Opinion No. 62-46

March 22, 1962

BY: OPINION OF EARL E. HARTLEY, Attorney General Boston E. Witt, First Assistant Attorney General

TO: Mr. Robert D. Castner, State Auditor, State Capitol Building, Santa Fe, New Mexico

QUESTION

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1. "Does the State Investment Council have the authority to establish a suspense fund as was done with the First National Bank of Santa Fe, New Mexico?

2. "Was the so-called 'bond exchange' in fact an exchange of bonds and/or securities, or rather was it

a. a sale of bonds and/or securities and

b. a purchase of bonds and/or securities?"

CONCLUSIONS

1. Yes.

2. See analysis.

OPINION

ANALYSIS

We have taken the liberty of discussing your question in reverse order.

Before dealing with the legal perplexities of the questions posed, it might be well to set forth the facts of the transaction so as to more clearly understand the problems concerned.

On or about the tenth day of January, the council entered into a transaction wherein it agreed to transfer to a group of securities brokers, who had bid as a syndicate, a package of bonds issued by political subdivisions of this state. These bonds had a total aggregate par value of $ 6,486,500. They were carried on the books of the council at cost, being $ 6,447,733.47. The syndicate of brokers agreed to transfer to the council in return the sum of $ 5,939,791.96 cash, which sum was deposited in an "escrow account" established by the Department of Finance and Administration. The council

then took the cash so deposited and went into the open market and purchased other bonds of various kinds. These bonds purchased had a par value totaling exactly the par value of the bonds disposed of. The cost assigned to the bonds acquired was the cost of the bonds disposed of, i.e., $ 6,447,733.47.

There is no evidence that these transactions were entered into on a basis other than complete good faith by the council and the investment officer. We do not want it implied from what we say herein that we are suggesting otherwise. Our goal is to determine whether the transaction was in fact an exchange and, if so, whether a loss has occurred within the meaning of Section 7, Article XII, New Mexico Constitution, which reads in part:

". . . all losses from such interest-bearing notes or securities which have definite maturity dates shall be reimbursed by the state."

That the securities involved were interest-bearing securities with definite maturity dates is beyond question. Bonds are securities bearing interest. **The Commissioner of Internal Revenue v. H. P. Hood & Sons,** 141 F.2d 467, 469. They are also securities having a fixed maturity date. **Gural v. Engle,** 128 N. J. L. 252, 25 A. 2, 257, 260.

In determining whether these transactions were, in fact, an exchange, we must consider the word "exchange" in its ordinary sense as accepted by the business world. **Wener v. Commissioner of Internal Revenue,** 242 F.2d 938.

The courts of the various jurisdictions of the United States have had occasion to define the word exchange many times. The highest court of this state has not, however, passed upon the legal definition of this term. We must, therefore, turn to the cases from other jurisdictions for its definition. The courts of the federal court system have, on numerous occasions, defined the term for income tax purposes, since it is found frequently in the Internal Revenue Code. We consider these cases especially significant in view of the close proximity to the facts involved herein.

The courts have shown unusual solidarity in defining the word "exchange" as a transfer of property for property, or for some value other than money. **Burger-Phillips Company v. Commissioner of Internal Revenue,** C.C.A. Alabama 126 F, 2d 934, 936. So, it can be said that an exchange is the act of giving or taking something in return for something else regarded as an equivalent; it relates to a mutual giving and receiving of commodities **without** the intervention of money. **U.S. v. Paine,** 31st Fed. Supp. 898, 900. The courts have said that the word is a term of art and is a word of precise import, meaning the giving of one thing for another, requiring the transfers to be in kind and excluding transactions into which money enters either as consideration or as a basis of measure. **Trenton Cotton Oil Company v. Commissioner of Internal Revenue,** 147 F.2d 33, 36. **The U.S. v. Rodenbough,** 21st F.2d 781. **Hoovel v. State,** 125 Tex. Cr. R. 545 69 SW 2d 104. **Long v. Fuller,** 21 Wisc. 121, 124, **Topzant v. Koshe,** 242 Wisc. 585, 9 N. W. 2d 136, 138. **Badgett v. U.S.,** 157 Fed. Supp. 120. **State v. Brown,** 83 Ark. 44, 102 S. W. 2d 394, 395.

The criterion for determining whether the transaction is a sale or exchange is whether there is a determination of value of either property and, if no price is set for either property, there is an exchange. **Gruver v. Commissioner of Internal Revenue,** 142 Fed. 2d 363, 366.

The courts consider an exchange to be a contract between two parties by which the parties mutually give, or agree to give, one thing for another; the thing or both things not being money. **Steere and Ballah v. Gingery,** 21 N. Dak. 183, 110 N. W. 774, 775. **Colgan v. Farmers and Mechanics Bank,** 59 Ore. 469, 114 Pac. 460, 464. Likewise it has been said that:

"An exchange is an executed contract operating per se as a reciprocal conveyance of the thing given and the thing received in exchange. It enters into the very idea of an exchange that the thing given or taken in the exchange shall be specified and so distinguishable from the other things of like kind as to be clearly known and identified."

Preston v. Keene, 39 U.S. 133. And again that:

"An 'exchange' is a covenant **by which contractors give to one another** one thing for another, whatever it be except money, for, in that case, it would be a sale."

Dairyman's Liquid Coop. Association v. Metropolitan Casualty Insurance Co., 8 N. Y. Supp. 2d 403 412.

One recent case is of particular interest. It involved a case wherein a person desired to transfer certain shares of stock to a corporation in return for the shares of the corporation. However, he transferred the shares, in fact, to another corporation which was later merged with the corporation destined to receive the stock. The federal court said that the intervention of a third party in the transaction took it out of the realm of an exchange -- a case not unlike the one at hand. See **Morgan v. Helvering,** 117 Fed. 2d 334.

Having satisfied ourselves with the precise nature of the thing delineated "exchange," we now turn to the task of placing the transaction in question alongside the definition of an exchange to see if it is, in fact, an exchange or if, when all of the technical niceties are case aside, in truth two transactions have occurred -- a sale of securities and a purchase of securities.

It is evident from the facts set forth above that the procedure followed by the council involved more than two parties. It was not a transaction in which the council gave a package of securities to a syndicate in return for a package of securities. What in fact occurred was that the council delivered a package of bonds to the syndicate in return for cash. This, in our judgment, does not amount to an exchange. It was, as a matter of law, merely a sale. The fact that the council took the cash and placed it in a separate account in the bank and then purchased other securities with it is, in our opinion, irrelevant in determining whether in the first instance a sale or exchange occurred.

As we view the problem, the first transaction was consummated and became complete when the syndicate accepted the bonds and the council, acting on behalf of the state, accepted the cash. The contention will, I am sure, be advanced that the transaction was not complete inasmuch as one issue of bonds originally transferred to the syndicate was returned after the cash had been received. We view this merely as a return of unacceptable securities. The council had agreed with the syndicate to the return of any securities within 30 days, if a legal defect was found to exist. We do not view this as any evidence of an exchange. Once we have decided that this transaction was a completed sale, as we must under the authority cited herein, then it becomes clear that the remaining action of the council was merely a purchase of securities on the open market.

For these transactions to have become an exchange, the council would have had to enter into a contract with the lowest bidding syndicate to exchange a package of designated bonds for another package of designated bonds from the bidding broker.

Whether or not the cash was placed in an escrow account and whether or not the account was legally established, as is discussed below, is in our judgment irrelevant to the determination of the transaction as a sale or an exchange.

The salient facts of the transaction that take it outside the scope of exchange are:

1. More than two parties were involved in the transaction -- sellers in the market place intervened between the transfer of the bonds by the council and receipts of other bonds by the council.

2. Cash was used in the transaction as a basis of measure, if not in fact as the consideration.

3. At the time of contracting, the bonds to be received by the council could not be distinguished from other things of like kind and, in fact, were not known and could not be identified.

4. Bonds received did not come from the person receiving the bonds from the council.

We hold that the action of the council was a sale of securities and a purchase of securities -- not an exchange of securities.

We turn now to the second portion of your second question which is by far the most troublesome problem posed. If the transactions were, in fact, a sale of securities and a purchase of securities, does it follow that a loss has been sustained within the meaning of Article XII, Section 7 of the Constitution? We think that it does.

Treating the two transactions separately -- as a sale and purchase -- it seems clear that the council sold securities with an assigned cost of $ 6,447,733.47 and received, in lieu thereof, cash totaling $ 5,939,791.96. This resulted in a difference of $ 507,941.51. In so far as the second transaction is concerned, the council purchased securities having a

total aggregate par value of $ 6,486,500 -- as indicated above, the exact par value of the securities disposed of -- for $ 5,939,791.96 cash.

In reaching the conclusion that a loss has occurred, we are not unmindful of the council's argument that even if the action was not an exchange, the two transactions taken together show that, in fact, no loss has occurred or will occur since, at the time the securities mature, the council will have exactly the same number of dollars, capital - investment - wise, that it had when it purchased the original securities. In support of this contention, it cites to us our letter opinion addressed to it, wherein we approved a procedure of operation and, in so doing, indicated that under that set of facts the transaction should be treated as a whole and, therefore, no constitutional loss occurred. We do not think that letter can solve our problem here. We were there concerned with but one instantaneous sale, whereas here we are presented with two separate transactions varying in kind as well as time. We think the two situations are distinguishable.

In rendering a decision on this set of facts, we also establish a precedent under which this and future councils will operate so we must think not only of today but also of tomorrow. We must think not only of this transaction but of all future transactions that will be conducted by this council and its successors.

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

We feel that were we to allow these two transactions to be placed together to create a fiction that no loss occurred from the sale and purchase, we would be opening the door to the eventual nullification of the constitutional requirement. To allow this procedure to be followed would, in our judgment, be tantamount to saying that the council can take a loss in any sale of securities if, at a subsequent time, the loss is made up by purchasing securities. The council would have us hold that if a purchase resulting in a net gain follows closely in time a sale resulting in a net loss, no constitutional loss is incurred. This argument falls of its own weight. First, it would do violence to the constitutional provision requiring losses to be reimbursed, making a nullity of it, and, secondly, we are unable to see as a matter of law how the question of time of a subsequent transaction can affect the fact of loss in any single transaction. How would one draw the line where

some subsequent transactions would offset the loss and some would not? Must the purchase be within one day of the loss? Must it be within one week of the loss? When? One can see that adoption of such a rule would lead only into a morass of legal entanglement that would result in the destruction of Article XII, Section 7.

Under the council's theory, a council could sell securities at a loss which would have to be made up by the state; then, at some subsequent time, if the council made a favorable purchase that resulted in a gain, the council could advance the proposition, as this council has, that the general fund has suffered for no reason since the loss was made up by another transaction and, in fact, the permanent funds for the entire period show a net gain at the expense of the general fund. Certainly, under the rule we establish, the permanent funds could show a net gain if two or more transactions be viewed together. However, we feel that is not the proper test to be used in applying the constitutional requirement. As we view this requirement, each transaction must meet it standing alone, and, if it does not, then the loss must be reimbursed even though over a series of transactions a net gain results to the permanent funds at the expense of the general fund. To decide otherwise would result in the destruction of the requirement.

The council points out that if this procedure is adopted, a council could wrongfully increase the capital account of the permanent funds at the expense of the general fund. We do not see in this remote possibility the great danger the council envisions. But assuming that such possibility exists, we prefer to accept that risk rather than the much greater risk of depletion of the trust by use of a procedure whereby the constitutional limitation is circumvented. We, therefore, are of the opinion that there was a loss in the constitutional sense that that it must be reimbursed by the state.

We must fit one more piece in the puzzle before it is solved. The question arises whether the reimbursement takes place **ipso facto** from the general fund or whether such reimbursement must be by legislative action. We feel the latter is correct. The only manner in which the constitutional provision in question could, in and of itself, amount to an appropriation from the general fund is if the provision is self executing. We think that it is not. The rule laid down by our Supreme Court as regards self executing provisions of the constitution is, as follows:

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

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

We leave this question by concluding that our opinion is:

1. The action of the council amounted to a sale and a purchase.

2. The action resulted in a loss within the meaning of Article XII, Section 7, but,

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

We recognize the serious consequences that can flow from our decision, and, thus, if the council should desire a court decision on these questions, we will cooperate in every way possible to effect a speedy decision.

2. You have asked whether the creation of a suspense fund by the investment council, as used in this transaction, is in accordance with law. Our answer is yes.

Section 11-2-3, New Mexico Statutes Annotated, 1953 Compilation reads in part, as follows:

". . . and provided further, that every official or person in charge of any state agency receiving any monies . . . in cash or by check, draft or otherwise, on deposit in escrow, or in evidence of good faith to secure the performance of any contract or agreement with the state of New Mexico, or with any department, institution or agency of the state of New Mexico, which said monies shall have not yet been earned so as to become the absolute property of the state shall deliver or remit to the state treasurer within the times and in the manner hereinbefore in this section provided, which money shall be by said state treasurer deposited in a suspense account to the credit of the proper official, person, board or bureau in charge of any state agency so receiving said monies; . . ."

This section specifically gives the state treasurer the authority to establish such a suspense fund for the benefit of the council. However, the mere fact of establishment of such an account is not evidence, in and of itself, of an exchange. The need for this account in the transaction herein discussed was because the council gave the syndicate a right to return within 30 days any bonds containing legal defects. If some bonds were returned, as actually happened, the money for those bonds could then be returned to the syndicate. This could not have been done had the money been credited directly to the permanent fund account. So, the establishment, or non-establishment, is not, in our judgment, necessarily evidence of an intention to have an exchange, as opposed to a sale.