

## **Opinion No. 89-19**

June 13, 1989

**OPINION OF:** HAL STRATTON, Attorney General

**BY:** Patricia Leigh Disert, Assistant Attorney General

**TO:** Phillip J. Archibeck, State Investment Officer, State Investment Council, Ark Plaza, 2025 South Pacheco Street, Santa Fe, New Mexico 87505

### **QUESTIONS**

- 1a. May the state investment council sell bonds or other fixed income investments from the permanent fund at a loss?
- 1b. If so, does paragraph 2 of Article XII, Section 7, New Mexico Constitution have any effect on such a transaction?
2. If the state investment council does sell a bond or other fixed income investment at a loss, must that loss be reimbursed by the state as required in paragraph 1 Article XII, Section 7, New Mexico Constitution?

### **CONCLUSIONS**

- 1a. Yes.
- 1b. See analysis.
2. Yes, but it is the legislature's duty to make the reimbursement because N.M. Const. Art. XII, § 7 is not self-executing.

### **ANALYSIS**

1. It is our understanding that this question is based on circumstances created by the First Republic Bank failure, in which bonds held by the state investment council have decreased in value to a point whereby it is impossible to transact a sale or exchange which meets the requirements of paragraph 2 of Article XII, Section 7, New Mexico Constitution.

It is our opinion that the state investment officer may sell bonds or other permanent fund fixed income investments at a loss under certain circumstances. The state investment officer's decisions regarding permanent fund investments are controlled by several factors: specific constitutional provisions, statutory provisions related to the state investment council and the investment of public money, and the prudent man rule. Article XII, Section 7 of the New Mexico Constitution states:

The principal of the permanent school fund, and other permanent funds, shall be invested by a state investment officer in accordance with policy regulations promulgated by a state investment council. The legislature may by a three-fourths vote of the members elected to each house provide that said funds may be invested in interest-bearing or other securities. All losses from such interest-bearing notes or securities which have definite maturity dates shall be reimbursed by the state.

The state investment officer, in order to realize increased income, may, with the approval of the state investment council, sell interest-bearing notes or securities at less than their original acquisition cost, providing the proceeds are immediately reinvested in sufficiently higher yielding interest-bearing notes or securities, to provide for a portion of the increased inter-est income to be amortized over the life of the new investment which will restore to the corpus of the fund the amount of the capital loss realized on the sale of the original investment.

In making investments, the state investment officer, under the supervision of the state investment council, shall exercise the judgment and care under the circumstances then prevailing which businessmen of ordinary prudence, discretion and intelligence exercise in the management of their own affairs not in regard to speculation but in regard to the permanent disposition of their funds, considering the probable income as well as the probable safety of their capital; provided, not more than fifty percent of the permanent school fund or other permanent fund, shall be invested at any given time in corporate stocks and bonds nor shall more than ten percent of the voting stock of a corporation be held; and provided further, stocks eligible for purchase shall be restricted to those stocks of businesses incorporated within the United States which have paid dividends for ten consecutive years or longer immediately prior to the date of purchase and which are listed upon a national stock exchange. (As amended November 4, 1958 and September 28, 1965).

Section 6-8-7 NMSA, 1978 states in pertinent part:

Subject to the limitations, conditions and restrictions contained in policy making regulations or resolutions promulgated by the council and subject to prior authorization by the council, the state investment officer has the power to make purchases, sales, exchanges, investments and reinvestments of the permanent fund. The state investment officer is charged with the duty of seeing that money invested is at all times handled to the best interests of the state.

The prudent man rule encompasses a range of fiduciary responsibilities. Protection of the trust property is the most important of those responsibilities. "[T]he trustee has a duty to take whatever steps are necessary... to protect and preserve the trust property from loss or damage." G. Bogert, **Trusts**, § 99, at 358 (6th ed., Hornbook Series, 1987). "Moreover, it is **incumbent** on the trustee to watch constantly the investment of the trust fund and be on the alert to protect it from harm, or to terminate or convert the investment if it becomes unsound." 90 C.J.S. **Trusts** § 320, at 507 (1961) (emphasis added). "As a corollary to that general duty -- to employ the estate's assets profitably --

there arises the further duty to sell or convert unproductive assets and reinvest the proceeds." **In re Sinclairs Will**, 104 N.Y.S.2d 826, 828 (Sur. Ct. 1951).

As the trustee of the permanent fund, the state investment officer is under the duty to sell unproductive assets. The court in Sinclair, in reviewing the trustee's duty, states: "consequently, when this asset ... became unproductive, it was incumbent on the trustee, acting in conformity with its duty to make the assets they hold productive, to dispose of it and reinvest the proceeds in income producing property." *Id.* at 828. If in the state investment officer's discretion asset protection includes selling a security for less than the purchase price and taking a loss rather than holding such security and risk taking a larger loss, it is his duty to so act.

It has become increasingly apparent that the continued retention of any investment below its cost earns no "brownie" points for the trustee, and is a potential candidate for a charge of negligent performance. A loss may not be ipso facto evidence of negligence, but it is always the starting point for such an allegation. Under-performers call for greater attention, more frequent deliberation, and continuing documentation than over-performers and they rarely warrant the confidence which many administrators exhibit that such holdings "will eventually go up."

Fleming, *Prudent Investments, The Varying Standards of Prudence*, 12 Real Prop. Prob. and Tr. J. 243, 252 (1977).

When we look at the powers and duties conferred by Section 6-8-7, NMSA 1978, we see nothing to contradict these obligations. This office held in Op. Att'y Gen. No. 60-9, in response to a similar question regarding the sale or exchange of permanent fund securities originally held in the state portfolio, that Section 6-8-7 NMSA 1978 confers "broad powers" on the investment officer to sell and exchange securities, and that the primary purpose of the creation of the council was to "improve the position of the permanent fund in regard to its investments generally, and specifically, its return on the funds invested, keeping in mind, of course, the preservation of the principal."

In that opinion, this office went on to state:

If the present proposal under consideration involved an attempt by the Council to dispose of originally held securities which were clearly and rapidly deteriorating in value, little doubt if any, would be expressed that the Council had the right so to act. Indeed, it might be said that the Council had the duty under its investment standard so to act.

Op. Att'y Gen. No. 60-9.

It is still our opinion, based on the strict fiduciary duty imposed by the prudent man rule, the purpose of the permanent fund, and the broad powers conferred by the constitution and statutes that the state investment officer may sell bonds or other fixed income investments at a loss where doing so is necessary to protect the fund.

1b. Paragraph 2 of N.M. Const. Art. XII, Section 7 does not alter our conclusion. The pertinent part states: "The state investment officer **in order to realize increased income, may,**..." (emphasis added). This paragraph, which was added by amendment in 1965, presents an additional option to the state investment officer allowing him to choose to incur a loss by the premature sale of a healthy investment when the reinvestment of the money will yield a larger return than would occur if the investment officer held the original security. Jockeying for higher investment yields and actively incurring losses to achieve those yields had not been a traditionally accepted method of trusteeship prior to that amendment and had been found unconstitutional. Paragraph 2 is clearly worded to meet this specific situation. See Op. Att'y Gen. No. 62-46. The amendment simply enables the state investment officer to make a loss transaction for **improvement** rather than **protection**, which transactions the Attorney General had held in Op. Att'y Gen. No. 62-46, to be unconstitutional.

Therefore, it is our opinion that the state investment officer has the power and the duty to sell fixed income securities at less than their original acquisition cost and take a loss which cannot be made up by increased interest income where, in his discretion, such action is consistent with the protection and preservation of the permanent fund.

2. Your second question was addressed by this office in Op. Att'y Gen. No. 62-46 (1962).

We feel that the loss provision of the constitution and the detailed statutory provisions under which the council operates were conceived out of jealous regard by the constitutional framers and the members of the legislature for the safe-keeping of the permanent funds that are held in trust for our school children. We consider them something more than mere technical road-blocks to flexible operation of the investment program. While it is true that at times they give the appearance of hindering rather than aiding a sound investment program, we must point out that the very nature of the provisions themselves give ample evidence of the legislative emphasis being placed upon safety, even at the expense of flexible operation. We are aware that in times past the council has had to reject very attractive investments because of these requirements, and we are sure that it will have to do so in the future, but we are convinced that the great emphasis has been placed upon safety as the controlling principle, and we have approached the solution of this problem with this thought in mind.

Id. at 344.

That Opinion concluded that the loss provision in paragraph 2 of Article XII, Section 7, NMSA 1978 is not self-executing. The Attorney General stated:

We must fit one more piece in the puzzle before it is solved. The question arises whether the reimbursement takes place ipso facto from the general fund or whether such reimbursement must be by legislative action. We feel the latter is correct. The only manner in which the constitutional provision in question could, in and of itself, amount to an appropriation from the general fund is if the provision is self-executing. We think that

it is not. The rule laid down by our Supreme Court as regards self executing provisions of the constitution is, as follows:

"A constitutional provision may be said to be self executing when it takes immediate effect and ancillary legislation is not necessary to the enjoyment of the right given, or the enforcement of the duty imposed" Lanigan v. Gallup, 17 N.M. 627.

We think that this provision fails to meet this test. From which fund is the money to come? The provision is silent. We think that it will require legislative action to designate the source of revenue from which the reimbursement is to be made.

The constitutional provision is not self executing in so far as the loss requirement is concerned.

Id. at 345. See also 16 C.J.S. Trusts § 46, at 127 (1961).

"The fact that a provision is mandatory does not indicate that it is self-executing, and clauses in a constitution which are not self-executing, but which direct legislation to carry them into effect, have at most no more than moral force, even when they are mandatory in terms." Id. at 127.

Therefore, while we hold that the loss must be reimbursed we also hold that it is up to the legislature to effect it. Accordingly, we recommend that in the event of a loss, the state investment council inform the legislature thereof.

#### **ATTORNEY GENERAL**

HAL STRATTON Attorney General