to all participants in the general investment fund before 1993 appears similar to the method declared arbitrary and unreasonable in *Riley*. However, unlike the dispute in *Riley*, there would likely be no liability for that time period because, as we understand it, the allocation method probably overcompensated the participating funds rather than working to their detriment.[17] This occurred because fluctuations in the daily balance of each fund during the month were ignored. There is also the strong possibility that any claim for a deficiency incurred before July 1993 would be barred by the statute of limitations set out in AS 09.10.129 or the doctrine of laches. For these reasons, the department need not look further back than July 1993 in making an adjustment to reflect the actual earnings of a participant in the general investment fund.

We located no authority for the proposition that it would be arbitrary to calculate interest earned on owned funds using a representational fixed investment instrument.[18] The reasonableness of this allocation method would depend on whether the facts cited by the department would be accepted by a court as providing justification. In our opinion, this income allocation method as applied to owned funds participating in the general investment fund for the 1993 - 1997 period was determined in good faith, is not contrary to existing law, and is defensible under the relevant statutes. For the foregoing reasons, we believe that there

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[17] In July of 1994 the Department of Administration directed the correction of an error in crediting realized gains and losses on fixed investments of the general investment fund for the period July 1, 1988 - June 30, 1993. In making the correction, a total of $4.2 million was credited to the funds entitled to receive interest. In a memo dated June 30, 1994, the Commissioner of Revenue argued that, for the period, each of the funds had been credited with approximately 92 percent of total earnings, a rate which exceeded that paid by one-year Treasury bills. With the additional 8 percent we believe it is reasonable to assume that the method then in effect tended to over-rather than under-compensate participants in the general investment fund.

[18] The Intergovernmental Cooperation Act provides that states advancing their own funds in anticipation of the receipt of federal funds are entitled to receive interest from the federal treasury at the rate equal to "the average of the bond equivalent rates of 13-week Treasury bills auctioned during the period for which interest is calculated, as determined by the secretary." 31 U.S.C. § 6503(d)(1). *But see Urban Renewal Agency v. Swank*, 635 P.2d 1244 (Ore. 1981) where the Oregon Supreme Court found unauthorized under state law an investment pool managed by a county that granted certificates of investment to participating political subdivisions for fixed periods and at stated rates of interest.

should be no adjustment of investment earnings for state-owned funds for the period July 1993 - July 1997 during which a proxy rate was used to fix the rate of accrued interest.

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