



STATE OF WASHINGTON
STATE INVESTMENT BOARD

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June 16, 2017

TO: David Schumacher, Director
Office of Financial Management

FROM: Theresa J. Whitmarsh
Executive Director

SUBJECT: **2017 CONTINGENCY PLANNING FOR WASHINGTON STATE INVESTMENT BOARD OPERATIONS ON JULY 1**

In response to your request, here is an updated contingency plan for the Washington State Investment Board (WSIB). In this memo I will address:

1. Services funded by appropriations in the enacted transportation budget.
2. Services that do not require an appropriation, such as from non-appropriated funds.
3. Services that must continue based on certain constitutional mandates and federal law
4. Services necessary for the immediate response to issues of public safety or to avoid catastrophic loss of property

Background

As of March 31, 2017, the WSIB has under management \$97 billion in investments for 17 retirement plans for public employees, teachers, school employees, law enforcement officers, firefighters, and judges; \$16.2 billion in industrial insurance trust funds; and \$3.3 billion in permanent funds that benefit higher education, and other trust funds, including the Guaranteed Education Tuition program and the Development Disabilities Endowment Fund. Total assets under management as of March 31 are \$116.5 billion. All WSIB expenses are paid for from investment earnings and administrative fees paid by those for whom we manage money. The WSIB does not receive any monies from the general fund.

1. Services funded by appropriations in the enacted transportation budget.

N/A – WSIB does not receive an appropriation from the transportation budget.

2. Services that do not require an appropriation, such as from non-appropriated funds.

The WSIB's budget consists of appropriated and non-appropriated expenses. The bulk of WSIB's expenses are non-appropriated—nearly 94 percent. Non-appropriated expenses include all money managers and consultant fees, investment research, and legal fees specifically related to investments. Appropriated expenses, which make up six percent of our budget, include staff salaries and benefits, facilities, office equipment, and travel.

3. Services to continue based on certain constitutional mandates and federal law

Our assigned Assistant Attorney General has advised us that we are legally required to continue operations in the event of a government shutdown because (1) shutting down WSIB operations would likely lead to an unconstitutional impairment of contract. (2) shutting down WSIB operations could lead to liability for breach of fiduciary duties; and (3) shutting down WSIB operations could lead to liability for violations of the federal and/or state securities laws. In short, the WSIB must continue operations because its activities are constitutionally mandated and/or necessary to avoid catastrophic loss of state property (exposure to legal liability on behalf of the WSIB and/or the State of Washington).

The state cannot impair its contractual obligations to retirees and members of public defined benefit retirement plans; its contracts between the state and beneficiaries of other trust funds, some of which contain private assets; nor its contracts with investment partners.

While investment expenses are non-appropriated, all WSIB operating expenses are appropriated, including staff salaries for our 98 FTEs. In the event of a government shut-down, starting July 1, the WSIB must have staff able to exercise the actions necessary to ensure the flow of cash necessary to support various activities that would otherwise continue in the absence of an operating budget. In addition, the agency must be able to fulfill its fiduciary duty to trust fund beneficiaries and its contractual obligations to business partners. Unlike some multi-faceted organizations, the WSIB has a singular mission: "To invest with integrity, prudence, and skill to meet or exceed the financial objectives of those we serve." While adequate fulfillment of this fiduciary duty requires all of our current 98 FTEs, we believe that for a period not exceeding two weeks, the agency could meet its fiduciary obligations with 81 FTEs. However, in order to effectively sustain this mission in a fully legal and responsible manner, we consider every position essential to achieve our mission.

4. Services necessary for the immediate response to issues of public safety or to avoid catastrophic loss of property

Failure to keep the WSIB open could expose the state to significant liability for breaching its fiduciary duties as well as damage claims under federal and state securities laws. The WSIB has a duty to prudently manage the investment funds under its authority. Without staff to monitor and manage the investments, the state would face potential claims from beneficiaries of those investment funds for breach of fiduciary duty; security fraud claims from our Plan 457(a) deferred compensation, defined contribution, Guaranteed Education Tuition (GET), and Developmental Disabilities Endowment Fund (DDEF) participants for failing to disclose the possibility that they would lose access to their funds and WSIB oversight of the managers; and breach of contract claims or liquidated damages related to the investment contracts.

Please contact Celina Verme at 956-4740 if you have any questions.

Thank you.

Attachment



Bob Ferguson
ATTORNEY GENERAL OF WASHINGTON

Revenue and Finance Division
PO Box 40123 • Olympia, WA 98504-0123 • (360) 753-5528

MEMORANDUM

DATE: June 9, 2017

TO: Mary C. Lobdell, Legal Services Director
Washington State Investment Board, MS 40916

FROM: Michael J. Nelson II, Assistant Attorney General 
Revenue and Finance Division, MS 40123

SUBJECT: **WSIB Contingency Plan**

I. QUESTION PRESENTED

You have asked our office for advice regarding the Washington State Investment Board's ("WSIB") ability to continue operations past June 30, 2017 in the event that the Washington State legislature does not enact an operating budget for the 2017-19 fiscal biennium.

II. SHORT ANSWER

The WSIB is legally required to continue operations in the event of a government shutdown because (1) shutting down WSIB operations would likely lead to an unconstitutional impairment of contract; (2) shutting down WSIB operations could lead to liability for breach of fiduciary duties; and (3) shutting down WSIB operations could lead to liability for violations of the federal and/or state securities laws. In short, the WSIB must continue operations because its activities are constitutionally mandated and/or necessary to avoid catastrophic loss of state property.¹

III. BACKGROUND

The current fiscal biennium ends on June 30, 2017. As of the date of this memorandum, the legislature has not yet enacted an operating budget for the 2017-19 fiscal biennium. Although it is not expected that the legislature will fail to pass an operating budget for the 2017-19 fiscal biennium, this memorandum is being provided for the purposes of contingency planning in the event that the legislature does fail to enact an operating budget.

¹ To avoid confusion, when this memorandum refers to "catastrophic loss of state property," it is referring to exposure to legal liability on behalf of the WSIB and/or the State of Washington. "Catastrophic loss of state property" does not refer to or touch upon the retirement and other public trust funds managed by the WSIB.

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IV. DISCUSSION

In the event of a government shutdown, the State will only be able to provide essential services that (1) are funded by the transportation budget; (2) do not require appropriations; (3) are constitutionally or federally mandated; or (4) are necessary for the immediate response to issues of public safety or to avoid catastrophic loss of state property.² The WSIB is legally required to continue operations in the event of a government shutdown because (1) shutting down WSIB operations would likely lead to an unconstitutional impairment of contract; (2) shutting down WSIB operations could lead to liability for breach of fiduciary duties; and (3) shutting down WSIB operations could lead to liability for violations of the federal and/or state securities laws. In short, the WSIB must continue operations past June 30, 2017 because its activities are constitutionally mandated and/or necessary to avoid catastrophic loss of state property.

A. Unconstitutional Impairment of Contract

The WSIB is constitutionally required to continue operations in the event of a government shutdown because ceasing WSIB operations would likely lead to an unconstitutional impairment of contract under both the State and Federal Constitutions.

Article I, Section 23 of the Washington State Constitution provides that “[n]o . . . law impairing the obligations of contracts shall ever be passed.” Although the impairment prohibition is not absolute, the State’s impairment of its own contracts is subject to more stringent review under the contract clause than impairment of contracts between private parties. *Retired Pub. Emp. Coun. of Wash. v. Charles*, 148 Wn.2d 602, 623-24, 62 P.3d 470 (2003).

The three-part test to determine if there has been an impairment of a public contract is: (1) does a contractual relationship exist; (2) does the legislation substantially impair the contractual relationship; and (3) if there is substantial impairment, is it reasonable and necessary to serve a legitimate public purpose. *Pierce Cty. v. State*, 159 Wn.2d 16, 28, 148 P.3d 1002 (2006) (citing *Tyrypak v. Daniels*, 124 Wn.2d 146, 152, 874 P.2d 1374 (1994)).

In this case, the first element is satisfied because a contractual relationship exists between the State of Washington and the members and retirees of the retirement systems. Our state adheres to the “contract of employment vested right” theory relative to public pension systems, as opposed to looking upon retirement benefits as mere gratuities that may be granted at the conclusion of long and faithful service. *Weaver v. Evans*, 80 Wn.2d 461, 475, 495 P.2d 639 (1972). In this state, a pension granted to a public employee is not a gratuity but is deferred compensation for services rendered. *Id.* (quoting *Bakenhus v. Seattle*, 48 Wn.2d 695, 698, 296 P.2d 536 (1956)). Accordingly, the Supreme Court of Washington has held that members and retirees of the retirement systems have certain pension rights that are contractual in nature. *Retired Pub. Emp. Coun. of Wash.*, 148 Wn.2d at 623-24 (citing *Bakenhus*, 48 Wn.2d at 701). Members and retirees

² See David Schumacher, *Contingency Planning for State Agency Operations* (2017).

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also have vested contractual pension rights to “a retirement system actuarially designed through systematic funding to meet present and future pension liabilities.” *Retired Pub. Emp. Coun. of Wash.*, 148 Wn.2d at 615 (citing *Weaver*, 80 Wn.2d at 478). In this case, a contractual relationship exists between the State of Washington and the members and retirees of the retirement systems; therefore, the first element is satisfied.

The second element is satisfied as the failure to appropriate money to the WSIB expense account would substantially impair the contractual relationship between the State of Washington and the members and retirees of the retirements systems. Pursuant to RCW 43.33A.160(2), the operating expenses (including employee salaries) are paid out of the WSIB expense account, which is subject to appropriation by the legislature. If the legislature fails to appropriate monies to the WSIB expense account, then there is no money to pay employees or to pay for other operating expenses.³ If the WSIB operations staff is not at work, cash cannot be transferred from the investment accounts to the treasury to pay benefits, and no one will be present to monitor investments. Therefore, to avoid an unconstitutional impairment of contract, the WSIB is legally obligated to provide the staff and services necessary to ensure the required payment of promised retirement benefits. Thus, the contractual relationship here would be substantially impaired.

The second element is likely satisfied here even though this is a case of legislative inaction (as opposed to positive legislative action). This is because an unconstitutional impairment of contract can also arise in the context of inaction. *See, e.g., Mun. of Metro. Seattle v. O'Brien*, 86 Wn.2d 339, 349-52, 544 P.2d 729 (1976) (finding that the State Treasurer’s failure to remit the proceeds of a local motor vehicle excise tax to the Municipality of Metropolitan Seattle constituted an unconstitutional impairment of the contract between the municipality and its bondholders); *Weaver*, 80 Wn.2d at 478 (finding that the systematic method of funding the retirement system by the legislature to attain and maintain its financial soundness was a vested contractual right that could not be modified except for the purpose of maintaining the flexibility and integrity of the system).

Finally, the third element is satisfied because a government shutdown due to the legislature failing to come to an agreement on a budget is not reasonable and necessary to serve a legitimate public purpose. Instead, this action (or inaction) by the legislature is detrimental to the legitimate public purposes of government. During a government shutdown, the government is closed and cannot properly perform its core functions (i.e., ensuring public safety, providing for education, providing for the well-being of its people, managing natural resources, managing economic growth, etc.). Therefore, the legislative action (or inaction) in this case is not reasonable and necessary to serve a legitimate public purpose, and this element is satisfied. Because all three elements are satisfied here, I conclude that shutting down WSIB operations would likely lead to an unconstitutional impairment of contract under the Washington State Constitution.

³ RCW 43.88.260 prohibits “any agency head or disbursing officer to incur any cash deficiency” This provision would arguably prohibit WSIB staff from voluntarily continuing to work past June 30 upon the anticipation that at some point the legislature would pass an appropriation bill to fund the WSIB expense account.

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Shutting down WSIB operations would also likely lead to an unconstitutional impairment of contract under the United States Constitution. Article I, Section 10, Clause 1 of the United States Constitution provides that “[n]o State shall . . . pass any . . . Law impairing the Obligation of Contracts” Whether a state law operates as an unconstitutional impairment of a contractual relationship is answered by a three step inquiry: (1) whether there is a contractual relationship; (2) whether a change in the law impairs the relationship; and (3) whether the impairment is substantial. *Gen. Motors Corp. v. Romein*, 503 U.S. 181, 186, 112 S. Ct. 1105, 117 L. Ed. 2d 328 (1992). An impairment of a contract is substantial if it deprives a private party of an important right, thwarts performance of an essential term, defeats the expectations of the parties, or alters a financial term. *S. Cal. Gas Co. v. City of Santa Ana*, 336 F.3d 885, 890 (9th Cir. 2003). The first element is satisfied because, as discussed above, a contractual relationship exists between the State of Washington and the members and retirees of the retirement systems. *See Retired Pub. Emp. Coun. of Wash.*, 148 Wn.2d at 623-24 (citing *Bakenhus*, 48 Wn.2d at 701). The second element is also satisfied because, as discussed above, the withholding of WSIB operating funds, by failing to appropriate money into the WSIB expense account, would substantially impair the contractual relationship because the WSIB would not be able pay out benefits. Finally, the contractual impairment in this case would be substantial because (1) it would deprive retirees of their right to pension benefits, and (2) would deprive members and retirees of their vested contractual right to have a retirement system that has a systemic method of funding. *See Weaver*, 80 Wn.2d at 478. Accordingly, ceasing WSIB operations would also likely lead to an unconstitutional impairment of contract under the United States Constitution.

Accordingly, the WSIB is constitutionally required to continue operations in the event of a government shutdown because ceasing operations would likely lead to an unconstitutional impairment of contract under both the State and Federal Constitutions.

B. Fiduciary Duties

Should the WSIB cease operations on June 30, 2017, it could lead to liability for breach of fiduciary duties; therefore, continued operations may be necessary to avoid catastrophic loss of state property. There are two potential sources of law here. First, in previous memoranda to the WSIB, William Song came to the conclusion that trust law principles apply to the management of certain fund assets; therefore, the WSIB has a fiduciary obligation under trust law principles to ensure that the assets managed by the WSIB are properly allocated, even if subject to legislative appropriation.⁴ Therefore, trust law principles may be one possible source of fiduciary duties and thus a possible source of liability if employees are not able to come to work and no one is present to manage fund assets.

A second source of fiduciary duties comes from RCW 43.33A.140. That statute provides for a standard of care with respect to management of assets entrusted to the WSIB. It provides that

⁴ See William Song, *Legislative Appropriation of Funds to the WSIB Expense Account* (2013); William Song, *Washington State Investment Board: Trust Characteristics and Implications* (1997).

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“[t]he state investment board shall invest and manage the assets entrusted to it with reasonable care, skill, prudence, and diligence under circumstances then prevailing which a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an activity of like character and purpose.” RCW 43.33A.140. This statute, depending on how it is interpreted and applied, may also provide for liability on the part of the WSIB where no money is allocated to the WSIB expense account and thus no employees are present to manage assets entrusted to the WSIB. Accordingly, ceasing WSIB operations could lead to liability for breach of fiduciary duties under trust law principles and/or RCW 43.33A.140. Since ceasing WSIB operations could lead to liability for breach of fiduciary duties under trust law principles and/or RCW 43.33A.140, continued operations may be necessary to avoid catastrophic loss of state property.

C. Securities Laws

The WSIB regularly purchases, sells, transfers, and monitors securities (both registered securities and securities exempt from registration). Should the WSIB cease operations on June 30, 2017, it could lead to liability for violations of the federal and/or state securities laws. Specifically, the WSIB could face liability for securities fraud under Section 10(b) of the Securities Exchange Act of 1934, and Rule 10b-5 promulgated thereunder, and/or under RCW 21.20.010. Accordingly, continued operations may be necessary to avoid catastrophic loss of state property.

In a typical Section 10(b) private action under the federal securities laws, a plaintiff must prove (1) a material misrepresentation or omission by the defendant; (2) scienter; (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation. *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta*, 552 U.S. 148, 157, 128 S. Ct. 761, 169 L. Ed. 2d 627 (2008); *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 341-42, 125 S. Ct. 1627, 161 L. Ed. 2d 577 (2005). If the WSIB were to cease operations, it is conceivable that this could lead to a violation of Section 10(b) of the Securities Exchange Act of 1934, and Rule 10b-5 promulgated thereunder. For example, if the WSIB knew (or believed there was a strong likelihood) that the government was going to shutdown (and thus the WSIB would cease operations), and the WSIB failed to disclose this to counterparties, this may end up being a violation of Section 10(b). First, failing to disclose this would likely be a material omission. Second, since there would be knowledge of the looming shutdown, and assuming the WSIB failed to disclose it, scienter may be established. Third, if this was in connection with the purchase or sale of a security, the third element would be satisfied. Fourth, reliance would likely be established here because there is a presumption of reliance in securities fraud cases. *See Basic Inc. v. Levinson*, 485 U.S. 224, 248-49, 108 S. Ct. 978, 99 L. Ed. 2d 194 (1988). Finally, the last two elements would be satisfied where the omission causes an economic loss (for example, if the WSIB were unable to remit payment following a drawdown notice because the WSIB had ceased operations).

Similarly, the WSIB could also be liable for securities fraud under state securities laws. A securities fraud claim under the Securities Act of Washington has two essential elements: (1) a fraudulent or deceitful act, (2) committed in connection with the offer, sale, or purchase of any

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security. RCW 21.20.010; *Kinney v. Cook*, 159 Wn.2d 837, 842, 154 P.3d 206 (2007). If the WSIB knew (or believed there was a strong likelihood) that the government was going to shutdown (and thus the WSIB would cease operations), and the WSIB failed to disclose this to counterparties, this may end up being a violation of RCW 21.20.010 since this situation could be seen as a material omission in connection with the purchase or sale of a security. Since ceasing WSIB operations could lead to liability for violations of the federal and/or state securities laws, continued operations may be necessary to avoid catastrophic loss of state property.

V. CONCLUSION

The WSIB is legally required to continue operations in the event of a government shutdown because (1) shutting down WSIB operations would likely lead to an unconstitutional impairment of contract; (2) shutting down WSIB operations could lead to liability for breach of fiduciary duties; and (3) shutting down WSIB operations could lead to liability for violations of the federal and/or state securities laws. In short, the WSIB must continue operations because its activities are constitutionally mandated and/or necessary to avoid catastrophic loss of state property.

MJN/DA
cc: Tor Jernudd, AAG