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September 13, 2004

School Board for Battle Lake Public Schools  
Independent School District No. 542  
402 Summit Street West  
Battle Lake, Minnesota 56515-4029

Dear Battle Lake School Board Members:

The State Auditor's Office reviewed the handling of funds that the Battle Lake Public Schools, Independent School District No. 542 (ISD 542), received as a bequest. We believe that the handling of those funds was not in compliance with Minnesota law. Specifically, we believe that:

- ISD 542 had no authority to create a non-profit corporation; nor to give the bequest to this non-profit corporation;
- The bequest was public funds; and these funds were not invested in compliance with Minnesota law; and
- The use of these funds for scholarships appears to fall outside the purpose stated in the bequest.

We recommend that ISD 542 adopt and implement a plan to bring the handling of these funds into compliance with Minnesota law.

### **Background**

In 1998, ISD 542 was notified that it had received a bequest from a former student's estate to ISD 542's Building Fund.<sup>1</sup> In response to that bequest, the school district's attorney helped form the non-profit corporation Battle Lake Education Foundation of Battle Lake, Minnesota (the Foundation). The Foundation's Articles of Incorporation were signed in March 1999, and filed with the Minnesota Secretary of State's Office on April 2, 1999. The purpose of the Foundation was to assist ISD 542 with capital expenditures and to grant scholarships to ISD 542 graduates.<sup>2</sup> According to the Articles

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<sup>1</sup> See Royal Swen Broberg 1996 Trust, Article 5 ¶ 4. Specifically, the Trust provided: "All the rest, residue and remainder of the trust estate, including my IRA account, after payment of taxes and other expenses, to the Building Fund of INDEPENDENT SCHOOL DISTRICT #542, BATTLE LAKE PUBLIC SCHOOL, located in Battle Lake, MN." It is our understanding that Mr. Broberg died on November 5, 1997.

<sup>2</sup> See Articles of Incorporation of Battle Lake Education Foundation of Battle Lake, Minnesota, Article II.

of Incorporation, the Foundation was to be operated, supervised and controlled by ISD 542.<sup>3</sup> However, the Foundation was given the authorization to control the Foundation's funds.<sup>4</sup>

At the School Board's request, on approximately December 8, 1999, the bequest was transferred to Merrill Lynch, to be placed in the Foundation's account.<sup>5</sup> When asked for any statements of investment restrictions or investment policies for the account, we were informed that the funds were invested in a balanced fund, with a goal of maintaining a mix of 60% stock, 35% bonds and 5% fixed assets, with a return of 8%. The Foundation also asked Merrill Lynch to avoid controversial stocks such as liquor, tobacco and personal firearm manufacturers. We were provided with no other written statements of investment restrictions or investment policies.

We were provided with some of the Merrill Lynch statements for the Foundation's account. The market value of the account as of January 31, 2000 was \$1,837,935. By August 31, 2002, the account was worth \$1,023,497. By March 31, 2003, the account was worth \$951,627. In addition to the loss of funds due to market conditions, the Foundation used some of the funds to award scholarships to students and to fund improvements for ISD 542.<sup>6</sup>

### **The Transfer of the Bequest to the Foundation Was Not Authorized by Law**

A school board does not have the authority to create a non-profit corporation. In a 1986 Minnesota Attorney General opinion, a county attorney was advised that local units of government had no express or implied authority to create non-profit corporations.<sup>7</sup> In 1997, the legislature expressly prohibited local units of government from creating non-

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<sup>3</sup> *Id.* The Foundation's Articles of Incorporation were drafted by the School Board's attorney. We were informed that the School Board appointed the Foundation's Board and approved the Foundation's expenditures.

<sup>4</sup> *Id.*

<sup>5</sup> See December 8, 1999 letter from Superintendent Rick Bleichner to Mr. Tim Reames, Trustee for Royal Swen Broberg 1996 Trust (school board requests that funds be placed in Foundation's Merrill Lynch account); and December 8, 1999 letter from Mr. Tim Reames to Charles Schwab (requesting transfer of funds to Foundation's Merrill Lynch account). According to Supplemental Information filed with the Foundation's 2002 taxes, the following assets were transferred to the Foundation from Royal Broberg: 12,000 shares of Merck, 23,012 shares of Unical, 623 shares of Diameler Chrysler, 200 shares of Ensco International, and 17,729 shares of Magelan (*sic*) Petro.

<sup>6</sup> Specifically, according to the Foundation's tax forms (Form 990) available to us, the Foundation spent \$250,000 for scholarships and capital improvements for ISD 542 in 2000; in 2001, the Foundation spent \$60,000 for an outdoor facility and \$1,000 for scholarships; and in 2002, the Foundation spent \$60,000 for the outdoor facility, \$6,000 for landscaping, \$3,500 for wrestling mats, and \$19,000 for scholarships. We did not obtain the Foundation's 2003 tax forms.

<sup>7</sup> See Op. Atty. Gen. 92a-30 (January 29, 1986).

profit corporations.<sup>8</sup> We know of no express authority allowing ISD 542 to create a non-profit corporation.

A school board may receive bequests, donations or gifts for the benefit of the district.<sup>9</sup> The Broberg Trust was for the benefit of the Building Fund; there was no separate trust for scholarships. The school board has the authority to act as the trustee of any trust created for the benefit of the district, or a trust created for the benefit of the district's pupils.<sup>10</sup> This bequest was to the Building Fund of ISD 542. ISD 542 accepted the bequest for the benefit of the District's Building Fund.<sup>11</sup> We know of no authority for ISD 542 to then give the bequest to a non-profit corporation.

In most cases, there is no problem if education foundations give funds to schools. Education foundations are privately operated, non-profit organizations established independent of the school districts.<sup>12</sup> Often the goal of the education foundation is to raise funds to provide education enrichment programs that may otherwise be unavailable to the schools.<sup>13</sup> In short, education foundations are created to help fund school districts. However, in this case, it appears that ISD 542 used its bequest to fund the education foundation.

We believe ISD 542 had no authority to create the Foundation in 1999. Similarly, we believe that ISD 542 had no authority to direct that the bequest to ISD 542's Building Fund be distributed to the Foundation's Merrill Lynch account. As a result, we recommend that ISD 542 remove what remains of the bequest from the Foundation's accounts, and exercise control over the bequest in compliance with Minnesota law.

### **The Investment of Public Funds Was Improper**

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<sup>8</sup> See Minn. Stat. § 465.715, subd. 1 (1997). The prohibition is currently found at Minn. Stat. § 465.717, subd. 1 (2004). The 2000 legislature provided that non-profit corporations created by political subdivisions prior to May 31, 1997 could continue to exist if the political subdivision adopted a resolution by August 1, 2003. See Minn. Stat. § 465.719, subd. 2 (2004). Because the Foundation was created in 1999, this grandfather provision does not apply to the Foundation.

<sup>9</sup> See Minn. Stat. § 123B.02, subd. 6 (2004). See also Minn. Stat. § 465.03 (2004). Acceptance of the bequest must be in accordance with the terms prescribed by the donor, and by a resolution adopted by two-thirds of the governing body. *Id.* We recommend that school districts establish a gift acceptance policy to receive gifts or bequests.

<sup>10</sup> See Minn. Stat. § 123B.02, subd. 6 (2004).

<sup>11</sup> Clearly the School Board did not reject the bequest or the School Board would not have had the authority to direct that the funds be placed in the Foundation's account. By directing the funds to the Foundation's account, ISD 542 accepted the bequest.

<sup>12</sup> It is estimated that there are more than 4,800 education foundations in the United States. See National School Boards Association's Leadership Insider (January 2004), found at [www.nsba.org](http://www.nsba.org); National Center for Public & Private School Foundations, found at [www.intime.uni.edu](http://www.intime.uni.edu). A copy of the State Auditor's Position Statement on Education Foundations is enclosed.

<sup>13</sup> Some bequests are made directly to existing education foundations. If this bequest had been made to an existing foundation, instead of to ISD 542, then the restrictions on the investment of public funds discussed next in this letter would not have applied. However, the Foundation had not been created at the time of the bequest, and the bequest was made directly to ISD 542's Building Fund.

All funds, including trust funds, held or administered by a school district are considered public funds under Minnesota law.<sup>14</sup> Once accepted by ISD 542, the bequest became public funds. The type of investments available for public funds are limited, and do not include equity or corporate stocks.<sup>15</sup> We do not believe that ISD 542 could accept the bequest, and then avoid the restrictions on the investment of public funds by directing that the funds be deposited in the Foundation's account.

Prior to completing an initial transaction with a broker, and annually thereafter, a school district must provide the broker with a written statement of investment restrictions that includes a provision that all future investments must be made in accordance with Minnesota statutes governing the investment of public funds.<sup>16</sup> The broker must acknowledge annually the receipt of the statement of investment restrictions and must agree to handle the account in accordance with the restrictions.<sup>17</sup> A school district may not enter into a transaction with a broker until the broker has provided this written acknowledgement to the school district.<sup>18</sup> It appears Merrill Lynch was not provided with the required statement of investment restrictions.

The transfer of these public funds to an unauthorized Foundation, and their subsequent investment in corporate stock, has unfortunately resulted in the loss of public funds – funds that now will not be available for ISD 542's Building Fund.<sup>19</sup> We recommend that ISD 542 bring the investment of these public funds into compliance with Minnesota law. The divestiture and reinvestment of these funds, to come into compliance with Minnesota law, must be done in a reasonable and prudent financial manner. We further recommend that ISD 542 provide its broker with a statement of investment restrictions so that all future investments are made in accordance with Minnesota statutes governing the investment of public funds.

### **Development of Investment Policy**

We also recommend that ISD 542 adopt an investment policy.

The first step in a prudent investment process is to know the standards, laws and trust provisions applicable to the funds. The funds must then be managed in accordance with applicable laws, the trust document, and any written investment policy statements. Goals

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<sup>14</sup> See Minn. Stat. § 118A.01, subs. 2 and 4 (2004).

<sup>15</sup> See Minn. Stat. § 118A.04 (2004). Officials are not personally liable for any loss sustained from funds invested according to Minn. Stat. §§ 118A.04 and 118A.05. See Minn. Stat. § 118A.02, subd. 2(b) (2004).

<sup>16</sup> See Minn. Stat. § 118A.04, subd. 9(b) (2004). A form for the required annual notification and certification is contained on the State Auditor's website, [www.auditor.state.mn.us](http://www.auditor.state.mn.us), and a copy is enclosed for your review.

<sup>17</sup> *Id.* at subd. 9(c).

<sup>18</sup> *Id.*

<sup>19</sup> Had \$1.8 million been invested in 3-month Treasury bills in 2000, the school district would have been able to make expenditures of \$225,000 per year for five years, and still would have had an ending balance in 2004 of approximately \$850,000.

and objectives should be set that are consistent with the portfolio's current and future resources, the limits and constraints of the applicable trust documents, and the governing statutes.<sup>20</sup>

While not required by state law, we recommend that ISD 542 consider adopting a written investment policy. Sample policies can be found, among other places, at the website of the Government Finance Officers Association, [www.gfoa.org](http://www.gfoa.org). A written policy helps make sure that the School Board, the public, and ISD 542's investment advisor have the same understanding of ISD 542's financial goals, and provides a procedural framework for pursuing those goals. To draft the written policy, ISD 542 will be required to identify the statutes and trust provisions that are applicable to these funds; statutes and trust provisions that place restrictions on what ISD 542 may do with these funds.

### **The Bequest Must Be Used For the Purposes Stated in the Bequest**

The bequest was specifically made to ISD 542's Building Fund. However, some of the funds have been used for scholarships.

A trustee must act in good faith to honor the intent of the bequest.<sup>21</sup> Similarly, a gift accepted by a school district for a specific purpose must be used in accordance with the terms prescribed by the donor.<sup>22</sup> The Minnesota Supreme Court has recognized that a gift for a public purpose that is intended to inure to several generations will often have conditions attached to the gift – conditions that must be honored.<sup>23</sup>

Although the expenditure of funds for scholarships may be a laudable goal, ISD 542 cannot accept a gift for a specific purpose, and then use the gifted money for another purpose. There is no evidence that it is impracticable, inexpedient, or impossible to comply with the literal terms of the trust.<sup>24</sup> Nor has any District Court judge ruled that reasonable efforts to comply with the literal language of the trust have failed.<sup>25</sup>

ISD 542 must use the funds consistent with the intent of the bequest.

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<sup>20</sup> Several resources exist that can guide ISD 542 in responsibly managing these funds. One such document is *Prudent Investment Practices: A Handbook for Investment Fiduciaries*, written by the Foundation for Fiduciary Studies. See, e.g., [www.ffstudies.org](http://www.ffstudies.org). See also Minnesota Prudent Investor Act, Minn. Stat. § 501B.151 (2004).

<sup>21</sup> See, e.g., *In re Ruth Easton Fund*, 680 N.W. 2d 541 (Minn. App. 2004) (distribution of charitable fund must be consistent with grantor's intent of producing new, full-length theatrical works); *Longcor v. City of Red Wing*, 206 Minn. 627, 289 N.W. 570 (1940) (action to compel compliance with conditions of gift for charitable purposes, an auditorium); *Owatonna v. Rosebrock*, 88 Minn. 318, 92 N.W. 1122 (1903) (bequest for kindergarten). The Trust was created under California law. California law is consistent with Minnesota law. See, e.g., Cal. Probate Code § 16000; *Estate of William Nicholas*, 177 Cal. App. 3d 1071, 223 Cal. Rptr. 410 (1986); *Estate of Edward B. Gross*, 216 Cal. App. 2d 563, 31 Cal. Rptr. 281 (1963).

<sup>22</sup> See Minn. Stat. § 465.03 (2004).

<sup>23</sup> See, e.g., *Longcor*, 206 Minn. at 633, 289 N.W. at 572.

<sup>24</sup> See *In re Ruth Easton Fund*, 680 N.W.2d at 549-551.

<sup>25</sup> *Id.*

**Conclusion**

We believe that ISD 542 has not complied with Minnesota law in the handling of this bequest. We believe ISD 542 had no authority to turn the funds over to the Foundation. We believe that these public funds have not been invested in accordance with Minnesota law. Finally, we believe that the use of these funds for scholarships falls outside the scope of the bequest.

Please notify us regarding your actions to bring the handling of these funds into compliance with Minnesota law. In addition, please provide us with a copy of a completed statement of investment restrictions for these funds, as well as any investment policies that you adopt. If you have any questions about this matter, please feel free to call my Deputy State Auditor/General Counsel Carla Heyl at 651-297-3673.

Sincerely,

Patricia Anderson  
State Auditor

Enclosures

cc. Superintendent Rick Bleichner  
Mr. Leon Bjerke, Foundation Chair  
Mr. Oscar J. Sorlie, Attorney for ISD 542  
Mr. Randall Highland, Auditor for ISD 542