

LAND GRANT TRUST ADMINISTRATION

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The purpose of this memorandum is to determine whether the Department of State Lands may fund its management of trust land from the interest from the permanent trust funds and the expendable income from trust lands.

Determination: The State of Montana as the trustee for trust lands may recover the costs of administering the trust from the interest generated by the trust lands except as provided in Article X, section 5, of the Montana Constitution.

The conditions imposed on the lands and the funds resulting from their sale or lease are found in The Enabling Act and the state constitution. The conditions upon the disposal and use of lands granted to the state by the federal government at the time of Montana's admission to statehood have been heavily litigated. A fairly clear delineated area of permissible uses can be derived from these cases. The federal government granted lands to the state for the following purposes: (1) support of common schools; (2) state government buildings at the capitol; (3) university purposes; (4) a penitentiary; (5) support of an agricultural college; (6) a school of mines; (7) normal schools; (8) a reform school; and (9) an asylum for the deaf and dumb. There are some restrictions on the usage of some land grants that are not applicable to others. These differences will be highlighted in the discussion of the various cases involving the land grants.

The first case involving granted lands dealt with the capitol land grant. In State ex rel. Bickford v. Cook, 17 Mont. 529 (1896), the court held that the Legislature has the power to control the capitol land grant fund and its

disposition for the specific purposes for which lands are granted. The distinctiveness of land grant money was explained 2 years later. In State ex rel. Dildine v. Collins, 21 Mont. 448 (1898), the court stated that the university land grant fund is a trust fund. It is on a different footing entirely from funds arising from taxation. Bonds for construction of university buildings are properly payable from profits from the trust fund.

The Cook and Collins cases were followed in State ex rel. Koch v. Barrett, 26 Mont. 62 (1901). The Barrett case dealt with the propriety of leasing the granted lands, as opposed to selling them and investing the proceeds. The court found that the lands granted by Congress became a trust. The funds derived from the lands were trust funds, to be devoted exclusively to the purpose of the trust through the agency of the state.

... the manifest intention of congress was to create a permanent endowment, which was to be preserved inviolate; and to require that the revenues derived therefrom should be faithfully applied to the support of the institutions created, and not be diverted to other purposes. So long as this intention is carried out, we think it makes no difference what mode is adopted. The grant was made in view of conditions existing at the time, and others which might arise. Id. at 70.

The court found that the leasing system was proper. It was not a condition precedent to require the sale of land and investment of the proceeds prior to using income generated by the lands for their specified purposes. The distinctions placed on the various types of land grants came into play in a case involving the normal school land grant. The court found that the provision of The Enabling Act providing a land grant for normal schools pertained only to the manner of the management and disposition of the lands themselves. It did not control the funds derived from the sale or leasing of the lands. The funds derived from the sale and leasing of the lands passed to the state and could be disposed of as the state saw fit, subject only to the condition that the funds must be used exclusively for normal school purposes. The 1889 Montana Constitution, however, limited the usage of

the normal school land grant proceeds. State ex rel. Haine v. Rice, 33 Mont. 365 (1906).

State ex rel. Galen v. District Court, 42 Mont. 105, 114, 112 P. 706 (1910), found that the fund created from the sale of lands granted to the state by Congress for a particular purpose is a trust fund "established by law in pursuance of the Act of Congress". This finding necessitated strict construction of The Enabling Act.

In 1914, the people of Montana passed an initiative entitled "The Farm Loan Act", authorizing the State Board of Land Commissioners to invest the permanent common school fund and other permanent educational, charitable, and penal institution funds in certain school district bonds, state bonds, United States bonds, certain state warrants, capitol building bonds, irrigation district bonds, and first mortgages on good, improved farm lands in Montana. The Attorney General ruled in 1916 that the initiative was unconstitutional. The issue was presented to the courts in the case of State ex rel. Evans v. Stewart, 53 Mont. 18, 161 P. 309 (1916). The court disagreed with the Attorney General and upheld the validity of investing in farm mortgages. The court discussed the limitations contained in The Enabling Act as follows:

With respect to the lands granted for common school purposes, the Enabling Act fixes a minimum sale price and declares that the proceeds from such sales, together with five percent of the proceeds from the sales of public lands in the state, shall constitute a permanent school fund the interest from which only shall be expended. It also provides that the lands granted may be leased under regulations prescribed by the legislature of the state, with a limitation upon the term of any such lease and upon the quantity which may be let to any individual, company or corporation. . . . Of the lands granted for university purposes it declares that they shall not be sold for less than \$10 per acre, but may be leased in the same manner as provided in section 11 (common school lands). With reference to the grants for capitol building and penitentiary purposes, it prescribes no restrictions or regulations whatever. . . . The only limitation imposed with reference to the other grants enumerated above is that: "The lands granted by this section shall be held, appropriated, and disposed of exclusively for the purposes herein mentioned, in such manner as the legislatures

of the respective state may severally provide." It will thus be seen that the Enabling Act does not attempt to regulate the manner in which the permanent funds derived from these grants shall be invested; and, as the Farm Loan Act deals only with the investment of those funds, no possible conflict can be discovered between the two Acts. Id. at 22.

Not all farm mortgages invested in were repaid. The court was then confronted with interpreting Article XI, section 3, of the 1889 Constitution, which provided that the public school fund "shall forever remain inviolate, guaranteed by the state against loss or diversion". After passage of The Farm Loan Act, over \$4 million of the permanent school fund was invested in farm mortgages. When the investments were made, the mandatory duty imposed by the constitution upon the state to guarantee the fund against loss or diversion came squarely before the state. The state was obligated to repay the school fund from the proceeds of the farm mortgage loans and lands and from other sources. Toole County Irrigation District v. State, 104 Mont. 420, 67 P.2d 989 (1937).

It was recognized in the case of Newton v. Weiler, 87 Mont. 164, 286 P. 133 (1930), that the constitutional provisions relating to trust lands are limitations upon the power of disposal by the Legislature. A series of cases challenged the propriety of issuing bonds from the various land grants for the construction of buildings. The use of land grant income to retire the bonds was upheld in each of the following instances: construction of buildings at the normal school in Billings, State ex rel. Blume v. State Board of Education, 97 Mont. 371, 34 P.2d 515 (1934); construction of a journalism building for a "university purpose", State ex rel. Wilson v. State Board of Education, 102 Mont. 165, 56 P.2d 1079 (1936); construction of a chemistry-pharmacy building, State ex rel. Dragstedt v. State Board of Education, 103 Mont. 336, 62 P.2d 330 (1936); and construction of a Montana Veterans and Pioneers Memorial Building, Willett v. State Board of Examiners, 112 Mont. 317, 115 P.2d 287 (1941).

The focus of litigation concerning the use of land grants and funds shifted to

oil and gas leasing. A pooling arrangement was challenged in Toomey v. State Board of Land Commissioners, 106 Mont. 547, 81 P.2d 407 (1938). The court found that pooling of school lands with private lands for unit operation for the production of oil and gas and the apportionment of the royalties from the pool are not violative of The Enabling Act, which grants general authority to lease school lands for the extraction of oil and gas. If the pooling arrangement is treated as the sale of an estate or interest in the school lands, it still does not violate The Enabling Act because the requirement of public sale after advertising applies only where the whole interest in land is sold. When an estate or interest in the land is sold, the full market value of the estate or interest disposed of is ascertained "in such manner as may be provided by law". The Legislature is given ample power to determine the method by which to ascertain the full market value of the estate or interest.

Relying on Galen, supra., to find that The Enabling Act is to be strictly construed, the court found that an oil and gas lease could not be extended beyond the time limitation in The Enabling Act. Texas Pacific Coal & Oil Co. v. State, 125 Mont. 258, 234 P.2d 452 (1951).

The problems engendered with the customary methods of oil leasing were encountered in the 1950s. The court found that the "royalty" collected under an oil and gas lease on school lands is required to be credited to the permanent school fund because royalties are based on production and production is a permanent disposition of an estate in the land. "Rentals" or cash bonuses collected under an oil and gas lease were required to be placed in the common school interest and income fund available for the maintenance and support of schools and institutions. State ex rel. Dickgraber v. Sheridan, 126 Mont. 447, 254 P.2d 390 (1953). This holding was clarified in State ex rel. Strandberg v. State Board of Land Commissioners, 131 Mont. 65, 307 P.2d 234 (1957). The court found that the Legislature, in leasing oil lands, is under an obligation to obtain the full market value of the estate or interest disposed of on a rental basis, as well as for the sale of the land itself or the

oil and gas in and under the land. There could be no sacrifice of the rental for additional royalty without, at the same time, violating Article XVII, section 1, of the 1889 Constitution. The court upheld the legislative scheme because no hard-and-fast rule could be devised for determining the full market value of oil and gas leases involving both rentals and royalties.

In a case determined shortly after Strandberg, supra., the court apparently overturned the line of decisions dating back to Galen, supra., when it held that The Enabling Act must be liberally construed with the view of accomplishing the object sought to be attained. State ex rel. Morgan v. State Board of Examiners, 131 Mont. 188, 309 P.2d 336 (1957), overruling Bryant v. State Board of Examiners, 130 Mont. 512, 305 P.2d 340 (1956). The Morgan decision allowed the capitol land grant fund to be used to repair old buildings and to install a roll call voting machine in the House of Representatives.

Leasing of state land for the underground storage of natural gas was upheld in State ex rel. Hughes v. State Board of Land Commissioners, 137 Mont. 510, 353 P.2d 331 (1960). The court said The Enabling Act contemplates that an interest or estate less than the fee may be leased or disposed of.

The statutory scheme of granting agricultural leases was challenged in State ex rel. Thompson v. Babcock, 147 Mont. 46, 409 P.2d 808 (1966). The court said that it is incumbent upon the State Board of Land Commissioners, in leasing state-owned land held in trust for the people, to secure full market value for the lease. Full market value is determined by the value of a similar lease in the particular community, coupled with the applicant's ability as a farmer and other variables that allow the state to secure as large a return as possible, yet preserve the productive capacity of the land. The commissioners may not speculate but must secure sustained income continually benefiting the public in general. Preference rights of the lessee were held proper if bids received were within the range of market value. The sustained income or sustained yield concept articulated in Thompson was

further elucidated in Jerke v. State Department of Lands, 182 Mont. 294, 597 P.2d 49 (1979). The court said:

Sustained yield is the policy which favors the long term productivity of the land over the short term return of income. . . .

The preference right seeks to further this policy by inducing the State's lessees to follow good agricultural practices and make improvements on the land. This is accomplished by guaranteeing that the lessees will not lose the benefits of their endeavors by being outbid when their leases terminate. They are preferred and may renew their leases by meeting the highest bid submitted.

Where the preference right does not further the policy of sustained yield, it cannot be given effect. In such a situation, full market value can be obtained only by pure competitive bidding. Id. at 296, 297.

The court further stated that the grazing district holding the preference right did not even use the land, but subleased it. It could not use good agricultural practices or make improvements. The sublessee, who as a member of the district was prevented from bidding on the lease, was not motivated to further the policy of sustained yield because he was not assured that the land would be allocated to him. The court found that to allow exercise of the preference right in this instance would be to install the district rather than the Department of State Lands as the trustee of the land, and sustained yield would have no place. Allowing an existing lessee who does not use the land to exercise a preference right constitutes an unconstitutional application of the preference right statute. Jerke, *supra*.

Jerke was followed in Skillman v. Department of State Lands, 188 Mont. 383, 613 P.2d 1389 (1980), and distinguished in Steffen v. Department of State Lands, ___ Mont. ___, 724 P.2d 713 (1986), where the lessee retained significant responsibility and control throughout the lease.

In 1967, the Legislature enacted Chapter 295, of the Laws of 1967, authorizing a maximum of 2 1/2% of school land revenues to be used to

improve and develop the land in order to increase the value of the land or the revenue from the land. This law is still in effect and is codified as Title 77, chapter 1, part 6. An Attorney General's opinion was requested to determine if the law violated the Enabling Act or Article XI, section 12 and Article XVII of the 1889 Montana Constitution. In upholding the validity of the law, Attorney General Anderson cited Toomey, supra. and Newton, supra. as establishing the state as the trustee for the lands. Attorney General Anderson stated:

In the execution of the trust imposed under such a grant, it is now well settled that a state, acting in its role as trustee, has an inherent equitable right to reimbursement from the trust for all charges and expenses necessarily incurred in the execution of the trust where there is no provision to the contrary in the grant creating the trust. U.S. v. Swope, (C.C.A. 8th - 1926) 16 F.2d 215; State ex rel. Greenbaum v. Rhoades, 4 Nev. 312 (1868); Betts v. Commissioners of the Land Office, 27 Okl. 64, 110 Pac. 766 (1910); Bourne v. Cole, 53 Wyo. 31, 77 P.2d 617 (1938). This rule applies to the trust imposed by the grant of school lands to Montana for there is no provision in the Enabling Act which requires the state to bear the costs of improvement, development, administration or land conservation measures from its general revenues. 32 A.G. Op. 8 (1967) at 70.

The Attorney General found the use of the proceeds from the school lands consistent with the intention of the grant to attain funds for the maintenance of schools and institutions. The Attorney General found no provision that indicated that the constitutional framers intended to place restrictions on the trustee's right to require payment for the expenses of administration, conservation, improvement, and development of the trust lands from the proceeds of the lands. The Attorney General also noted that a general rule of trusts is that in the absence of the denial of the right in the trust, a trustee

may recover the costs of administration from trust proceeds. *Id.* at 71. See Bogert, Law of Trusts, sec. 99, 124 (1973).

The Attorney General did not specifically discuss the requirement contained in Article XI, section 5, of the 1889 Constitution requiring 95% of the interest from the school funds and 95% of the rents received from leasing and other income to be apportioned to the school districts and the remaining 5% of each source of revenue to be added to the public school fund. This requirement was continued in Article X, section 5, of the 1972 Constitution. The failure to address Article XI, section 5, of the 1889 Constitution in the Attorney General's opinion is bewildering, because it appears to embody exactly the type of trust restriction the Attorney General referred to. The holding in the Attorney General's opinion appears correct as far as it goes; it simply does not address the most pertinent constitutional provision. Article X, section 5, of the Montana Constitution provides:

Section 5. Public school fund revenue. (1) Ninety-five percent of all the interest received on the public school fund and ninety-five percent of all rent received from the leasing of school lands and all other income from the public school fund shall be equitably apportioned annually to public elementary and secondary school districts as provided by law.

(2) The remaining five percent of all interest received on the public school fund, and the remaining five percent of all rent received from the leasing of school lands and all other income from the public school fund shall annually be added to the public school fund and become and forever remain an inseparable and inviolable part thereof. (emphasis supplied)

The Attorney General cited Betts, supra. However, in Betts, the Oklahoma Supreme Court, while recognizing the general rule regarding trust restrictions, did not allow the state to be reimbursed for expenses from "all the proceeds of the sale" of school lands. The court found that Article 11, sections 2 and 3, of the Oklahoma Constitution when read in conjunction required this result. The Alabama Supreme Court, when asked whether a constitutional provision governing the income from trust land referred to "gross income" or "net income", followed Betts. The court held that "the income" arising from the

sale of trust lands clearly excluded the thought that the income could be subject to the diminishing process of administering the trust. Opinion of the Justices, 47 So.2d 729 (Ala. 1950).

The Nevada Supreme Court in State ex rel. Greenbaum v. Rhoades, 4 Nev. 312 (1868), the Washington Supreme Court in State ex rel. Forks Shingle Co. v. Martin, 196 Wash. 494, 83 P.2d 755 (1938), and the Idaho Supreme Court in Moon v. State Board of Land Commissioners, 724 P.2d 125 (Id. 1986), all adhered to the general rule that in the absence of a specific restriction, the trustee has an equitable right to reimbursement from the trust for expenses incurred in administering the trust. In Greenbaum, the Nevada court interpreted language that pledged classes of land and "all proceeds thereof" for educational purposes, and declared that the proceeds could not be transferred for other uses, did not prohibit the Legislature from using a portion of the proceeds of the sale of the lands to administer the sale of other lands. The court said:

They probably had no intention of prohibiting the State from using a part of the trust estate to make the rest available; but if their attention had been called to the subject, would have left the State just where the Act of Congress placed it, in the form of an ordinary trustee with the legal right to use a part of the trust estate to make the balance available. Greenbaum at 316 - 317.

There is no indication in the 1971 -1972 Montana Constitutional Convention transcripts that the delegates were aware of or tried to revise the interpretations placed on the use of lands under the 1889 Constitution. The delegates did discuss the burdens that had been placed on taxpayers to repay the losses to the permanent school fund due to the Farm Loan Act. Verbatim transcript at 1539 - 1540. The delegates were very aware that the lands were a trust and that trust principles applied to the lands. Verbatim transcript at 2142 - 2150. Section 72-34-337, MCA, provides that a trustee has the power to pay expenses incurred in the administration of the trust.

While the vast majority of the cited cases were decided under the 1889 Constitution, the 1972 Constitution has carried forward the pertinent restrictions on the use of state lands and land grant trusts. Article X, section 3, of the constitution provides that "The public school fund shall forever remain inviolate, guaranteed by the state against loss or diversion." Article X, section 5, of the constitution restricting the use of the interest from the public school fund and income from school lands is quoted above. Article X, section 10, of the constitution provides that university system funds are inviolate and sacred to the purpose for which they were dedicated. They are also guaranteed by the state against loss or diversion. Article X, section 11, of the constitution deals with the disposition of state lands and interests in state lands.

The cases interpreting The Enabling Act and the constitutional provisions governing the land grant funds establish the parameters within which the Legislature may act in dealing with the land grant trusts. The trusts may be invested as the Legislature sees fit, so long as the investment plan conforms to Article VIII, section 13, of the constitution. In the event that the investments result in losses to the funds, the constitution requires that the losses be made good. The income from the funds may be pledged to the retirement of bonds, the proceeds of which must be used for a purpose for which the trust can be used.

The state as the trustee for trust lands may recover the costs incurred in administering the trust from trust income unless the Enabling Act or the constitution, as the documents creating the trust, restrict the state's right to recover the costs. The plain meaning of Article X, section 5, of the Montana Constitution restricts the use of any interest from school trust lands for a purpose not contained in Article X, section 5. A construction that would allow the State to recover costs under normal trust principles prior to disbursing the income would be to ignore the plain meaning of the language and to infer that the constitutional framers intended ordinary trust principles to apply. It is my opinion that Article X, section 5, of the Montana

Constitution contains an express restriction on the use of school land income
and interest.

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