

December 20, 1994

The Honorable Sharon Y. Miyashiro, Ph.D.  
Chairperson, Board of Trustees  
Deferred Compensation Plan  
Department of Human Resources Development  
State of Hawaii  
430 Punchbowl Street  
Honolulu, Hawaii 96813

Dear Dr. Miyashiro:

Re: Applicability of the Hawaii Public Procurement Code to the Administrator or Product Provider Contracts of the Deferred Compensation Plan

This confirms our orally conveyed response to the questions posed in your letter of May 9, 1994, requesting a legal opinion as to the applicability of the provisions of the Hawaii Public Procurement Code, Haw. Rev. Stat. ch. 103D ("Code"), to the current and future contracts of the Board of Trustees ("Board") of the Deferred Compensation Plan ("Plan") to engage the services of an administrator and with investment-product providers.

We answer as follows: (1) the Code does not apply to the Board's current administrator and investment-product-provider contracts because they were entered into before the Code's July 1, 1994 effective date; (2) the Code would apply to contracts the Board enters into after that date if "public funds" are used to fund them; (3) however, the Code would not apply if future contracts are funded exclusively with compensation of Plan participants deferred in accordance with section 457 of the Internal Revenue Code or the earnings from the investment of that deferred compensation because those funds are not "public funds" as that term is used in the Code. ([top](#))

#### Background Information

##### 1. The Contracts.

We understand the Board presently has four contracts, one for the services of an administrator, and three with investment product providers. These contracts were executed and became effective on September 22, 1982, November 23, 1982, and March 1, 1991. The administrator's contract expires on June 30, 1996, and the investment-product-provider contracts expire on February 29, 1996, and March 1, 1996. Each of these contracts includes a provision which thereafter, automatically extends the duration of the contract by one year for an unlimited number of years, unless the Board or the contractor affirmatively acts to stop the one-year automatic extension.

The administrator's contract was awarded in accordance with Haw. Rev. Stat. § 88E-3 ("An administrator may be engaged only after a solicitation of proposals from interested persons in accordance with specifications deemed appropriate by the board"). The product-provider contracts were awarded using "a competitive bidding process based on the specifications and considerations deemed appropriate by the board" pursuant to Haw. Rev. Stat. § 88E-9.<sup>1</sup>

##### 2. The Plan.

Haw. Rev. Stat. ch. 88E which authorizes the establishment of the Plan<sup>2</sup> was enacted in 1981 to take advantage of changes in the federal income tax law, offer a "'non-cost' fringe benefit . . . to public employees," and provide "an additional source of income to participating officers and employees when they retire."<sup>3</sup> H. Stand. Comm. Rep. No. 716, Haw. H.J. at 1237 (1981).<sup>4</sup> In late 1978, Congress enacted § 457 of the Internal Revenue Code which authorized public sector

employers to adopt unfunded deferred compensation plans by which their employees could opt to defer payment of certain specified amounts of their compensation, and thereby postpone the time when that compensation would be considered gross income and taxed.<sup>5</sup> ([top](#))

To satisfy § 457's requirements, Haw. Rev. Stat. § 88E-8 provides in pertinent part: that "[s]ums deferred under the plan, as well as property and rights purchased with such amounts and income attributable to such amounts, shall remain an unrestricted asset of the respective state or county jurisdiction."

Haw. Rev. Stat. §§ 88E-9 and -10 facilitate the administration of this requirement by providing that "[t]he board may create a trust or other special funds for the segregation of funds or assets resulting from compensation deferred and for the administration of the plan," and that the State's Director of Finance is to serve as the custodian of these funds. ([top](#))

However, Haw. Rev. Stat. § 88E-13 provides that "[c]osts for implementing and administering the plan shall be borne by the plan and its participants, except for incidental expenses, such as, the cost of payroll deductions and the routine processing of forms." Every committee report accompanying the adoption of ch. 88E (and H.B. No. 767 which H.B. No. 7 revived in the 1981 special session) emphasizes that "the plan shall bear all implementation and administrative costs." See, H. Stand. Comm. Rep. No. 7, Haw. H.J. 36 (Sp. Sess. 1981). H. Stand. Comm. Rep. No. 362 on H.B. No. 767, Haw. H.J. 1088 (1981), specifically notes:

Some concern was expressed over the section of the bill stating that the plan shall bear all implementation and administrative costs, and the effect this would have on initial "start-up" costs. Your Committee believes that such costs are clerical and house-keeping in nature. The bill provides for the "start-up[]" costs, but the plan will reimburse the State for these costs.

Haw. H.J. at 1088 (1981). We understand that except for the initial reimbursable "start-up" appropriation, no appropriations have been made for the Plan. We further understand that because of this legislative history, from the beginning, the Board has operated under a premise that its contracts were not funded with "public funds." ([top](#))

### 3. The Code.

The Legislature enacted the Code in special session in 1993. Act 8, Sp. Sess. Laws of Hawaii (1993) ("Act 8"). It became fully effective on July 1, 1994. The Code's literal language and its accompanying legislative history make clear that the Legislature has developed and pronounced strong and detailed policies about procurement, what it entails, and how it is to be conducted by public agencies.<sup>6</sup> However, it does not apply to every contract or every procurement involving or made by a state agency.

Contracts "solicited or entered into [before] July 1, 1994" are not subject to the Code. Haw. Rev. Stat. § 103D-102(a) (Comp. 1993). Contracts which do not involve the "expenditure of public funds irrespective of their source by a governmental body" are not subject to the Code. Haw. Rev. Stat. § 103D-102(b) (Comp. 1993, as amended by Act 186, Haw. Sess. Laws 409, 421 (1994)). Contracts for one of nine specifically described types of goods or services are not subject to the Code. Haw. Rev. Stat. § 103D-102(b) (1) - (9) (1994). Finally, contracts of governmental bodies "expressly exempt [by other laws] from the requirements of [chapter 103D] or any of its provisions," are not subject to the Code. Haw. Rev. Stat. § 103D-102(c). ([top](#))

### Discussion

Answering your questions in order, the Code does not apply to the existing administrator or investment-product-provider contracts because they were entered into prior to the July 1, 1994, applicability date in § 103D-102(a). By their pre-July 1, 1994, terms, they extend themselves by

one-year increments without any intervention by the Board or its contractors.

Whether the Code applies to contracts the Board enters into after July 1, 1994, or to modifications it might make to the existing contracts after that date, depends upon whether any of the other exemptions in § 103D-102 apply. ([top](#))

Board contracts clearly are not exempt from the Code's provisions under any of the nine enumerated exemptions in § 103D- 102(b). Similarly, they are not exempt despite §§ 88E-3's and -9's "solicitation of proposals," "specifications" and "competitive bidding process" which suggest that contracting mechanisms different from the Code were to be used. We are not convinced that these phrases constitute the "express" exemption contemplated under § 103D-102(c), especially in light of the legislature's later stated interest (through its adoption of the Code) in maximizing competition and opening up the public procurement process to as many participants as possible. ([top](#))

However, a persuasive argument can be made that contracts funded with compensation deferred by Plan participants are not subject to the Code's requirements because the contracts are not funded with "public funds." Haw. Rev. Stat. § 88E-13 expressly provides that the costs for administering the Plan must be borne by the Plan and its participants. The initial legislative history specified that "start-up" appropriations be repaid by the Plan and its participants. Except for the appropriation made when the Plan was first established, no appropriations have been made to pay for the Plan's administrative expenses. Historically, only compensation deferred by participants and assets generated by the deferred sums' investment have been available to the Board to pay the Plan's administrative costs. ([top](#))

In addition, under § 88E-11, the State "shall not be liable for the sums deferred or the results of any investment product," although under § 88E-8, as required by the federal tax laws, the "sums deferred under the plan, as well as property and rights purchased with such amounts and income attributable to such amounts, shall remain an unrestricted asset of the respective state or county jurisdiction," until they are permitted to be paid out (and taxed) by those same federal tax laws. However, the legislative history of the federal tax law makes clear that the sums deferred represent sums which the employer, absent dissolution or insolvency, will pay the participant as a result of the participant's initial decision to defer that payment and to specify how the sums deferred are to be invested, pending their future disbursement. ([top](#))

Long-standing agency interpretation of statutes which the agency is responsible for administering and implementing is entitled to "much weight." *Keller v. Thompson*, 56 Haw. 183, 532 P.2d 664 (1975). Courts will defer to that construction unless it is "palpably erroneous." *Treloar v. Swinerton and Walberg Co.*, 65 Haw. 415, 653 P.2d 420 (1982). From its inception, the Board has administered the Plan, and contracted for the services of both its administrator and its investment product providers, utilizing only the provisions of §§ 88E-2 and -9. This interpretation cannot be said to be "palpably erroneous" particularly when one understands the state and federal legislative objectives for deferred compensation plans generally and the Plan in particular.

There are no cases from Hawaii which are helpful in construing "public funds," and the legislative history of the Code is similarly not enlightening as to whether the term was intended to encompass moneys which must belong to the State in order that the State may offer an additional non-cost fringe benefit to its employees. Other courts have, however, determined whether moneys owed individuals by government in other contexts are "public funds." In Arizona, the Supreme Court has concluded that federal funds which by federal law are available to private parties only when a state agency serves as the disbursing agency are not "public funds," even though they are held by a state agency. To be "public funds," the state must have "equitable" and "legal" rights to them. *Navajo Tribe v. Arizona Dept. of Administration*, 528 P.2d 623 (1974).<sup>7</sup> A distinction must be drawn between money over which a state has control, e.g., money collected as rent from a source and used to pay an obligation owed by a state to another, which are public funds, and money which the state merely collects, holds, or disburses. *McIntosh v. Aubry*, 18 Cal.

Rptr. 2d 680, 688 (1993). ([top](#))

Given all of this, we believe it is more appropriate to characterize the money used to fund the contracts for administrator and investment product providers as not constituting "public funds." Having reached that conclusion, we must conclude that the Code's provisions do not apply to the contracts.

In closing, two points must be noted. First, only contracts funded with deferred compensation or the proceeds generated by their investment are exempt from the Code's coverage. Second, and more importantly, nothing prevents the Board from utilizing the more detailed source selection methods outlined in the Code and its implementing administrative rules to fashion the procedures and specifications or elicit the proposals contemplated in Haw. Rev. Stat. §§ 88E-2 and -9. As custodians and fiduciaries for the participants of the Plan, the Board could not be faulted if it recognized the legislative public policy preference for competition inherent in the Code and, at minimum, self-consciously conducted its activities consistently with that objective. ([top](#))

Very truly yours,

Charleen M. Aina  
Deputy Attorney General

APPROVED:

Robert A. Marks  
Attorney General  
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<sup>1</sup>These provisions were used rather than those in the State's public contracts and competitive bidding laws in effect at the time, e.g., Haw. Rev. Stat. §§ 103-22, -26, -32, because the Board, with input from the Attorney General, concluded that funds for the contracts were not public funds. [BACK TO DOCUMENT](#) ([top](#))

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<sup>2</sup>Haw. Rev. Stat. § 88E-2 provides:

The State may establish a deferred compensation plan in accordance with section 457 of the Internal Revenue Code of 1954, as amended, for the benefit of employees to defer a portion of their compensation to a future period of time . . . An employee may authorize deductions to be made from the employee's wages for the purpose of participation in the plan. [BACK TO DOCUMENT](#) ([top](#))

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<sup>3</sup>This objective is reflected in the legislative history of the federal income tax law:

The committee believes that the regulations concerning nonqualified deferred compensation plans involving an individual election to defer compensation proposed by the Internal Revenue Service on February 3, 1978, if adopted in final form, would seriously impact upon the employees of many States and localities. If adopted, the regulations would prohibit employees of State and local governments from participating in salary-reduction deferred compensation plans as a means of providing retirement income.

Senate Rep. No. 95-1263 on Pub. L. No. 95-600, reprinted in U.S. Code Cong. & Admin. News

6761, 6828 (1978). [BACK TO DOCUMENT \(top\)](#)

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<sup>4</sup>H.B. No. 767 which this committee report discusses was enacted but vetoed during the 1981 regular session of the Legislature. However, as noted in S. Stand. Comm. Rep. No. 11 on H.B. No. 7 of the 1981 special session of the Legislature which established the Plan, H.B. No. 7 was identical to H.B. No. 767, H.D. 2. [BACK TO DOCUMENT \(top\)](#)

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<sup>5</sup>Section 457 codified the conclusions of prior private letter rulings issued by the Service. The plans which elicited these rulings:

typically involve an agreement between the employee and the State or local government, under which the employer agrees to defer an amount of compensation not yet earned. Frequently, these plans permit the employee to specify how the deferred compensation is to be invested by choosing among various investment alternatives provided by the plan. (However, the employer must be the owner and beneficiary of all such investments and the employee or his beneficiary cannot have a vested, secured, or preferred interest in any of the employer's assets.) Benefits under these plans (including gains and losses and investment income on investments made with the deferred compensation) typically are paid to the employees upon retirement or separation from service with the employer, or, in the case of the death of an employee, to the designated beneficiary. Typically, these plans provide also for the payment of benefits in case of an emergency beyond the employee's control. Many plans also provide for optional modes of distributing benefits (e.g., lump-sum payment or installments over 10 years) upon the occurrence of the event which causes benefits to be paid. [\(top\)](#)

Senate Rep. No. 95-1263 on Pub. L. No. 95-600, reprinted in U.S. Code Cong. & Admin. News 6761, 6827 n. 6 (1978).

The rulings are extensions of earlier revenue rulings in which the Service concluded that "an unsecured promise to make a future payment, not represented by a note, is not an item of gross income under the cash receipts and disbursements method," and court decisions "which held that neither the constructive receipt doctrine nor the case equivalent doctrine would be applied to a taxpayer merely because the taxpayer agreed with the payor in advance to receive compensation on a deferred basis rather than currently, as long as the agreement was made before the taxpayer had obtained an unqualified and unconditional right to the income." Id. at 6826. [BACK TO DOCUMENT \(top\)](#)

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<sup>6</sup>In section 1 of Act 8, the Legislature observed:

It is the policy of the State to foster broad-based competition. Full and open competition shall be encouraged. With competition, the State and counties will benefit economically with lowered costs. Therefore, it is the legislature's intent to maintain the integrity of the competitive bidding and contracting process by discouraging the State and counties from making changes to contracts once the contracts are awarded. If any contract needs to be amended, compelling reasons must exist for making the changes.

In an accompanying committee report, the Legislature noted:

It is clear to your Committees that the area of sole source procurement, the center of current controversy and investigation by a special Senate committee, needed to be addressed. This bill allows for the awarding of sole source contracts only after a written determination is made that there is only one source for the required good, service, or construction.

S. Stand. Comm. Rep. No. S8-93 (Sp. Sess. 1993). [BACK TO DOCUMENT \(top\)](#)

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<sup>7</sup>The court summarized the law from other jurisdictions:

Payment of funds into the state treasury does not necessarily vest the state with title to those funds. *Ross v. Gross*, 300 Ky. 337, 188 S.W.2d 475 (1945). Only monies raised by the operation of some general law become public funds. *Cyr & Evans Contracting Co. v. Graham*, 2 Ariz. App. 196, 407 P.2d 385 (1965). Custodial funds are not state monies. *MacManus v. Love*, 499 P.2d 609 (Colo. 1972). The term "public funds" refers to funds belonging to the state and does not apply to funds for the benefit of contributors for which the state is a mere custodian or conduit. *Pensioners Protective Assn v. Davis*, 112 Colo. 535, 150 P.2d 974 (1944)

Id. at 624-25. [BACK TO DOCUMENT \(top\)](#)