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The Honorable Glen B. Gainer
Chairman, Board of Trustees of the
Public Employees Retirement System
State Capitol, Room W-100
Charleston, West Virginia 25305

Dear Chairman Gainer:

You have requested our opinion on the legality and constitutionality of the proposed loan of Consolidated Pension Fund moneys to cover the cost of salary increases for West Virginia public school teachers. The legal issues involved fall primarily into two categories: whether such a loan would violate the State Constitution's prohibition on state debt, and whether it would violate the legal principles which govern the proper use of such pension funds. The question presented goes to the heart of state constitutional jurisprudence in West Virginia and, so far as we can tell, is a matter of first impression in this state.

As is clear from our analysis below, we are acutely aware of the tension between the State Constitution's prohibition on incurring debt and the requirement that retirement funds be invested safely and securely. In this case, it appears to us that the Legislature has deliberately attempted to steer a constitutional course between these competing principles. Our conclusions are guided by the fact that legislative enactments are entitled to a presumption of constitutionality and may be overturned only if unconstitutional beyond a reasonable doubt. "In considering constitutional restraint, the negation of legislative power must be manifest beyond reasonable doubt." Syllabus Point 2, State ex rel. State Building Commission v. Moore, 155 W. Va. 212, 184 S.E.2d 94 (1971). In Re Dostert, ___ W. Va. ___, 324 S.E.2d 402, 413, n.20 (1984), overruled on other grounds, Harshbarger v. Gainer, ___ W. Va. ___, ___ S.E.2d ___, No. 19713, January 22, 1991; City of Charleston v. Coghill, 156 W. Va. 877, 207 S.E.2d 113, 118 (1973).

Although the question is a complex and a close one, we do not find the proposed loan unconstitutional under this controlling

standard, nor do we find that the proposed loan on its face violates fiduciary principles applicable to the investment of pension funds. The problems which the loan does present are detailed below and should be carefully considered by the Board of Investments in deciding whether to make and, if so, how precisely to structure such a loan. Finally, we find that the loan might jeopardize the Public Employees Retirement System's federal tax-exempt status, a problem which should be resolved before a final decision on the loan is made.

In this opinion, we do not of course address the public policy question of whether it is wise to finance teacher pay raises in the fashion proposed, but limit ourselves to the legal questions which the proposed loan raises. Before presenting our legal analysis, we will describe the essential facts involved in the question.

I.

THE PROPOSED LOAN

The loan in question would be made pursuant to Senate Bill 8, enacted in the Third Extraordinary Session of 1990, and codified as W. Va. Code § 12-6-9d (1991). Subsection (b) of § 9d sets up the following loan mechanism:

(b) Whenever the governor determines that there are insufficient general revenue funds available for the timely payment for necessary improvements in public education as appropriated by the Legislature in the budget bills for the fiscal years [1991] and [1992], the governor may request the state board of investments to lend those moneys necessary to meet such payment and the state board of investments shall transfer moneys from the consolidated pension fund . . . in the amount determined by the governor to be sufficient and necessary to meet such payments, within the amount determined by the board . . . to be prudently available. The manner and timing of such transfers shall be in the discretion of the board The total of the amounts

transferred may not exceed a total of [\$100] million . . . during the fiscal years [1991] and [1992]. On the date the loan is transferred . . . interest shall accrue at the current interest rate of the fund from which the loan originated, plus one-fourth of one percent, and the current interest rate shall be recalculated every six months.

W. Va. Code § 12-6-9d (1990) [emphasis added]. We understand that the current market value of the Consolidated Pension Fund is approximately \$2.475 Billion. In subsection (a), the Legislature sets forth the basis for its policy determination that teacher pay raises should be financed in this fashion, as well as its finding that the loan is consistent with the Consolidated Pension Fund's financial soundness:

(a) The Legislature hereby finds and declares that the West Virginia supreme court of appeals has determined that **public education has a constitutionally preferred status**; that there is a large amount of investable funds in the consolidated pension fund; that loans made under **commercially reasonable terms** to finance needed public education improvements are necessary investments in the future of West Virginia; and that loans from the consolidated pension fund will assist in financing the needs of primary and secondary education, without in any way impairing the solvency or financial soundness of the consolidated pension fund. This section is enacted in view of these findings.

Id. [emphasis added]

Subsection (d) of § 9d creates a special account in the treasury, under the control of the Board of Investments, as a sinking fund for repayment of the loan. An amendment to W. Va. Code § 11-15-30 (1990), the Consumer Sales Tax Act, dedicates to this special sinking fund the first \$5 Million of the tax in each month, commencing August 1, 1992. A dedicated revenue source is thus provided for repayment of the loan. Subsection (d) expressly invokes the "special fund doctrine for budgetary transfer activities involving more than one fiscal year," thus signalling the Legislature's intention that, as with other special revenue

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accounts, no additional appropriation would be required in future years in order to transfer the specified sales tax revenues to the special account. See McGraw v. Harshbarger, ___ W. Va. ___, 301 S.E.2d 848 (1983). Subsection (c) of § 9d further provides:

(c) . . . Repayment of the loans shall begin six months from the date the funds were transferred and **payments** shall be made **every six months** thereafter, or sooner if agreed to in writing by the board of investments and the governor: Provided, That **all loans shall be repaid in full by [August 31, 1996]**.

Id. [emphasis added] The loan mechanism established by these statutes thus combines the following elements:

1. The amount and timing of transfers from the Consolidated Pension Fund is apparently left to the Board's discretion.
2. The limit on transfers is \$100 Million for fiscal years 1991 and 1992.
3. Interest is pegged a quarter point above the fund's "current interest rate," and is to be recalculated every six months, and the loan is described as being made on "commercially reasonable terms."
4. A dedicated revenue source is provided, in the form of the first \$5 Million each month of Consumer Sales Tax proceeds, a special revenue account is created, and the "special fund doctrine" is invoked, providing for the automatic funding of the special account from fiscal year to fiscal year.
5. Repayment in full is required by August 31, 1996.

Below is our discussion of the law.

II.

THE STATE CONSTITUTION'S DEBT PROHIBITION

The prohibition is as follows:

No debt shall be contracted by this State, except to meet casual deficits in the revenue, to redeem a previous liability of the State, to suppress insurrection, repel invasion or defend the State in time of war; but the payment of any liability other than that for the ordinary expenses of the State, shall be equally distributed over a period of at least twenty years.

W. Va. Const. art. X, § 4.

As with similar constitutional provisions in other states, this section of our constitution has been a frequent subject of interpretation by the courts. The special fund doctrine invoked in § 9d(d) resulted from the courts' passing on the issuance of "self-liquidating" bonds, used to finance government projects and funded from some revenue source other than the State's general fund. A classic example would be the issuance of revenue bonds for the construction of a bridge, with the bonds to be repaid with tolls collected from bridge users. The special fund doctrine allowed such schemes because the general revenues of the State were protected, with bondholders restricted to the pledged revenues for repayment on their investment. It was held that no debt was created within the meaning of the State Constitution, since the full faith and credit of the State was not pledged,¹ and general

¹The credit of the State shall not be granted to, or in aid of any county, city, township, corporation or person; nor shall the State ever assume, or become responsible for the debts or liabilities of any county, city, township, corporation or person; nor shall the State ever hereafter become a joint owner, or stockholder in any company or association in this State or elsewhere, formed for any purpose

revenues were not involved. Examples of such decisions by the West Virginia Supreme Court of Appeals include State ex rel. Board of Governors v. O'Brien, 142 W. Va. 88, 94 S.E.2d 446 (1956); State ex rel. State Road Commission v. O'Brien, 140 W. Va. 114, 82 S.E.2d 903 (1954); See also State ex rel. County Court v. Demus, 148 W. Va. 398, 135 S.E.2d 352 (1964).

In Board of Governors v. O'Brien, the Supreme Court of Appeals listed other funding sources that it found were generally held not to violate state debt prohibitions, commenting:

"[I]t has generally been held that an obligation payable from a special fund created by the imposition of fees, penalties, or excise taxes, and for the payment of which the general credit of the state is not pledged and resort may not be had to property taxation, is not a debt within the meaning of constitutional debt limitations . . . [quoting 49 Am.Jur., States, Territories and Dependencies, Section 67]"

Id. at 94 S.E.2d 450 [emphasis added].²

In 1970, The Supreme Court considered a statute which authorized the State Building Commission to issue "revenue bonds" to finance construction of state office buildings, the bonds to be repaid with rent charged to the state agencies which would occupy the buildings. The court struck down this statute, primarily on

whatever.

W. Va. Const. art. X, § 6.

² A 1954 Opinion of the Attorney General, 46 Op. Att'y Gen. 35 (1954), concluded on the basis of language in State ex rel. State Road Commission v. O'Brien, 140 W. Va. 114, 82 S.E.2d 903 (1954), that a dedicated excise tax was not constitutional because the West Virginia Supreme Court of Appeals had declined to adopt or approve the special fund doctrine. It seems clear to us that in subsequent cases the court has done so. Indeed, the language quoted in the text is from a decision handed down scarcely two years after the 1954 O'Brien case. Our previous opinion thus is no longer an accurate statement of the law.

the basis that the rental payments would have come from appropriated funds. State ex rel. Hall v. Taylor, 154 W. Va. 659, 178 S.E.2d 48 (1970). The court did so despite a statutory disclaimer that no state debt was created, despite the restriction of the bondholders to pledged revenues, and despite the contention that the Legislature was free to withhold appropriations in any year it might choose to do so.³ Then in 1974, the court approved issuance of bonds by the Housing Development Fund in a case in which general revenue funds were involved but were found to be protected from any requirement of a future appropriation. State ex rel. W.Va. Housing Development Fund v. Waterhouse, 158 W. Va. 196, 212 S.E.2d 724 (1974).⁴

³ The following year, the Court upheld a modified statute which adopted essentially the same scheme; the new statute used rental payments from special revenue sources, as opposed to funds from general appropriations. State ex rel. State Building Commission v. Moore, 155 W. Va. 212, 184 S.E.2d 94 (1971).

⁴ In Waterhouse, the Court disapproved a provision requiring the Governor to include in his budget funds to cover any deficiency in the bond insurance fund, on the basis that it was a violation of separation of powers, W. Va. Const. art. V, § 1, for the legislature to prescribe what the Governor must include in his budget. The court also based this holding on W. Va. Const. art. VI, § 51, the "Modern Budget Amendment," since that provision of the Constitution contemplates an executive budget, that is, a budget under the exclusive control of the executive. Compare the following provision of § 9d:

(c) Full repayment of all moneys transferred, with interest, shall be made to the board of investments by payment into such pension fund from amounts appropriated by the Legislature or in the absence of appropriations from the amounts specified in . . . [§ 11-15-30] . . . of this code, by budget action as first priority from the moneys available for each fiscal year. (Emphasis added.)

While the meaning of the underscored language is unclear, it is questionable under Waterhouse whether this portion of the statute is constitutional, to the extent it seeks to require the Governor to take a specified "budget action." But see Dadisman v. Moore, ___ W. Va. ___, 384 S.E.2d 816 (1988). However, the question is not determinative of the conclusions we reach in this opinion.

The importance of the distinction between the use of general revenue and the use of a "special fund" for repayment of an obligation was radically diminished, and even eviscerated, in 1984 in State ex rel. Resource Recovery-Solid Waste Disposal Authority v. Gill, ___ W. Va. ___, 323 S.E.2d 590 (1984). That decision greatly liberalized the special fund doctrine, expressly eliminating the requirement that general revenues not be drawn on for repayment, and overruling Hall v. Taylor:

[T]he ultimate source of revenues from which bonds are payable is not necessarily determinative.

There is no proposal that these bonds be secured by the general credit . . . of the State Indeed, . . . the bond legislation expressly disclaims that they create any state debt or liability.

State ex rel. Resource Recovery-Solid Waste Disposal Authority v. Gill, 323 S.E.2d at 594. After reciting the disclaimer language in the statute and bonds involved in Gill, the court continued:

Hall discounted such disclaimers . . . , finding that "mere legislative declaration that a state debt is not created by the statute is not conclusive or binding upon a court. Whether a state debt is created by the statute is a judicial question, rather than a legislative question." [citation omitted] We agree with this principle, but would add that no court could force the legislature to appropriate money to pay bonds issued with such precise, unmistakable disclaimers.

Id. After determining that the source of funding, i.e., general revenues, was incidental, the court stated:

If the determinative issue is not the source of the revenues, it must be whether the bonding scheme "would bind subsequent legislatures to make appropriations in subsequent fiscal years." [citing Hall v. Taylor]

. . . .

There is a world of difference between authorizing future legislatures to act and requiring them to do so. . . . [L]egislation does not necessarily violate the constitutional debt limitation simply because it anticipates future appropriations of public funds from year to year to effect the purposes of the act.

323 S.E.2d at 594-95.

Under Gill, which is still the most recent pronouncement of the Supreme Court on the question, the constitutional debt provision is not violated by an obligation which requires general legislative appropriations for its repayment, at least so long as the creation of state debt is disclaimed, and as long as future legislatures are not "bound" to appropriate funds. Of course Gill did not involve the type of dedicated special revenue account which § 9d creates, nor its mechanism for automatic funding from year to year, absent affirmative action by the Legislature. Section 12-6-9d appears to contemplate future appropriations, see subsection (c), quoted above, but it is clear that a special revenue account such as that created by the statute is by definition independent of the normal fiscal year-to-fiscal year appropriation requirement which controls general revenue moneys. See McGraw v. Harshbarger, cited above.

More importantly, §§ 12-6-9d and 11-15-30 (the sales tax section) attempt purposely to track the course approved in Gill and previous decisions, by supplying a dedicated revenue stream, in this case from an already-existing tax. Subsection (d) explicitly invokes the "special fund doctrine," making it clear that the Legislature intended to avoid a violation of the constitutional prohibition on contracting state debt. Under Board of Governors v. O'Brien, discussed above, the dedication of an existing non-property-tax revenue source (an excise tax), which appears not to require future, new appropriations, would seem to satisfy the requirements of the special fund doctrine, even as it existed prior to Gill. And it is difficult to conclude that even a requirement of future appropriations would violate what remains of the doctrine subsequent to Gill.

The absence of an express disclaimer of the creation of state debt distinguishes this situation from the one reviewed in Gill. The loan mechanism under consideration here, however, does not contemplate the issuance of any evidence of indebtedness, because no sale of bonds to the public is involved. It is difficult to see

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how a disclaimer analogous to that involved in Gill would be made under these circumstances, and we are reluctant to attach great significance to its absence, particularly in view of this statutory framework's otherwise substantial satisfaction of the tests described in Gill. The specification of the identified portion of sales tax revenues as the repayment source, together with the absence of any language pledging the state's full faith and credit or creating a general obligation, leads to the logical conclusion that repayment is limited to the sales tax source.

To the extent it is possible to predict the Supreme Court's interpretation of these facts in the light of current controlling authority, we cannot conclude that the Court would find the consolidated pension fund loan authorized by § 12-6-9d violative of the constitutional prohibition on state debt, under the rationale of Gill or prior decisions, and in light of the statute's presumption of constitutionality. The freedom of the Legislature not to make future appropriations from general revenue funds, indeed in this case the lack of any requirement that it do so, together with the identification of specified revenue sources, appear to us to be the heart of the special fund doctrine as currently interpreted in West Virginia. We therefore cannot conclude that the loan would violate the constitutional prohibition on state debt found in art. X, § 4.

We turn next to the legal principles which bear directly on the particular use of pension moneys contemplated by the proposed loan.

III.

RESTRICTIONS ON USE OF PENSION FUNDS

Analysis of the legal issues raised by the use of state pension funds for the loan in question requires an examination of the statutes governing the Public Employees Retirement System and the State Board of Investments, and of the decision of the West Virginia Supreme Court of Appeals in Dadisman v. Moore, ___ W. Va. ___, 384 S.E.2d 816 (1988).

The West Virginia Public Employees Retirement Act, W. Va. Code § 5-10-1 et seq., as amended, was originally adopted in 1961, and § 5-10-38 (1961) provided for the investment of PERS funds:

All moneys of the retirement system not currently required for the payment of annuities or other benefits shall be invested by the board of public works in any securities or investments in which the sinking funds of the state may be legally invested, or in any securities or investments in which the deposits in savings banks and participation deposits in banks and trust companies may be legally invested, as provided by the general laws . . .

W. Va. Code § 5-10-38. The investment of the state's sinking funds is now dealt with in § 13-3-7 of the Code ("Municipal Bond Commission"), which, in relevant part in subsection (a)(2), permits investment in "[g]eneral obligations of the State or any of its agencies, boards or commissions"

However, in 1978 the Legislature established the consolidated pension fund under the control of the Board of Investments, rather than the Board of Public Works, W. Va. Code § 12-6-8 (1983); and § 12-6-9 (1990) now specifies the permissible types of investments "[n]otwithstanding the restrictions which may otherwise be provided by law" Section 12-6-9(e) permits investment in "[d]irect and general obligations of this state [emphasis added]." Finally, § 12-6-9d, enacted subsequent to § 12-6-9(e), provides specific authorization for investment in the loan in question here. We look to well-established principles of statutory construction and, accordingly, we view the last-enacted and most specific statute [§ 12-6-9d] as controlling.⁵ See Butler v. Rutledge, ___ W. Va.

⁵ To the extent the permissible investments enumerated in § 12-6-9(e) could be viewed as relevant, however, we also interpret the terms "direct and general obligations" to encompass the loan created by § 9d, because it is a direct obligation of the state. We understand the term "general obligation" to mean an obligation to which the state's general revenues and the state's full faith and credit are pledged. State ex rel. Hall v. Taylor, 154 W. Va. 659, 178 S.E.2d 48, 58-59 (1970); State ex rel. State Road Commission v. O'Brien, 140 W. Va. 114, 82 S.E.2d 903, 909 (1954). On the other hand, we understand "direct obligation" to be merely an obligation made directly by the state in its own name, rather than, for example, through a board or commission. See Guaranty

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_____, 329 S.E.2d 118 (1985) and UMWA v. Kingdon, ___ W. Va. ___, 325 S.E.2d 120 (1984).

The fundamental action of the Supreme Court of Appeals in its decision in Dadisman was to declare unconstitutional and illegal certain actions of the executive and the Legislature, primarily their failure to budget and appropriate the level of PERS funding called for by statute and necessary to keep the retirement fund actuarially sound, and their re-appropriation to other purposes of funds previously earmarked for the retirement fund. In its opinion, the court found the West Virginia Public Employees Retirement System to embody contractual and trust obligations by the state to its retired employee participants, obligations going beyond the explicit provisions of the statutes.

In Section IV of its opinion in Dadisman, entitled "Investment of Funds," the Supreme Court of Appeals traces the history of some of the statutes governing the investment of retirement moneys. Curiously, the court does not acknowledge the permissible investments list contained in the Board of Investments statute at § 12-6-9(e), restricting itself to a brief footnote acknowledging the transfer of "investment duties" to the Board of Investments, and characterizing this as being of a "housekeeping" nature. Id., 384 S.E.2d at 831, n.16. Instead, the court discusses the superseded sinking funds statute. While this discussion could be

Trust Co. of N. Y. v. W. Va. Turnpike Commission, 144 W. Va. 266, 107 S.E.2d 792, 796 (1959).

By using the term "and" between the words "direct" and "general" in § 12-6-9(e), we interpret the legislature to have intended authorization of both types of obligations. The use of the conjunctive "and" is not in any event determinative; it is the legislative intent which controls. Carper v. Kanawha Banking & Trust Co., 157 W. Va. 477, 207 S.E.2d 897, 921 (1974). The term "general obligation" is the more restrictive of the two; its use alone would thus have created the more restrictive condition. The addition of the term "direct" can therefore only have been intended to add something not already present in the term "general," which it does by including in the permissible list, along with general state obligations, obligations which are merely direct obligations of the state. In addition, read in context, § 12-6-9 provides the board with authorization to "invest funds . . . in any of the following: . . . (e) Direct and general obligations of this state . . . [emphasis added]". We thus conclude that this loan would be included in the § 9(e) list of permissible investments, to the extent that section might be found relevant.

read as indicating the court's intent that the sinking fund statute should control the investment of consolidated pension fund moneys, we do not think the court's opinion should be so interpreted, for several reasons.

First, no specific facts involving the investment of retirement funds are described in the opinion, technically qualifying the court's comments as dicta.⁶ Second, the language of the opinion is hortatory rather than mandatory: "Guidance for proper pension fund investments may be drawn from Code § 5-10-38." Id. at 832 [emphasis added]. Third, Chapter 12-6, Series II, of the Board of Investments Administrative Regulations, governing the Consolidated Pension Fund, expressly adopts § 12-6-9 as the controlling list of permissible investments and, in Tables I and II, specifies the diversification of fund portfolios among a wide variety of securities. These legislative rules thus demonstrate that the Fund is currently being managed on that basis. In the absence of any facts in the Dadisman case implicating permissible types of investments, we conclude that Section IV of the court's opinion was intended to set a high fiduciary standard and to provide general guidance to the Board, not to construe the specific statute which should control the permissibility of the type of loan involved here. As the court stated:

The Respondents are mandated to remove pension funds from speculative to secure investments and to make future investments of the PERS funds consistently with the highest standards of fiduciary duty.

Id. at 832.

For purposes of this analysis, the primary thrust of the Dadisman decision was its recognition of this fiduciary duty, the duty imposed on those entrusted with pension funds to invest and manage such funds with the highest degree of care and responsibility. Although the court in Dadisman does not explicitly address whether the degree of care required with respect to pension

⁶ The record in Dadisman reveals only that the petitioner in that case originally complained about the making of industrial development loans at discounted interest rates, but the court makes no reference to them in its opinion. As is clear from the discussion in this opinion, the rate of return on the loan involved here does not appear to present any such issue, since it is set a quarter point above the fund's current rate.

funds differs from the level of care the Board must exercise in dealing with the other funds entrusted to it, the opinion nonetheless provides guidance on that question. It may be said in general that when making investment decisions, the Board of Investments deals not with its own money and therefore has a fiduciary duty on all such decisions. Under Dadisman, however, when the Board makes an investment decision on pension funds, it is dealing not only with funds which are not its own, but with funds which are not even the state's. Dadisman v. Moore, 384 S.E.2d at 830:

Moneys . . . contributed to a public employees' retirement plan . . . become part of the corpus of the trust and are not thereafter state funds available for expropriation or use for any purpose other than that for which the moneys were entrusted.

The higher level of care required with respect to pension funds therefore flows from the beneficial "ownership" of the funds by private parties, rather than by the state or the citizens in general. Id., Syllabus Points 21 and 22.

Under the foregoing authority, we conclude that the State Board of Investments is bound to exercise a particularly high level of care and prudence when investing Consolidated Pension Fund moneys. We also conclude that the specific loan contemplated by § 12-6-9d qualifies as a permissible type of investment. That is not the end of the inquiry, however. It remains for the Board of Investments to assure itself that the making of the loan in the manner specified by the Legislature, and with whatever additional "commercially reasonable" conditions the Board might add, if any, meets the highest fiduciary standards imposed by the Supreme Court of Appeals.⁷

⁷ These standards raise the question of whether improvement of public education, see § 12-6-9d(a), is a legitimate factor for the Board to consider in deciding whether to make the loan. Under Dadisman, the Board should be guided primarily by its assessment of the appropriateness of the investment as an investment, rather than by unrelated purposes that would be served by making the loan.

On the other hand, we are not persuaded by the argument that this loan would violate Dadisman's proscription against the "use" of retirement funds for purposes unrelated to PERS. We do not think the loan would involve the "use" of pension funds for an unrelated purpose, any more than any investment involves the "use" of funds

The most obvious question about the propriety of this loan under the standards announced in Dadisman would seem to be its security, and security must certainly be a significant factor in determining the "commercial reasonableness" of a loan, as well as its advisability under a fiduciary standard. The uncertainty about the security of this loan derives from the possibility that a future legislature might alter the special revenue mechanism, or the dedication of the sales tax established in § 11-15-30. That possibility is one which the members of the Board of Investments must obviously weigh in their capacity as trustees of the PERS funds.

But we do not mean to suggest that the commitment made by the Legislature in dedicating the specified portion of sales tax revenues is insignificant; it may well be enforceable in court. If the Legislature has properly structured the loan mechanism to meet the requirements of the special fund doctrine, then repayment would not be enforceable against the general revenues of the state. By the same reasoning, however, repayment should be enforceable against the special revenue account established by § 12-6-9d(d). If it stands for anything, the Supreme Court's decision in Dadisman certainly stands for the enforceability of the state's obligations to the Consolidated Pension Fund.

In this connection, the legislative declaration that the loan be made on "commercially reasonable terms," § 12-6-9d(a), combined with the provisions of § 9d(b) vesting discretion in the Board of Investments as to the amount, manner, and timing of the transfers of funds, indicates that the Board may amplify the loan structure specified by the statute. The Board may add terms which will address the question of security, for example. This opinion, of course, applies only to the statutory framework. The questions we have raised regarding the transaction may well be addressed by the Board in devising the specific terms of the loan, should the Board choose to make it.

We are mindful, as always, of the risks in predicting how courts, and how our own Supreme Court of Appeals, may construe new facts, and how they may choose to apply the law to them. In this

for an unrelated purpose. The proceeds of any investment will naturally be used for the recipient's own purposes. The real question is the propriety of the investment in terms of factors such as the yield obtained for the fund from the investment, and the security of the funds while they are invested.

case, the court would be called on to rule on the Legislature's considered decision to create a direct state obligation, on commercially reasonable terms, to finance teacher pay raises, while at the same time avoiding the creation of the type of debt the court has construed the State Constitution to prohibit. Absent application of portions of the Dadisman decision in a manner we think unlikely and unwarranted, we believe the question of this loan is properly committed to the discretion of the Board, under the high fiduciary standards discussed above.

Because this state obligation is presumptively an appropriate investment, we are unable to conclude as a matter of law that the loan would violate the legal standards applicable to the investment of pension moneys, including the standards announced by the court in Dadisman. Nor can we conclude as a matter of law that the loan called for by § 9d would violate either the Board's ordinary duty of care, or its fiduciary duty to the state's retired employees. We consider that to be a matter for the exercise of expert financial judgment, weighing the probable yield, liquidity needs, security, and all other factors ordinarily considered in making such decisions. The Board's factual inquiry should include a survey of other outstanding loans from the Consolidated Pension Fund, in order to do a complete analysis of the proportion this loan would bear to the value of the entire fund portfolio, in the context of other loans already on the books⁸. The legality of the transaction after action by the Board would of course be subject to further review.

⁸ We understand that there may be two instances of loans currently on the books which were funded with Consolidated Pension Fund moneys. Apparently, neither of them involves PERS funds, but they nonetheless have a bearing on the advisability of making the § 9d loan, as well as having potential relevance to the federal tax issues discussed in Section IV of this opinion, below. The two instances apparently involve the Pneumoconiosis Fund, see W. Va. Code § 23-4B-8a [1988], and the Workers Compensation Fund, see W. Va. Code § 31-18B-1 et seq., and we understand the total amount involved to be somewhat in excess of \$40 Million.

IV.

FEDERAL TAX IMPLICATIONS

The provisions of the Federal Internal Revenue Code applicable to the tax-exempt ("qualified") status of governmental retirement plans such as West Virginia's must be considered prior to making the loan to the state. Although it is beyond the scope of this opinion to express whether such loan would affect the qualified status of the underlying governmental plans, we will highlight significant areas of concern. We recommend that the question be submitted to the Internal Revenue Service before a final decision is made.

It is our understanding that the governmental retirement plans which participate in the consolidated pension fund are qualified plans under § 401(a) of the Internal Revenue Code of 1986, as amended, and that these plans are exempt from federal income taxation pursuant to § 501(a) of the Internal Revenue Code. The tax-exempt status enjoyed by qualified governmental plans (1) allows employer contributions to be tax-deferred and not currently taxable to plan participants; (2) permits member contributions to be tax-deferred, provided the employer picks up such contributions; and, (3) makes the investment income on the qualified trust exempt from current federal income taxation under § 501(a) of the Internal Revenue Code. Loss of the tax-exempt, *i.e.*, qualified, status of the retirement systems would of course be detrimental to the plans' members and beneficiaries.

Although the Employees Retirement Income Security Act of 1974, as amended, ("ERISA") exempts governmental plans from Title I (the Labor Code provisions) of ERISA and from many of the Title II qualification requirements set forth in § 401(a) of the Internal Revenue Code, such plans must still satisfy many of the requirements of the Internal Revenue Code which pre-date ERISA.⁹

⁹ See, *e.g.*, the coverage requirements of § 401(a)(3), the non-discrimination rules of § 401(a)(4), and the vesting provisions of § 401(a)(7). Governmental plans must also satisfy the requirements of § 415 of the Internal Revenue Code relating to limitations on contributions or benefits. These provisions of the Internal Revenue Code are not directly applicable to the loan in question here.

Specifically, governmental plans must satisfy two fiduciary requirements imposed by federal law in order to retain tax-exempt status under § 401(a) and 501(a) of the Internal Revenue Code.

First, governmental plans must comply with § 401(a)(2) of the Internal Revenue Code, the so-called "anti-diversion" or "exclusive benefit" rule. This rule requires that no part of the principal or income of the exempt trust is to be used for, or diverted to, purposes other than the exclusive benefit of the employees and their beneficiaries. Treas. Reg. § 1.401-2; Treas. Reg. § 1.401(a)-2(a). Certain loans may violate this provision. See e.g., Feroleto Steel Co., Inc., 69 T.C. 97, Dec. 34,706. With respect to the prudence of certain investment decisions regarding pension plan assets, the Treasury Regulations provide that the investments are to be governed by local law. Treas. Reg. § 1.401-1(b)(5)(i). It should also be noted that investments in employer securities, i.e. debt instruments, may be subject to certain reporting requirements under § 6033 of the Internal Revenue Code. Treas. Reg. § 1.401-1(b)(5)(ii).

Although we could find no revenue ruling or case law directly on point with the proposed loan, the Internal Revenue Service has set forth certain general requirements which must be complied with under the exclusive benefit rule where pension funds are to be invested in stock or securities of the employer corporation. The four requirements are:

- (1) the cost of the investment must not exceed fair market value at the time of purchase;
- (2) a fair rate of return commensurate with the prevailing market rate must be provided;
- (3) sufficient liquidity of the pension fund must be maintained to permit distribution in accordance with the terms of the retirement plan; and
- (4) the safeguards and diversity that a prudent investor would adhere to must be present.

Revenue Ruling 69-494, 1969-2 C.B. 88.

Second, qualified governmental plans may not engage in "prohibited transactions," as defined in § 503 of the Internal Revenue Code. Section 503 was enacted to require arm's length dealings between the creator of a trust and the trustee.

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A governmental plan and trust can lose tax-exempt status by lending any part of its income or corpus to the creator or settlor of the trust "without the receipt of adequate security and a reasonable rate of interest." I.R.C. § 503(b)(1) [26 U.S.C. 503(b)(1)]. In the present situation, the state is of course the creator of the tax-exempt governmental plans and trusts.

With respect to the term "adequate security", the Treasury Regulations provide that:

[T]he term "adequate security" means something in addition to and supporting a promise to pay, which is so pledged to the organization that it may be sold, foreclosed upon, or otherwise disposed of in default of repayment of the loan, the value and liquidity of which security is such that it may reasonably be anticipated that loss of principal or interest will not result from the loan.

Treas. Reg. § 1.503(b)-1(b)(1).

Careful consideration should also be given to the question of whether W. Va. Code § 12-6-9d provides a "reasonable rate of interest." Section 503(b) of the Internal Revenue Code does not provide a definition of this term, but other provisions of the Internal Revenue Code and Title I of ERISA provide some guidance. Essentially, the loan must provide a fair rate of interest commensurate with the prevailing market rate for similar loans. In other words, what interest rate would local banks charge for similar loans?

Although we do not express an opinion on whether the proposed loan would constitute a prohibited transaction, the requirements of adequate security and a reasonable rate of return should be met prior to the making of the loan. We recommend that questions implicating federal tax law be submitted to the Internal Revenue Service for review before a final decision is made on this loan.

CONCLUSION

For the reasons outlined above, and in view of the strong presumption of constitutionality to which acts of the Legislature

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are entitled, we cannot conclude that the loan of Consolidated Pension Fund moneys to cover the cost of teacher salary increases is prohibited by the West Virginia Constitution or violative of the Supreme Court of Appeals decision in Dadisman. This opinion extends only to the finding that, in our opinion, the constitution is not violated by the loan mechanism established by statute.

The State Board of Investments is charged with the responsibility for all investment decisions with respect to these funds and is obliged to exercise the highest degree of fiduciary care, responsibility, and prudence in considering whether to make this loan and, if so, what additional "commercially reasonable" terms, if any, to require before doing so. It is also the Board of Investments' duty to make inquiry as to all relevant facts which a prudent investor should inquire about such as, for example, the reasonably predicted revenues from the dedicated sales tax provided by the statute, the status of repayment on the obligation to which the sales tax is currently dedicated, and any similar facts which might bear on the advisability and security of the loan. Finally, we recommend that the possible federal tax problems briefly discussed above be definitively resolved before any final decision is made on the loan.

Very truly yours,

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