

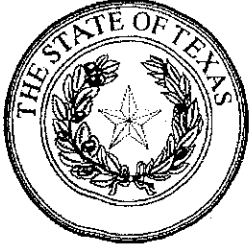
State Board of Education

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October 11, 2007

Honorable Greg Abbott
Texas Attorney General
P.O. Box 12548
Austin, Texas 78711

FILE # 11-45397-07

I.D. # 45397

RQ-0638-GA

Re: Opinion Request regarding the Constitutionality of Provisions of HB3699 and Related Questions

Dear General Abbott:

I am writing as Chair of the State Board of Education ("SBOE") to ask for your opinion regarding several issues involving the management of the Permanent School Fund ("PSF"), including the constitutionality of Section 51.413 of the Texas Natural Resources Code, as adopted by HB3699, 80th Legislative Session¹. That section purports to authorize the Texas School Land Board ("SLB") to transfer proceeds from the sale of land held within the PSF to the Available School Fund ("ASF"). Our board is very concerned that such a transfer under Section 51.413 may violate several provisions of the Texas Constitution.

The PSF appears to be established under three different sections of the Texas Constitution. Article VII, Section 2 refers to the "Perpetual School Fund", Article VII, Section 4 refers to the "Public Free School Fund" and Article VII, Section 5 to the "Permanent School Fund". While different terms are used, we understand that there is only one fund, consisting of lands dedicated to the support of public education and investments derived from the proceeds of the sale of such lands and will refer to a single "PSF" in this request. See, Texas Attorney General's Opinion DM-316 (1995)².

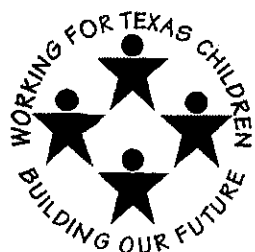
My first question is whether the Perpetual School Fund, the Public Free School Fund and the Permanent School Fund referred to in Sections 2, 4 and 5 of Article VII of the Texas Constitution constitute a single fund.

We understand the PSF to be managed by two entities, the School Land Board and the State Board of Education³. The School Land Board is entrusted

¹ Conforming changes consistent with Section 51.413 were also made to Section 51.412(a) and should be considered part of this request, as well.

² That opinion relies in part on 2 GEORGE D. BRADEN, THE CONSTITUTION OF THE STATE OF TEXAS: AN ANNOTATED AND COMPARATIVE ANALYSIS, 510 (1977). The reference to Article VII, Section 4 within Section 5 following the 2003 amendment to the latter section also argues for an understanding by the voters that the fund referred to in both sections is one and the same.

³ The School Land Board, together with the Texas Land Commissioner, manage lands originally dedicated to the fund and acquired with proceeds from the sale of such lands under Chapter 51 of the Natural Resources Code. The State Board of Education is directly granted authority to manage the investment assets of the PSF under Article VII, section 5 of the Texas Constitution, with additional statutory guidance in Chapter 43, Texas Education Code.



with lands dedicated to the PSF pursuant to Article VII, Section 4 of the Texas Constitution:

The lands herein set apart to the Public Free School fund, shall be sold under such regulations, at such times, and on such terms as may be prescribed by law; and the Legislature shall not have power to grant any relief to purchasers thereof. The proceeds of such sales must be used to acquire other land for the Public Free School fund as provided by law or the proceeds shall be invested by the comptroller of public accounts, as may be directed by the Board of Education herein provided for, in the bonds of the United States, the State of Texas, or counties in said State, or in such other securities, and under such restrictions as may be prescribed by law; and the State shall be responsible for all investments.

As proceeds from the sale of lands are transferred to the State Board of Education, they are invested pursuant to Article VII, Section 5(f).

(f) Notwithstanding any other provision of this constitution, in managing the assets of the permanent school fund, the State Board of Education may acquire, exchange, sell, supervise, manage, or retain, through procedures and subject to restrictions it establishes and in amounts it considers appropriate, any kind of investment, including investments in the Texas growth fund created by Article XVI, Section 70, of this constitution, that persons of ordinary prudence, discretion, and intelligence, exercising the judgment and care under the circumstances then prevailing, acquire or retain for their own account in the management of their 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.

While the SLB is not subject to a constitutional standard for management of its land, we assume that body is subject to a very similar "prudent person" standard in managing land under Section 163.004 of the Texas Property Code⁴. Both bodies have traditionally managed their portions of the PSF as separate portfolios of assets. The SBOE has begun a process of asset allocation to diversify the PSF assets under their management⁵. Among the asset classes considered by the SBOE is investment in real estate, which has raised questions about the relationship, if any, of such investments with those managed by the SLB.

Assuming your answer to my first question is "yes", my second question is whether the SBOE and/or the SLB may consider the investments made by the other body when executing their investment activities under their respective fiduciary standards.

Assuming your answer to my second question is "yes", my third question is whether either or both the SBOE and SLB is required, consistent with their respective fiduciary standards, to consider the overall holdings of the PSF managed by both entities in making investments within their respective portfolios?

⁴ Chapter 51 of the Texas Natural Resources Code also contains detailed direction for the management and disposition of PSF lands.

⁵ In July 2006, the SBOE established the following asset allocation: Large Cap US Equity (24%), Small / Mid Cap US Equity (7%), Large Cap International Equity (14%), Small / Mid Cap International Equity (4%), Emerging Markets Equity (4%), Fixed Income (19%), Real Estate (6%), Real Return (6%), Absolute Return (10%), and Private Equity (6%). The SBOE has invested in the Large Cap US Equity, Small/Mid Cap US Equity, Large Cap International Equity, Fixed Income, and Emerging Markets categories and is scheduled to select managers for the Absolute Return category in November, 2007. The SBOE has taken no action at this time to invest in the Small/Mid Cap International Equity, Real Estate, Real Return and Private Equity categories.

My next questions deal with the provisions of Section 51.413 of the Natural Resources Code, as enacted by HB3699. That section purports to authorize the SLB to transfer funds directly to the ASF:

Sec. 51.413. TRANSFERS FROM THE REAL ESTATE SPECIAL FUND ACCOUNT TO THE AVAILABLE SCHOOL FUND AND THE PERMANENT SCHOOL FUND. The board may, by a resolution adopted at a regular meeting, release from the real estate special fund account funds previously designated under Section 51.401 of this chapter or managed, used, or encumbered under Section 51.402 or Section 51.4021 of this chapter to be deposited in the State Treasury to the credit of: (1) the available school fund; or (2) the State Board of Education for investment in the permanent school fund.

The composition of the PSF and ASF are defined in Subsection 5(a) of Article VII:

(a) The permanent school fund consists of all land appropriated for public schools by this constitution or the other laws of this state, other properties belonging to the permanent school fund, and all revenue derived from the land or other properties. The available school fund consists of the distributions made to it from the total return on all investment assets of the permanent school fund, the taxes authorized by this constitution or general law to be part of the available school fund, and appropriations made to the available school fund by the legislature. The total amount distributed from the permanent school fund to the available school fund: (1) in each year of a state fiscal biennium must be an amount that is not more than six percent of the average of the market value of the permanent school fund, excluding real property belonging to the fund that is managed, sold, or acquired under Section 4 of this article, on the last day of each of the 16 state fiscal quarters preceding the regular session of the legislature that begins before that state fiscal biennium, in accordance with the rate adopted by: (A) a vote of two-thirds of the total membership of the State Board of Education, taken before the regular session of the legislature convenes; or (B) the legislature by general law or appropriation, if the State Board of Education does not adopt a rate as provided by Paragraph (A) of this subdivision; and (2) over the 10-year period consisting of the current state fiscal year and the nine preceding state fiscal years may not exceed the total return on all investment assets of the permanent school fund over the same 10-year period.

The ASF consists in part of the biennial distribution made to it under the procedure set out in Article VII, Section 5(a)⁶. That process was adopted by the voters at an election in September, 2003 to convert the distribution from the PSF to the ASF from one based on income and dividends to a "total return" basis. The current process distributes a percentage of the PSF's "market value", exclusive of real property managed under Article VII, Section 4. It is the SBOE's position that this process approved by the voters in 2003 is the only means by which assets of the PSF may be distributed to the ASF.

We understand that two arguments were advanced during the legislative session for the constitutionality of Section 51.413: that it would constitute an "appropriation" of the real estate assets of the PSF, and that a distribution could be made from the SLB-managed real property to the extent that property constitutes a part of the "investment assets" of the PSF eligible for distribution, distinct from the "market value" the SBOE is authorized to distribute to the ASF.

⁶ Additional amounts are dedicated to the ASF by Article VIII, Section 7-a of the Texas Constitution. Other state taxes have in the past also been statutorily dedicated to the ASF.

Your office has previously ruled that the Legislature has no authority to appropriate real property assets of the PSF. Attorney General's Opinion M-347 (1969) held that proposed legislation that would appropriate mineral royalties directly to the ASF would violate Sections 2, 4 and 5 of Article VII⁷:

Thus, by virtue of the provisions of Sections 2, 4 and 5 of Article VII of the Constitution of Texas, all proceeds arising from a sale (or mineral lease) of any part of the land dedicated to the permanent school fund must be deposited in the permanent school fund, as such fund is constitutionally protected. From 1891 until 1964, one percent (1%) annually of the total value of the permanent school fund could have been transferred to the available school fund; however, this authorization to transfer was removed with the adoption of the amendment to Section 5 of Article VII... Subsequent to that date, no part of the permanent school fund is authorized to be transferred.

The reasoning of Attorney General's Opinion M-347 is correct and precludes any transfer of funds to the ASF, except by means of the process adopted by the voters in Article VII, Section 5. Article VII Section 2 requires "all sums that may come to the state from the sale" of lands dedicated to the PSF to be held within that fund. Section 4 of the same article requires ("must be used") the "proceeds" of sales of land to be applied to one of two specific uses: either the purchase of additional land for the PSF or transfer to the SBOE for investment. There is no provision in the Texas Constitution that authorizes a transfer from the PSF to the ASF outside of the process adopted in Article VII, Section 5(a) by which the SBOE determines a percentage of the market value of the PSF⁸. It is particularly persuasive that the voters amended the Texas constitution in 1964 to expressly repeal a limited authorization to transfer funds from the PSF to the ASF by legislative action⁹.

The term "appropriation" is used three times in Article VII, Section 5. Subsection 5(a) describes the ASF as including "appropriations made to the [ASF] by the Legislature" but does not authorize a source of funds for appropriation. Subsection 5(b) provides for the expenses of managing the assets of the PSF "shall be paid by appropriation from the [PSF]". That subsection contains no authorization to appropriate the assets of the PSF for any other purpose. Subsection 5(c) dedicates the ASF to the "support of the public free schools" and prohibits the appropriation of the PSF or ASF "to any other purpose" except those authorized in Section 5. The prohibition in Section 5(c) restricts the purpose of any appropriation of the ASF or PSF to those specifically referenced in Section 5; it does not authorize an appropriation or transfer of assets in the PSF to the ASF.

We understand that an argument may have been made during the legislative session that the PSF lands managed by the GLO are part of the "investment assets" of the PSF available for distribution to the ASF under Article VII, Section 5(a), yet not part of the "market value" to which the SBOE is authorized to apply a percentage for distribution to the ASF. While it is true that Section 5 uses both of those terms, the relationship of the investment assets as defined in Section 5 and the real property managed under Section 4 was addressed by your office in Texas Attorney General's Opinion GA-516 (2007). That opinion considered whether cash proceeds from the sale of land held by the General Land Office for reinvestment in other real property should be included in the market value of the PSF to which the percentage distribution is applied. That opinion held that "investment

⁷ See also Texas Attorney General's Opinion M-356 (1969) dealing with a similar question.

⁸ That same section allows the Legislature to determine a percentage should the SBOE fail to do so. Section 5 of Article VII also authorizes appropriation of the PSF for the expenses of the management of the PSF, discussed below.

⁹ Acts, 58 Leg., R.S., S.J.R. 6, amending Article VII, Section 5 as discussed in Attorney General's Opinion M-347 above.

assets" as that term is used in Article VII, Section 5(a) is limited to assets managed by the SBOE:

The meaning of the term "investment assets" in section 5 is revealed by section 5(f), which provides that "in managing *the assets of the [PSF]*, the [Board] may acquire,....sell..., or retain...any kind of investment" that a prudent person under the prevailing circumstances would acquire or retain. *Id.* Sec. 5(f) (emphasis added). "Investment assets" with respect to which the ASF distribution is calculated and generally addressed by Article VII, Section 5 are thus the assets subject to the investment control and management of the Board. ... Funds held by the Land Office in the state treasury for purchase of additional real property are simply not under the Board's investment management and control.

Thus, the definition of "investment assets" available for distribution to the ASF does not include the proceeds from the sale of real property managed under section 4.

Finally, the analysis of the constitutional amendment placed before the voters in 2003 is utterly silent concerning any possibility that funds would be distributed to the ASF except by the percentage determination set out in Article VII Section 5(a)(1):

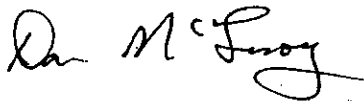
Analysis of Proposed Amendment:

The proposed amendment amends Section 5, Article VII, Texas Constitution, to allow the State Board of Education or the legislature to determine the amount distributed from the permanent school fund to the available school fund from a portion of the "total return," including capital gains, on all investment assets of the permanent school fund. The amendment places limits on the portion of total return that may be transferred to the available school fund and provides for payment from the permanent school fund of the expenses of managing permanent school fund assets.¹⁰

My fourth question is whether the SLB may constitutionally transfer funds to the ASF under the authority of Section 51.413 or any other provision of law.

We appreciate your attention to this matter. Should you need any additional information, please feel free to contact me or the following TEA staff: David Anderson, General Counsel or Holland Timmins, PSF Executive Administrator.

Sincerely,



Don McLeroy, D.D.S.
Chair, Texas State Board of Education

¹⁰ Analysis of Proposed Constitutional Amendments, Texas Legislative Counsel, July 2003, available at <http://www.tlc.state.tx.us/subsconamend/analyses03/analyses03.pdf>.