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Opinion No. 07-125

Application of Article II, Section 29, of the Tennessee Constitution to Local Government Investing in Mutual Fund Organized as Business Trust

QUESTION

Whether Article II, Section 29, of the Tennessee Constitution applies to a local government investing in a mutual fund organized as a business trust that invests in assets authorized under Tennessee law?

OPINION

Yes.

ANALYSIS

Article II, Section 29, of the Tennessee Constitution provides in part:

> [T]he credit of no County, City or Town shall be given or loaned to or in aid of any person, company, association or corporation, except upon an election to be first held by the qualified voters of such county, city or town, and the assent of three-fourths of the votes cast at said election. Nor shall any county, city or town become a stockholder with others in any company, association or corporation except upon a like election, and assent of a like majority.

The issue is whether this constitutional provision requires an election with the necessary affirmative vote before a local government may invest in a mutual fund organized as a business trust that invests in assets authorized under Tennessee law. As acknowledged in your letter, this Office has previously opined that it does.[1] The opinion request asks us to revisit this question and provides information from an investment company seeking to do business with Tennessee municipalities. This company maintains that investment by a local government in a mutual fund organized as a business trust (and which invests in assets otherwise authorized under Tennessee law) is the equivalent of direct investment in the underlying assets of the business trust, and thus, not prohibited by Article II, Section 29, of the Tennessee Constitution. As explained below, we do not agree.

[1] Op. Tenn. Att'y Gen. U91-117 (September 4, 1991).

To analyze the issue at hand, it is first necessary to consider the nature of business trusts. A business trust, also referred to as a "Massachusetts trust" or "common-law trust," is not a traditional trust. *Morrissey v. Commissioner of Internal Revenue*, 296 U.S. 344, 357, 56 S.Ct. 289, 295, 80 L.Ed. 263 (1935); *In Re Carriage House*, 120 B.R. 754, 762 (Bankr. D. Vt. 1990). A business trust's primary purpose is to conduct business for profit, while the object of a traditional trust is to hold and conserve particular property. *Id*. The business trust originated in Massachusetts as a way of organizing a business to avoid state law requiring a special act of the legislature to obtain corporate charters for businesses acquiring and developing real estate. *State Street Trust Co. v. Hall*, 41 N.E.2d 30, 34 (Mass. 1942).

A business trust is an unincorporated business organization created by an instrument by which property is held and managed by trustees for the benefit and profit of persons who hold transferable shares, which are issued by the trustees to evidence such persons' beneficial interests in the trust property. *Hecht v. Malley*, 265 U.S. 144, 146-47, 44 S.Ct. 462, 463, 68 L.Ed. 949 (1924); *State Street Trust*, 41 N.E.2d at 35. Legal title to the capital of the organization remains vested in the trustees. *Morriss v. Finkelstein*, 127 S.W.2d 46, 49 (Mo. Ct. App. 1939); *see generally Sternberger v. Glenn*, 175 Tenn. 644, 650 (1940) (trust implies two estates or interests — one equitable and one legal; one person holds the legal title, while another has the beneficial interest).

A business trust possesses many characteristics of an association, including centralized control, beneficial shares, a distinct legal existence provided by the declaration of trust, a limitation of liability, profit motivation, and the ability of shareholders to remove the trustees with or without cause. *Jim Walter Investors v. Empire-Madison, Inc.*, 401 F.Supp. 425, 428-29 (N.D. Ga. 1975). A business trust also has many characteristics of a corporation. While a business trust is not incorporated like a corporation, the courts have recognized many similarities. *Richardson v. Clarke*, 364 N.E.2d 804, 807 (Mass. 1977); *Swartz v. Sher*, 184 N.E.2d 51, 53 (Mass. 1962). In *State Street Trust*, the Court noted:

> [The business trust] possesses many of the attributes that are characteristic of a corporation. Title to property in one case is held by the corporation and in the other by trustees; centralized management is effected in one by a board of directors and in the other by trustees; the continuity of both the corporation and the trust is uninterrupted by the death of a stockholder or shareholder; the transfer of beneficial interests in both is readily and easily accomplished by the transfer of the shares and the shareholders in each seek limited personal liability. The sum total of these distinctive features of a business trust has brought trusts into such close resemblance to corporations that they have been frequently considered as corporations, sometimes by virtue of constitutional or statutory provisions and sometimes without such provision.

State Street Trust, 41 N.E.2d at 33. Similarly, in *Richardson*, 364 N.E.2d at 807, the Court observed that business trusts possess many of the attributes of corporations and, thus, cannot be governed solely by the rules that have evolved for traditional trusts.

The courts have also noted a strong similarity between the interests of a corporate shareholder and the certificate holder or shareholder of a Massachusetts business trust. *Goodhue v. State Street Trust Co.*, 165 N.E. 701 (Mass. 1929); *Kennedy v. Hodges*, 102 N.E. 432 (Mass. 1913). In *Goodhue*, the Court stated:

> The certificate holder is at least the owner of an undivided equitable interest in the property held by the trustee. There is in principle in this respect no distinction between such certificates and certification for shares in a domestic corporation.

Goodhue, 165 N.E. at 704; *see also Hecht*, 265 U.S. at 147, 44 S.Ct. at 463 (certificates for shares of a business trust resemble certificates for shares of stock in a corporation and are issued in a like manner, and they entitle the holders to share ratably in the income of the property and, upon termination of the trust, in the proceeds).

Additionally, the Bankruptcy Code treats a business trust as a corporation for purposes of declaring bankruptcy. In finding that a business trust could be adjudicated bankrupt on a voluntary or involuntary petition, courts have reasoned that the Bankruptcy Code defines the term "person" to include the word "corporation," and "corporation," in turn, is defined to include unincorporated companies and associations, and any business conducted by trustees wherein beneficial interests are evidenced by certificates or other written instruments issued to those participating in the trust fund.[2] *Associated Cemetery Management, Inc. v. Barnes*, 268 F.2d 97, 101 (8th Cir. 1959); *Re Universal Clearing House Co.*, 60 B.R. 985, 991 (Bankr. D. Utah 1986). Consequently, shareholders of a business trust are treated the same as shareholders in a corporation in bankruptcy.

Recognizing these characteristics of the business trust and the varied treatment of these trusts in other states, the General Assembly enacted the "Massachusetts Trust Act of 1961," Tenn. Code Ann. §§ 48-101-201, *et seq*., to govern business trusts in Tennessee. *See generally* Wheeler A. Rosenbalm, *The Massachusetts Trust*, 31 Tenn. L. Rev. 471 (1964). In Tenn. Code Ann. § 48-101-202(a), the General Assembly defined a Massachusetts trust as follows:

> A Massachusetts trust is an unincorporated business association created at common law by an instrument under which property is held and managed by trustees for the benefit and profit of such persons as may be or may become the holders of transferable certificates evidencing beneficial interests in the trust estate, the holders of which certificates are entitled to the same limitation of personal liability extended to stockholders of private corporations.

Then, in Tenn. Code Ann. § 48-101-203, the General Assembly emphasizes the business trust's status as an association by stating: "A Masschusetts trust is permitted as a recognized form of association for the conduct of business within the state of Tennessee."

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[2] 11 U.S.C. §§101(9)(A)(v), (41).

Additionally, Tenn. Code Ann. § 48-101-207 makes a large amount of corporate law applicable to this type of unincorporated business association. It states:

> Any Massachusetts trust shall be subject to such applicable provisions of law, now or hereafter enacted, with respect to domestic and foreign corporations, respectively, as relate to the issuance of securities, filing of required statements or reports, service of process, general grants of power to act, right to sue and be sued, limitation of individual liability of shareholders, rights to acquire, mortgage, sell, lease, operate and otherwise to deal in real and personal property, and other applicable rights and duties existing under the common law and statutes of this state in a manner similar to those applicable to domestic and foreign corporations.

Tenn. Code Ann. § 48-101-207.

Returning now to Article II, Section 29, this constitutional provision applies whenever a county, city, or town "becomes a stockholder with others in any company, association or corporation." Under the "Massachusetts Trust Act of 1961," a business trust is unequivocally designated as an "association." The Act also subjects business trusts to state corporate laws. Furthermore, the Act specifically acknowledges that a person's interest in the business trust estate is merely beneficial and evidenced by the transferable certificate that the person holds. In other words, that person is a mere shareholder. Legal title to the business trust estate is vested in the trustees. The provision of Article II, Section 29, at issue was present in the Tennessee Constitution when the "Massachusetts Trust Act of 1961" was enacted. Accordingly, it is our opinion that the General Assembly intends business trusts to be included in Article II, Section 29's proscription. *See Ragsdale v. City of Memphis*, 70 S.W.3d 56, 71-72 (Tenn. 2001) (provisions of the Tennessee Constitution are well known, and the legislature is presumed to know the existing law when it enacts new legislation).

Furthermore, it is our opinion that including business trusts within Article II, Section 29's ambit would be consistent with the intent of the framers of the Tennessee Constitution. *See Gaskin v. Collins*, 661 S.W.2d 865, 867 (Tenn.1983) (when construing a constitutional provision, the court must give effect to the intent of the people who adopted it). Originally, Article II, Section 29, as it appeared in the Constitution of 1835, consisted of only the first sentence of the current version of Article II, Section 29.[3] The prohibition at issue here was added in 1870 during Reconstruction.

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[3] The first sentence of Article II, Section 29, provides:

> The General Assembly shall have power to authorize the several counties and incorporated towns in this State, to impose taxes for County and Corporation purposes respectively, in such manner as shall be prescribed by law; and all property shall be taxed according to its value, upon the principles established in regard to State taxation.

Tennessee, like many other states, added this provision to its Constitution to prevent counties, cities, and towns from becoming burdened by debt resulting from "public financial support of privately sponsored 'internal improvements.'" *The Eye Clinic v. Jackson-Madison County General Hospital*, 986 S.W.2d 565, 570 (Tenn. Ct. App. 1999) (citing Lewis A. Laska, *A Legal and Constitutional History of Tennessee*, 1772-1972, 6 Mem. St. L. Rev. 563, 640-41 (1976)). The adoption of such provisions represented the reaction of public opinion to the dissipation of public funds by cities, counties, and towns in aid of the construction of railways, canals, and other like undertakings during the half century preceding 1880, and these provisions were designed primarily to prevent the use of public funds raised by general taxation in aid of enterprises apparently devoted to quasi-public purposes, but actually engaged in private business. *The Eye Clinic*, 986 S.W.2d at 570-71 (citations omitted).

In sum, the historical background of Article II, Section 29, reveals that the purpose of prohibiting a county, city, or town from becoming a stockholder in any company, association, or corporation was to prevent such entities from distributing taxpayer monies to private enterprises where such monies could be subject to the risk of loss. While the investment company that submitted information to you takes the position that owning shares of a business trust is the functional equivalent of actually owning the assets of a business trust, this is not accurate. As explained above, the trustees have legal title to a business trust's property. A shareholder of a business trust only has a certificate that evidences a beneficial interest in the assets of the business trust. In short, the certificate holder owns a share of a private business trust, which Article II, Section 29, was enacted to prevent.

Moreover, the ownership of these shares subjects the certificate holder to an entire set of business risks and variables different from those involved in actually owning the individual items that constitute the assets of the business. For instance, a business trust cannot guarantee that its net asset value will remain at a certain price per share. This is different from the actual purchase of United States Government securities, for example. The principal and interest of United States Government securities are guaranteed by the federal government or its agencies. Similarly, the yield on the shares of a business trust can vary depending upon market conditions and the transactions effected by the business trust. This is different from the interest on United States Government securities, which is guaranteed and does not vary once the security is purchased. Simply put, investment of taxpayers' dollars in business trusts would expose counties, cities, and towns to risks of loss that they do not face when they directly invest in government securities. Further, the risks can vary depending on the specific terms of the business trust involved. In addition, it should be noted that the level of risk could vary with the competence of the people operating any given business trust. The yield can (and does) vary between various business trusts investing in the same types of assets.

Another risk is personal liability of the certificate holder. While the Massachusetts Trust Act of 1961 expressly provides that certificate holders are to have the same limitation of personal liability as stockholders of a private corporation, it does not remove the possibility that the certificate holders of the business trust may be indirectly held personally liable in a derivative suit based upon

the trustee's rights to reimbursement or exoneration. Wheeler A. Rosenbalm, *The Massachusetts Trust*, 31 Tenn. L. Rev. at 481-84.

Perhaps the clearest and most serious example of the additional risk involved in investing in a business trust can be found in the bankruptcy law. Under the Bankruptcy Code, a business trust is treated as a corporation because of their many similarities, and the rights of shareholders of a business trust in bankruptcy are as limited as those of the shareholders of any corporation in bankruptcy.[4] In fact, there is the possibility that the business trust shareholders would receive nothing for their shares because of their rank behind other creditors.[5] This is clearly not the case when a county, city, or town directly purchases United States Government securities guaranteed by the federal government or its agencies.

For all of these reasons, it is the opinion of this office that Article II, Section 29, applies to business trusts. Consequently, a local government may not invest in a mutual fund organized as a business trust without first having an election resulting in the affirmative vote required by Article II, Section 29. *See McConnell v. City of Lebanon*, 314 S.W.2d 12, 17 (Tenn. 1957). The fact that a business trust's investments are limited to ones authorized by Tennessee law does not remove the election requirement. Article II, Section 29, does not speak in terms of requiring the election only for investments in private businesses that do not invest in government securities or investments otherwise authorized by Tennessee law. It speaks in absolute terms. It restricts the local government from becoming a stockholder in any company, association, or corporation without having the necessary election.

In the absence of the General Assembly's passing enabling legislation, it appears that any election held to permit a local government to invest in money market funds organized as a business trust would be constitutionally suspect. In *Berry v. Shelby County*, 201 S.W. 748 (Tenn. 1918), the Tennessee Supreme Court addressed the part of Article II, Section 29, that requires an election before a county, city, or town may lend its credit. In *Berry*, the Court found the statute authorizing the lending of the county's credit to be fatally incomplete and void because it did not also provide for the election required by Article II, Section 29. *Berry*, 201 S.W. at 749. The Court stated:

> An election cannot be held unless its holding be directed by law. The Constitution does not order it. It only makes the election a condition of the validity of the lending

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[4] As mentioned earlier, the Bankruptcy Code's definition of "person" includes corporations, and the definition of "corporation," in turn, includes business trusts. 11 U.S.C. §§101(9)(A)(v), (41).

[5] The rights of shareholders to business trust assets are placed behind those of secured creditors and behind those of all the unsecured creditors given priority under 11 U.S.C. §726. It is thus not uncommon for there to be little or nothing left to satisfy the claims of the shareholders of a corporation or a business trust. It is true that these rules cover Chapter 7 liquidations, but provisions in the other bankruptcy chapters prevent any dissenting creditor from receiving less than it would under a Chapter 7 liquidation. 11 U.S.C. § 1129(a)(7).

> of the aid of the county or city. It seems clear that the act authorizing the lending of credit should provide for the election; otherwise it is fatally incomplete and is void.

Id. at 751.

This Office has followed this reasoning in two opinions. Op. Tenn. Att'y Gen. U89-80 (June 20, 1989); Op. Tenn. Att'y Gen. U89-28 (March 30, 1989). Both of these opinions addressed the possible issuance of capital outlay notes under Tenn. Code Ann. § 9-21-601 to fund a lending of credit that was subject to Article II, Section 29. Both opinions stated that this could not be done because Tenn. Code Ann. § 9-21-601 does not provide for the election required by Article II, Section 29.

Applying *Berry* to the current situation,[6] it appears that the same result is dictated. To explain, Tenn. Code Ann. § 5-8-301 lists the permissible investments of idle funds by counties, and Tenn. Code Ann. § 6-56-106 lists the permissible investments of idle funds by municipalities. Neither statute lists mutual funds as a permissible investment. Each statute, though, does contain a catchall phrase. Tenn. Code Ann. § 5-8-301(b) provides that "counties are authorized to invest in the investment instruments noted in this section or as otherwise provided in the charter of those counties that have adopted a charter form of government pursuant to chapter 1, part 2 of this title," and Tenn. Code Ann. § 6-56-106(a)(10)(A) provides:

> (a) In order to provide a safe temporary medium for investment of idle funds, municipalities are authorized to invest in the following:
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> * * * *
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> (10)(A) Investment in the instruments set forth in subdivision (a)(2), (a)(5), (a)(7), or any type of investment authorized pursuant to a municipality's charter that is of a type that is not included in this part shall require the following:
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> (i) The municipality's legislative body must authorize the investment by ordinance; and
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> (ii) The legislative body must adopt a written enforceable investment policy by ordinance to govern the use of investments, with the policies being no less restrictive than those established by the state funding board to govern state investments in these types of instruments.
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> (B) Investment in instruments covered by this subdivision (a)(10) shall be prohibited until the legislative body has adopted written policies to govern the use of the investments or an ordinance has been passed to authorize the investment.

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[6] For a county, city, or town to become a stockholder in a company, corporation, or association, Article II, Section 29, requires a "like" election as that required for a county, city, or town to lend its credit. Therefore, it would appear that *Berry* applies here.

Neither of these catchall provisions provides authority for the election required by Article II, Section 29. Consequently, local governments may not use these statutes to invest in mutual funds organized as business trusts, because they do not provide for the election required by Article II, Section 29. *See Berry*, 201 S.W. at 749. Elections held by counties, cities, or towns without legislative direction or authority are futile. *Jarrolt v. Moberly*, 103 U.S. 580, 587-88 (1880).

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