APPENDIX O

Memo from Assistant Attorney General Regarding Tobacco-free Investments for the Children's Trust

MEMORANDUM

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ALASKA DEPARTMENT OF REVENUE
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COMMISSIONER'S OFFICE

State of Alaska
Department of Law

To: Wilson Condon
Commissioner, Alaska Department of Revenue

Date: August 12, 1998

File No.: 663-98-0297

Telephone No.: (907) 465-3600

Neil SM

From: Neil Slotnick
Assistant Attorney General

Subject: May the Children's Trust Fund be invested tobacco free?

You have asked whether, consistent with your fiduciary duty, you may invest the funds of the Alaska Children's Trust in tobacco-free investments. The short answer is that when investing funds of the Alaska Children's Trust, you may consider only the sole best financial interest of the Trust. Thus, you cannot consider the social implications of investment in tobacco-free securities.

FACTS

The Alaska Children's Trust (trust) was created in 1988. The trust exists as an endowment; the trust board may use the income of the trust to make grants for projects that will aid in the prevention of child abuse and neglect. The Commissioner of Revenue has the responsibility to invest the trust funds.[1]

During the first several years of its existence, no funds were deposited in the trust. In 1996, however, the Knowles administration breathed new life into the trust. The administration changed the governing structure of the trust and solicited several private donations to the trust. In the same year, the legislature appropriated $6 million to the trust. You were asked by the administration whether the funds in the trust could be invested tobacco-free. After careful consideration, including oral advice from the Department of Law, you concluded that an investment of trust funds in tobacco-free securities would be consistent with your fiduciary duties, including compliance with the prudent investor rule, and the duty of loyalty. The basis of your decision is well-documented in your department's investment policy manual at pages 106-17; 182-91; and Appendix X. In broad summary, you identified a tobacco-free fund that was comparable in terms of risk, expense, and expected return to the index fund in which you would

[1] Chapter 14 of Title 37 of the Alaska Statutes (AS 37.14) establishes and governs state trust funds. The Alaska Children's Trust is established by sections 200-270. (AS 37.14.200-37.14.270.) As explained later in this opinion, the Children's Trust statutes cross-reference and incorporate provisions from other statutes in Title 37.

otherwise invest. You also made a finding that "[p]rotecting Alaska's children from the harms caused by tobacco is consonant with the purposes of the trust." In this narrow circumstance, you concluded that, under the common law prudent investor rule, you could invest funds in the Alaska Children's Trust in tobacco-free securities.

After drafting the investment policy manual, you distributed a copy to former Deputy Commissioner of Revenue Milt Barker, and requested Mr. Barker's comments. You selected Mr. Barker to perform an independent review in part because Mr. Barker had been deputy commissioner in 1988 at the time the Children's Trust was established. That same year statutes defining the fiduciary duty of the commissioner were being amended, and Mr. Barker played a key role in marshaling the legislation concerning investment duties through the legislature. After reviewing the manual, Mr. Barker questioned whether Alaska's statutes allow the commissioner of revenue to consider the social implications of an investment. You then requested this opinion.

This memorandum will not revisit your finding that the common law prudent investor rule would allow investment of the Children's Trust in a tobacco-free index fund.[2] Instead, this memorandum will focus on the narrow question of whether Alaska law modifies the common law in a manner that precludes consideration of the social implications of an investment. As explained below, through a complex web of statutes, Alaska law prohibits you from considering anything but the financial best

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[2] Given your conclusions that the proposed tobacco-free investment has a comparable expected return and risk level as the contemplated alternative investments, and that the legislative intent in creating the trust is consonant with not supporting tobacco companies, our research has found support for the conclusion that the investment of funds of the Alaska Children's Trust in tobacco-free investments would be consistent with the common law prudent investor rule and the duty of loyalty. *See, e.g., Board of Trustees of Employee's Retirement System of City of Baltimore v. Mayor and City Council of Baltimore City*, 562 A.2d 720, 736-38 (Md. 1989) (requirement that retirement system invest in South Africa-free investments, where contemplated investments would yield competitive returns at comparable risk, does not violate the prudent investor rule or the duty of loyalty); III William Franklin Fratcher, SCOTT ON TRUSTS § 227.17 (4th ed. 1988) (trustees may "decline to invest in, or to retain, the securities of corporations whose activities or some of them are contrary to fundamental and generally accepted ethical principles"); *but see also, e.g.,* John H. Langbein and Richard A. Posner, SOCIAL INVESTING AND THE LAW OF TRUSTS, 79 MICH. LAW REV. 72 (1980) (arguing that neither common law of trusts nor ERISA permit a fiduciary to adopt social investment criteria). This conslusion does not address the question of who is the beneficiary of the trust, or imply that the beneficiary of the public funds in the trust is anyone other than the state.

interests of the funds you invest on behalf of the trust. Accordingly, you may not consider the harm or benefit to Alaska's children when determining how to invest the money in the trust.

DISCUSSION

A. The Alaska Children's Trust statutes allow consideration of only the financial interests of the fund

The children's trust statutes incorporate standards from other trust statutes. Thus, the commissioner's fiduciary duties to the trust include "invest[ing] and reinvest[ing] the assets of the trust as provided in this section and as provided for the investment of funds under AS 14.25.180(c) and AS 37.14.170." AS 37.14.210(4). The two statutes incorporated by AS 37.14.210(4) provide as follows:

> In carrying out investment duties under this chapter, the Alaska State Pension Investment Board has the same powers and duties in regard to the teacher's retirement trust fund as are provided in AS 37.10.071, except that the standard of prudence that the board must obey under AS 37.10.071(c) shall be in regard to the management of large trust investments rather than large investments.

AS 14.25.180(c).

> The commissioner of revenue is the fiduciary of the trust fund and shall invest the fund to provide increasing net income over long-term periods to the fund's income beneficiaries. The commissioner may invest the money in the fund on the basis of probable total rate of return to promote the long-term generation of income. In managing the trust fund, the commissioner shall
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> (1) consider the status of the fund's capital and the income generated on both a current and a probable future basis;
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> (2) determine the appropriate investment objectives;
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> (3) establish investment policies to achieve the objectives; and
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> (4) act only in regard to the financial interests of the fund's beneficiaries.

AS 37.14.170.

The statute incorporated in turn by AS 14.25.180(c), AS 37.10.071, sets out a lengthy list of powers and duties. Most important for this opinion is the duty described in subsection (c), which states

> In exercising investment, custodial, or depository powers or duties under this section, the fiduciary of a state fund shall apply the prudent investor rule and exercise the fiduciary duty in the sole financial best interest of the fund entrusted to the fiduciary. Among beneficiaries of a fund, the fiduciaries shall treat beneficiaries with impartiality.

AS 37.10.071(c).

These statutes present a confusing array of directives. First, AS 37.10.071(c) instructs that the commissioner must apply the prudent investor rule. It then modifies the prudent investor rule by instructing the commissioner to "exercise the fiduciary duty in the sole financial best interest of the fund entrusted to the fiduciary." AS 37.10.071(c). Next, AS 37.14.170 gives the commissioner a similar instruction, but without the words "sole" and "best": "[I]n managing the trust fund, the commissioner shall . . . act only in regard to the financial interest of the fund's beneficiaries." AS 37.14.170(4).

These statutes might appear to be in conflict. You are told to apply the prudent investor rule, which, in some limited circumstances, allows consideration of social implications of the investment, but then you are told to consider only the sole financial best interests of the fund. Further, you are also told to act in the fund's "financial interests," which appears to set a different standard than "sole financial best interests."[3]

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[3] In addition, AS 37.10.071 is incorporated indirectly through AS 14.25.180(c) whereas AS 37.14.170 is incorporated directly. Moreover, AS 14.25.180(c) modifies the incorporation of AS 37.10.071(c) in a way that does not make sense, stating, "the standard of prudence that the board must obey under AS 37.10.071(c) shall be in regard to the management of large trust investments rather than large investments." Current AS 37.10.071 makes no reference to a standard for "large investments." At the time that the legislature incorporated AS 14.25.180(c) in AS 37.14.210, however, AS 37.10.071(c) provided that "[i]n exercising investment, custodial, or depository powers or duties under this section, the commissioner shall exercise the judgment and care under the circumstances then prevailing that an institutional investor of ordinary professional prudence, discretion, and intelligence exercises in managing large investments with consideration for the purpose of the fund, the investment objectives, the continuing disposition of the fund's investments, and the probable safety of the capital as well as

The rules of statutory construction, however, require us to harmonize these statutes if possible. *Matter of Estate of Hutchison,* 577 P.2d 1074, 1075 (Alaska 1978) ("where one section deals with a subject in general terms and another deals with a part of the same subject in a more detailed way, the two should be harmonized, if possible"). Laws should be read as a whole. *Benner v. Wichman,* 874 P.2d 949, 957 (Alaska 1994) ("Whenever possible, we construe each part or section of a statute with every other part or section, to produce a harmonious whole.") Here, harmonization can be easily accomplished upon close reading of the statutes. First, statutory modification of the prudent investor rule is common. This is recognized by the Restatement of Trusts which requires that trustees conform to statutory modifications of the rule. REST. 3RD, TRUSTS, (Prudent Investor Rule) § 228 (1990) ("The prudent investor rule of § 227 is subject to the trustee's duty to respect applicable statutes"). Thus, no difficulty in interpretation is created by AS 37.10.071(c) both adopting and narrowing the prudent investor rule in one sentence.

Second, no conflict exists between the requirement of AS 37.14.170 that the commissioner act only in the financial interest of the trust and the requirement of AS 37.10.071(c) that the commissioner act in the sole best financial interest of the fund. Alaska Statute 37.14.170 addresses the circumstances where the fiduciary must consider the interests of the beneficiaries in securing both capital growth and income. In this circumstance, the legislature did not instruct the commissioner to act only in the "best financial interest" of the fund, apparently out of concern that such an instruction would limit the commissioner's ability to consider income generation as an investment objective. *Compare* AS 37.14.170 ("the commissioner shall . . . act only in regard to the financial interests of the fund's beneficiaries") *with* AS 37.10.070(a)(4) (in investing money in the state treasury above that required to meet current needs, "the commissioner shall . . . act only in regard to the best financial interests of the state"). In short, the instruction in AS 37.14.170, when harmonized with AS 37.10.071(c), would allow the commissioner to consider both capital growth and income while acting in the best financial interest of the trust.

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the probable investment returns." 1988 SLA ch. 141 § 20. Thus, at the time, the legislature had a reason for making the incorporation of AS 37.10.071 through AS 14.25.180(c): to make clear that the commissioner would use the standard for "large trust investments" rather than "large investments." The 1992 amendments to AS 37.10.071 simplified the language of subsection (c), eliminating the "large investment" clause in favor of a clearer adoption and modification of the prudent investor rule. The bottom line for this discussion, however, is that AS 37.10.071(c) clearly governs the commissioner's investment of funds in the trust, to the same extent as it would if it had been directly incorporated in the trust statutes.

When the two statutes are harmonized, the plain language of AS 37.14.170 and AS 37.10.071(c) would preclude the commissioner from considering the social implications of the investment. The commissioner must act only in regard to the financial interests of the trust's beneficiaries, and must exercise the fiduciary duty owed the trust in the sole financial best interest of the fund. This language on its face leaves no room for consideration of the social implications of an investment. The next step in the analysis is to apply the rules of statutory construction to determine whether an implicit exception to this mandate may exist.

"Statutory construction begins with an analysis of the language of the statute construed in light of its purpose." *Borg-Warner v. AVCO Corp.*, 850 P.2d 628, 633 n.12 (Alaska 1993). "The objective of statutory construction is to give effect to the intent of the legislature, with due regard for the meaning that the statutory language conveys to others." *City of Dillingham v. CH2M Hill Northwest,* 873 P.2d 1271, 1277 (Alaska 1994). Although Alaska does not adhere to a strict view of the plain language of a statute, "[i]f the language of the statute is unambiguous and expresses the intent of the legislature, and if no ambiguity is revealed by the legislative history, [the court] will not modify or extend a statute by judicial construction." *Conecky v. Camco Wireline, Inc.*, 920 P.2d 277, 281 (Alaska 1996).

Here, the statutory language leaves little room for interpretation. In the face of the explicit ban on consideration of anything but the best financial interest of the fund, it would take a very strong expression of legislative intent to allow the commissioner to consider the harm to children that results from tobacco. As explained below, although the legislative history of the investment provisions is complicated, we have found no support in the legislative record for any result other than adherence to the plain language of the statute.

B. The legislative history of the trust statutes does not support allowing the commissioner to consider the social implications of an investment

At the time that the children's trust was created in 1988, AS 37.14.210(4) provided that the commissioner of revenue has the power and duty "to invest and reinvest the assets of the fund as provided in this section and as provided for in the investment of surplus pension funds under AS 39.35.110(a), (c), (e), (f), and (i)." 1988 SLA ch. 19 § 1. Subsection (a) of AS 39.35.110 enumerated a list of investments in which the commissioner could invest; subsections (e) and (f) further defined these enumerations. Subsection (c) restated the prudent investor rule with certain restrictions, including a restriction that no more than 50 percent of the fund could be invested in corporate stocks.

In the same year that it was establishing the children's trust, the legislature was also considering HB 547, a comprehensive bill amending the statutes on investment. A version of this bill was eventually adopted that included a repeal of AS 39.35.110, adopted the current language of AS 37.14.170, and the version of AS 39.10.170 that was later amended in 1992. 1988 SLA ch. 141. The purpose of this legislation is well documented in an 77-page memorandum dated March 1, 1988, from the New York law firm of Wilkie Farr and Gallagher to the Department of Revenue ("Wilkie Farr"). In broad summary, the purpose of HB 547 was to provide more discretion and accountability to the Commissioner of Revenue. The administration and the legislature were concerned that the laundry list approach to investing prevented the commissioner from exercising the duties of a fiduciary. Under these limiting statutes, the commissioner could not invest in the best interest of the funds, nor could he be held responsible by the funds' beneficiaries for poor returns. HB 547 discarded the constraints on investment found in AS 39.35.110, and more firmly established the fiduciary duty of investing officials. In general, nothing in the legislative history of HB 547 contradicts the plain language of AS 37.14.170 or 37.10.170(c) (as amended) that restricts the commissioner to consideration of financial interests when making investments.[4]

After passage of HB 547, the children's trust statutes instructed the commissioner to look to a repealed statute to direct his investment activity. *See* former

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[4] In analyzing the "best financial interest" clause, the Wilkie Farr memorandum analogizes to federal pension legislation (ERISA) to conclude that HB 547 adopted a more stringent standard than the common law. Wilkie Farr at 13-18. Although the memorandum does not discuss whether a fiduciary may avoid investments that might harm the beneficiaries of the trust, the memorandum advises that the state should "assure that political pressure will not influence the administration and investment of Fund monies." *Id.* At 72. The analogy to ERISA is not entirely well-taken: ERISA employs different language than Alaska Statutes. *Compare* 29 U.S.C. § 1104(a)(1) *with* AS 37.14.170 & 37.10.071(c). ERISA, in fact, might allow consideration of the health or social interests of the beneficiaries. *See, e.g.*, Ian D. Lanhoff, *The Social Investment of Private Pension Plan Assets: May It be Done Lawfully under ERISA?*, 31 Labor Law Journal 387 (1980) (arguing that socially beneficial investment may be considered under ERISA where it meets appropriate investment criteria). Here, however, the plain language of Alaska's statutes provide a much clearer directive that the commissioner should consider only the financial interest of the fund. Thus, although the Wilkie Farr memorandum arguably provides some support for the conclusion that the legislature intended to prevent consideration of social implications of an investment, we rely on the plain language of the statute for reaching our conclusion.

AS 37.14.210(4), *incorporating* AS 39.35.110(a), (c), (e), (f) & (i). The revisor of statutes, however, submitted a bill the following year that amended AS 37.14.210(4) by deleting the reference to AS 39.35.110, and instead incorporating AS 37.14.170, AS 14.25.180(c), and, indirectly, AS 37.10.071. 1989 SLA ch. 50 § 42. The revisor's sectional analysis explained that this change "substitutes relevant current references for references rendered obsolete by the 1988 repeal of AS 39.35.110. The amendment was requested by the commissioner of revenue." Senate-House Joint Journal Supplement No. 10 at 7 (May 5, 1989).

The subsequent enactment that bears on this question was the adoption in 1992 of the current language of AS 37.10.071(c). As explained above, this statute contains the clearest expression that a state fiduciary may consider only the best financial interests of the fund when making investment decisions. The 1992 amendments to this statute, which added the phrase "sole best financial interests," were contained in SB 329. The main purpose of this bill was to create the Alaska State Pension Investment Board to make decisions concerning investment of state pension funds. Although this bill went through several permutations, eventually passing as a house committee substitute for SB 329, the phrase "sole best financial interests" of current AS 37.10.071(c) was in the original version of the bill. Nothing in the legislative history would support a conclusion that the phrase "sole best financial interest" means anything other than what it says.[5] In short, the plain language of AS 37.10.071(c) and AS 37.14.170 foreclose the ability of the commissioner of revenue to consider the social implications of investments.

CONCLUSION

In sum, the statutes governing the discretion of the commissioner in investing funds in the Alaska Children's Trust clearly modify the common law prudent investor rule in a manner that restricts the commissioner from considering anything other than the financial best interest of the fund. In adopting the statutes analyzed in this memorandum, the legislature sought to insulate state investment officers from pressure to

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[5] The legislative history does contain a letter of intent advising that "[a]cting within the fiduciary responsibility under the Prudent Investor Rule, and provided that, in the judgment of the manager, Purchase/Sale execution and transaction cost [sic] are competitive with Non-Alaska affiliated brokers, active managers are encouraged to do business with brokerage firms having offices in Alaska." 1992 Senate Journal at 1872. Although this letter would indicate that a manager placing orders with a brokerage firm may, in limited circumstances, consider location of a brokerage firm when deciding which firm to place an order with, this letter does not authorize the fiduciary to consider anything other than financial interests when deciding which securities to invest in.

consider matters other than the financial interests of a fund. Thus, we conclude that you cannot consider the health risks of tobacco when making investment decisions concerning the Alaska Children's Trust.[6]

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[6] Many readers of this opinion will likely ask whether the commissioner of revenue could justify tobacco-free investment on the ground that tobacco stocks are poor investments. A detailed answer to this question is beyond the scope of this opinion, but, in brief, although such a result is possible, it appears unlikely. In order to invest tobacco-free, an investment manager would have to construct an investment portfolio with all decisions concerning investment in tobacco securities based solely on the predicted financial performance of those securities. Few commissioners would be willing to claim sufficient expertise or resources to exercise the degree of care required for such decision-making; even if one did, there is no guarantee as to what outcome a commissioner would reach. Moreover, a small trust fund is well-served by a passive management philosophy because of the costs associated with active management and the limited ability to evaluate an active manager's performance. Finally, modern portfolio theory and the desire to avoid uncompensated risk would discourage use of investment criteria that tend to work against diversification.