DORSEY
DORSEY & WHITNEY LLP

CONFIDENTIAL LAWYER-CLIENT PRIVILEGE

File Memo

MEMORANDUM

TO: David Ewer, Director of Office and Budget and Program Planning

FROM: Dorsey & Whitney LLP
Joseph Gonnella

DATE: August 10, 2005

RE: Constitutionality of Montana Equity Capital Investment Act

Introduction

In its 2005 legislative session, the Montana Legislature enacted SB 133, which is to be cited as the "Montana Equity Capital Investment Act" (the "Act"). The Act authorizes the issuance of tax credits to guarantee a fixed rate of return to investors making investments in certain private investment funds intended to encourage economic development in Montana. You have asked us to review the constitutionality of the Act, particularly, whether under the Public Purpose Clause and the Appropriations Clause of the Montana Constitution, the State may use tax credits to guarantee a contractual rate of return to private investors to promote economic development.

Summary of the Act

The purpose of the Act is to benefit the State by attracting out-of-state venture investment funds interested in providing equity capital and near-equity capital to Montana businesses, to nourish a private seed and venture capital industry in Montana and to encourage lead local investors, all to strengthen the State's economy and build a significant, permanent capital resource to serve the needs of Montana businesses. (SB 133, Section 2) To achieve this purpose, the Act establishes the Montana Equity Capital Investment Board (the "Board"), a State board consisting of five members appointed by the Governor, and authorizes it to contract with a designated investor group to implement an investment plan approved by the Board. The designated investor group is to organize, capitalize and administer the Montana Equity Fund, and a sub-fund, the Montana Evergreen Fund, which are private investment funds. (*Id.*, Sections 4, 10) The designated investor group is also to contract with investors to provide capital for the Funds.

Investments made with the Montana Evergreen Fund are to be made in primary sector businesses headquartered in the State or having 50% of their gross sales receipts from products principally produced in the State or services provided from a Montana location. (*Id.*, Section 3(10)) In its contract with the Board, the designated investor group is to agree that its implementation plan for the Montana Equity Fund will provide that for every $1 invested by the

Economic Affairs Committee Meeting
September 9, 2005

Exhibit #4

Montana Equity Fund in its aggregate portfolio of fund investments, the designated investor group "shall seek to cause a minimum of $1 of equity capital or near-equity capital to be invested in Montana businesses or projects or primary sector businesses headquartered in the State or having 50% of their gross sales receipts from products principally produced in the State or services provided from a Montana location." (*Id.*, Section 10(2)) A "Montana business or project" means an entity with at least 50% of its employees or assets located in Montana. (*Id.*, Section 3(8)) "Equity capital" means stock or other ownership rights in a private business entity and "near-equity capital" means unsecured, undersecured, subordinated or convertible loans or debt securities. (*Id.*, Section 3(6), (11))

To encourage private individuals and entities to invest in the Funds, the Act authorizes the designated investor group to contract with investors for a scheduled return of capital and a rate of return on capital, which is guaranteed by certificates to be issued by the Board (the "Certificates"). (*Id.*, Sections 5(4), 8(6)(a)) The guaranteed return and rate of return are subject to approval by the Board and further circumscribed by a maximum rate of return imposed by the Act. (*Id.*, Section 5(4)) At the time of the investment, the Board is to issue a Certificate to the investor, which can be redeemed for tax credits. (*Id.*, Section 8) The Certificate is transferable and the Board is to establish, with the Department of Revenue, a system of registration for the tax credits. (*Id.*, Sections 6, 8) If the actual return or rate of return does not meet the scheduled return and rate of return in the contract, the holder is entitled to redeem the Certificate to reflect the difference in value as a tax credit against individual income taxes, corporation license taxes, or insurance premiums taxes. (*Id.*, Sections 8, 16, 17, 18) The amount of tax credits is limited by the Act to $60 million, a maximum of $12 million to be redeemed in a single year on a first-come, first served basis. (*Id.*, Section 8) A Certificate for tax credit may be carried forward for 12 years, but tax credits may not be claimed before July 1, 2010 or after July 1, 2031. (*Id*, Section 8(2), (5)). The Certificate is binding on the Board and the Department of Revenue once capital is provided to the Funds. (*Id.*, Section 8(10))

If the return on investment exceeds the scheduled rate of return, fees, reimbursement of expenses and up to 10% of net realized gains (which may be allocated to the designated investor group and specified investors), the excess amount (defined as "proceeds") is to be reinvested in the Montana Equity Fund until the Fund has invested or reserved for investment $60 million. (*Id.*, Sections 3(13), 10(6)) When this condition has been met, 75% of proceeds would then be distributed to the Montana Evergreen Fund and the remaining 25% to the State general fund until the Montana Evergreen Fund has invested or reserved for investment $60 million. (*Id.*, Section 10(6)(b)) Thereafter, all proceeds would be distributed to the State general fund. (*Id.*) Fifty years after organization of the Funds, all investments are to be liquidated and any proceeds deposited in the State general fund. (*Id.*, Section 10(8))

Although the Act may eventually increase State general fund revenues, it would not do so until after either or both Funds are capitalized at $60 million. So long as Certificates are outstanding, the Act requires the State to guarantee the scheduled return and rate of return of capital promised to private investors. Under this structure, the State is assuming part of the risk of investment in the Funds in return for proceeds resulting from a higher than expected rate of return and the economic development expected to result in the State from investments made by the Funds.

The Public Purpose Clause and the Appropriations Clause

Two provisions of the 1972 Montana Constitution appear to implicate the constitutionality of the Act: the Public Purpose Clause and the Appropriations Clause. The Public Purpose Clause stipulates that "[t]axes shall be levied by general laws for public purposes." (MONT. CONST., art. VIII, § 1 (1972)) The Appropriations Clause requires that "[n]o appropriation shall be made for religious, charitable, industrial, educational, or benevolent purposes to any private individual, private association, or private corporation not under control of the state." (MONT. CONST., art. V, § 11(5) (1972)) The two most recent cases decided by the Montana Supreme Court interpreting these two clauses unfortunately suggest that the Act may not pass constitutional muster. (For a more extended discussion of these two constitutional provisions and the confusing decisions that have interpreted them, see Ellingson, Mae Nan and Mahoney, Jerry C.D., *Public Purpose and Economic Development*, 51 MONT. L. REV. 356 (1990). We would be happy to forward to you a copy of the article at your request.)

In *Hollow v. State*, 222 Mont. 478, 723 P.2d 227 (1986), the Montana Supreme Court considered the constitutionality of legislation that authorized the Montana Economic Development Board (the "MEDB") to raise money for economic development projects through the issuance of revenue bonds. Prior law authorized the MEDB to issue its revenue bonds for economic development purposes, but those bonds were secured only by the revenues of the projects that were financed. The legislation at issue in *Hollow* authorized the MEDB to guarantee the payment of its revenue bonds or loans financed with such bonds with funds in the In-State Investment Fund in an effort to make the bonds more marketable and reduce the effective interest rate on loans to private businesses. Alternatively, the legislation allowed the MEDB to loan funds in the In-State Investment Fund to a capital reserve account securing revenue bonds of the MEDB or securing the guaranty of a financed loan. Funds in the In-State Investment Fund were derived in principal part from coal severance taxes.

The Court found the legislation unconstitutional under the Public Purpose Clause and the Appropriation Clause because the coal severance taxes in the In-State Investment Fund were used to "satisfy guaranties of private debts and obligations." (*Id.* at 485, 723 P.2d at 232) The Court offered no rationale for its holding and cited one case, *Veterans Welfare Comm'n v. VFW*, 141 Mont. 500, 379 P.2d 107 (1963), which invalidated the appropriation of public funds to pay the salaries of the secretaries of two private veterans' organizations. While the Court in an earlier case had held that economic development was a valid public purpose (presumably a linchpin for an analysis of these two constitutional clauses), at least for the expenditure of non-tax revenues (*Fickes v. Missoula County*, 155 Mont. 258, 470 P.2d 287 (1970)), the Court in *Hollow* failed to discuss this or any other precedent. Presumably, the Court's implicit rationale was that economic development, with the significant benefits it inevitably confers on private parties, is not a sufficient public purpose under the Public Purpose Clause and the Appropriation Clause for the pledge of tax revenues to state bonds.

The Court did, however, hold constitutional a contractual agreement that a future Legislature consider the appropriation of tax revenues to pay debt service on revenue bonds of MEDB or for deposit in the guarantee fund if other pledged revenues are insufficient (a so-called moral obligation pledge). This holding is consistent with *Huber v. Groff*, 171 Mont. 442, 558 P.2d 1124 (1976), in which the Court upheld a moral obligation pledge supporting revenue bonds issued by the Board of Housing. It is difficult to discern why the pledge of tax moneys to secure revenue bonds offends the Constitution but the appropriation of general fund moneys to pay debt service on revenue bonds does not, when the public purpose is identical in each instance. The Court simply stated, "What we do not and cannot condone is the direct use of tax monies by legislative provision which in effect directly pledges the credit of the state to secure the bonds involved in this case." (222 Mont. at 486, 723 P.2d at 232)

A case reaching a similar result, although not cited by the Court in *Hollow*, is *Hill v. Rae*, 52 Mont. 378, 158 P. 826 (1916) (state bonds issued to finance loans to farmers were valid since secured by mortgages on the farm lands of the borrowers, but guaranty fund to which the State had appropriated $20,000 to secure the bonds was invalid under the appropriation and loan of credit clauses). But other cases decided by the Court in the interim seem to be contrary to the decision in *Hollow*. For example, the Court in *Douglas v. Judge*, 174 Mont. 32, 568 P.2d 530 (1977), decided nine years before *Hollow*, upheld under the Public Purpose Clause and the Appropriations Clause legislation authorizing the use of proceeds of State general obligation bonds (directly secured by tax revenues) to fund loans to be made by the Board of Natural Resources to farmers and ranchers.

The second recent case is *White v. State*, 233 Mont. 81, 759 P.2d 971 (1988), decided two years after *Hollow*. There, the Court considered the constitutionality of legislation that authorized a Science and Technology Development Board (the "Technology Board") to issue revenue bonds and apply the proceeds to make investments in seed capital, start-up capital and expansion capital projects for qualifying science and technology companies and to invest in "certified Montana capital companies" making technology investments, again for the purpose of furthering economic development in the State. The bonds of the Technology Board were payable from income received by the Board from its investments and, to the extent such income was insufficient, coal severance tax revenues.

The plaintiffs argued that the legislation was unconstitutional under the Appropriations Clause because the investments ultimately benefited private individuals and the appropriations were not to entities under control of the State, relying on *Hollow* and *Hill*. (233 Mont. at 85, 759 P.2d at 973) The defendants argued that the tax revenue used to secure the bonds was appropriated to the Technology Board, which was under control of the State, and that the ultimate destination of the funds did not matter under the Appropriations Clause, relying on *Grossman v. State Department of Natural Resources*, 209 Mont. 427, 682 P.2d 1319 (1984) (upholding loans of the Department of Natural Resources to local government entities to finance hydroelectric projects some of which were to be leased to private companies and cooperatives), and *Huber v. Groff*, cited above (upholding the purchase of home mortgage loans by the Board of Housing). (759 P.2d at 973-74) After acknowledging that the money appropriated to the Board would be appropriated to an entity under the control of the State, the Court noted that "the significance of this argument would diminish greatly once bonds were issued." (*Id.* at 86, 759 P.2d at 974) The Court instead focused on the pledge of the coal severance tax and held that it

was impermissible because the legislation "in effect pledge[d] the credit of the state to secure the bonds issued by the [Technology] Board, the proceeds of which are to be used for the benefit of private businesses." (*Id.* at 87, 759 P.2d at 974) Thus, the principle relied on in *Grossman* and *Huber* under the Appropriations Clause (that funds were initially appropriated to an entity under control of the State) was deemed limited by the decision in *Hollow*, at least if the pledge of the credit of the State (or tax revenues) was involved.

As in *Hollow*, the Court in *White* did not examine whether the legislation at issue had a valid public purpose. Rather, the Court in both cases focused solely on the fact that tax revenue would be pledged to secure State bonds issued for economic development purposes. These two decisions imply that a public purpose assessment does not depend entirely on the *use* of public funds but also on the *source* of public funds and that tax revenue may not be pledged to bonds if economic development is the public purpose invoked by the Legislature. (See generally Ellingson, Mae Nan and Mahoney, Jerry C.D., *Public Purpose and Economic Development*, 51 MONT. L. REV. 356 (1990).)

Relying on *Hollow* and *White*, the Act would appear to be unconstitutional because it serves its economic development purpose by in effect pledging tax revenues to private investors or other holders of the Certificates. Indeed, the Act almost mirrors the investments made in "certified Montana companies" in the legislation that was found wanting in *White*. Moreover, the Board does not select the investors or even the investments but only the designated investor group; and it is the investors who are the ultimate beneficiaries of the Certificates. Thus, the Act is on weaker ground under the Appropriations Clause than the structure invalidated in *Hollow* or even those upheld in *Grossman* and *Huber*. Despite the fact that the Act does not authorize the issuance of bonds and the pledge of the State's credit to secure bonds, as did the legislation in *Hollow* and *White*, it does authorize the issuance of Certificates by the Board and a commitment, binding on the Board and the Department of Revenue, to appropriate tax revenue (by the redemption of the Certificates for tax credits) for economic development purposes in the event that the actual return of capital is less than the contractually scheduled return and rate of return. Because of that binding commitment, the "moral obligation" exception recognized as constitutional in *Huber* and *Hollow* cannot be relied upon.

Of course, there is a distinction between the tax credits authorized by the Act and the pledge of tax revenues examined by the Court in *Hollow* and in *White*. The tax credits provided for in the Act do not involve spending tax revenue, whereas the legislation considered in *Hollow* and in *White* each pledged tax revenues already collected. This distinction should not change the analysis, however, since tax credits reduce private individual and corporate tax liabilities owed to the State and their use will decrease the collections for the State general fund. It will likely make little difference to the Court that the tax credits give investors money that is *owed* to but not yet *collected* by the State. In light of the Court's apparent unwillingness to see tax money used to the ultimate benefit of private individuals and businesses for economic development purposes, it is unlikely that the Court will find much probative value in an argument distinguishing collected tax revenue from uncollected tax liabilities.

Another possible distinction between the Act and the legislation considered in *Hollow* and *White* is that the Certificates represent a contingent liability of the Board; the Certificates will be redeemed for tax credits only if the investment return of the Funds is less than is

scheduled in the investment contract. But, again, that distinction would seem inapplicable since the bonds at issue in *Hollow* were only contingently secured by the pledge of tax revenues (debt service was initially payable from loan repayments to be made by the private borrowers) and in *White* the coal severance tax revenues would be applied to debt service only if the investments failed to provide sufficient income to pay debt service. Indeed, the dissenting justice in *Hollow* argued that a guarantee was a contingent liability and a contingent liability was not a debt. (723 P.2d 233) Cf. *State ex rel. Simmons v. Missoula*, 144 Mont. 210, 395 P.2d 249 (1964) (lease payments are indebtedness of a city for purposes of Article 13, Section 6 of the 1889 Constitution, notwithstanding their contingent nature).

Consequently, regardless of whether the Act would further a public purpose found valid under the Public Purpose Clause and the Appropriations Clause in other contexts involving non-tax revenues, it appears the Act would be found constitutionally infirm under *Hollow* and *White*, which represent the most recent decisions of the Court on these issues.

Authorization of Debt

Since the Act appears to be unconstitutional under the Public Purpose Clause and the Appropriations Clause, we will discuss only briefly one other provision of the Montana Constitution that may also suggest the unconstitutionality of the Act.

Under Article VIII, Section 8 of the Constitution, "No state debt shall be created unless authorized by a two-thirds vote of the members of each house of the legislature or a majority of the electors voting thereon." While the Act was enacted by an approving vote of 72% of the members of the House, only 32 of the 50 Senators voted in its favor (16 voted in opposition) upon passage on third reading on March 29, 2005. The Act does not purport to create state debt.

While the Supreme Court's decisions under this Section of the Constitution are almost as serpentine as those discussed above, it appears clear that the pledge of tax revenues to the payment of an obligation owed to a third person creates a state debt for purposes of Article VIII, Section 8. See, e.g., *State ex rel. Ward v. Anderson*, 158 Mont. 279, 491 P.2d 868 (1971); *State ex rel. Diederichs v. State Highway Comm'n*, 89 Mont. 205, 296 P. 1033 (1931). Since the Certificates are redeemable by their holders like the bonds considered in *Ward* and result in tax credits, which, as discussed above, seem equivalent to tax revenues, it appears that a substantial argument can be made that the Certificates constitute state debt and have not been authorized by a sufficient vote of the Legislature under Article VIII, Section 8.

Conclusion

Because the Act appears indistinguishable from the legislation found wanting by the Montana Supreme Court in *Hollow* and *White*, it appears that a strong argument can be made that the Act is unconstitutional under the Public Purpose Clause and Appropriations Clause of the Montana Constitution. This result seems almost inescapable, even though earlier decisions of the Court had validated economic development as a legitimate legislative public purpose and had upheld the issuance of general obligation bonds to make loans to private parties. In addition, because the Certificates authorized to be issued by the Board under the Act appear to constitute state debt and the Act was not authorized by the requisite supra-majority voting requirement

under Article VIII, Section 8 of the Constitution, it further appears that the Act may be unconstitutional in this respect as well.

If you have questions about our analysis, please let us know.