The Tobacco Settlement: States Propose Trust Funds, Endowments, and Foundations

Executive Summary

Many Governors are considering the establishment of trust funds, endowments, and foundations to manage and administer funds states will receive because of the national tobacco settlement reached in November 1998. Trust funds, endowments, and foundations are usually established to segregate funds in a budget, codify policy and intentions for spending the funds, or for preserving funds for future use. All are instruments by which funds or assets may be reserved for specific purposes, and there are guiding principles that dictate their management. The governing instrument is the critical component of successful fund administration.

- Governmental trust funds are usually created to reserve revenue for specific purposes. They have varying degrees of oversight and management.

- Endowments are commonly used when parties wish to preserve a base amount of funds in perpetuity or for some long period of time. The funds are usually kept apart from other assets. Only the interest income, or a portion of the income, is used to support specific objectives outlined in a charter or governing instrument.

- Foundations are nonprofit, philanthropic entities established to aid and maintain charitable activities. They often are in the form of a trust fund, although some foundations have endowments.

For Governors and state policymakers, planning and establishing concise goals and accountability measures are critical to successful fund management, regardless of the mechanism the state may use to receive and manage tobacco settlement funds. Key questions the Governor should ask are:

- what are the state’s legal and constitutional constraints associated with the various options;
- is the state planning to spend principal, interest, or both; and
- what is the best structure to administer the funds?
Background
On November 23, 1998, the attorneys general of forty-six states, five commonwealths and territories, and the District of Columbia reached an agreement with the five major tobacco companies, which represent 97.5 percent of the tobacco industry. Worth $206 billion over the next twenty-six years, the settlement will provide payments to states based on a formula developed by the attorneys general. Four additional states—Florida, Minnesota, Mississippi, and Texas—individually settled with the tobacco industry for more than $40 billion.

The master settlement agreement does not specify how states may spend their settlement payments. There have been many debates around the nation about how best to use these funds. Governors are playing key roles in leading this debate. Some Governors are choosing to establish trust funds and endowments to protect some or all of the funds for specific purposes. Other Governors are proposing to create foundations to administer some of these monies.

Some issues for a Governor to consider when developing a proposal for the tobacco settlement funds include:
• the potential legal and constitutional constraints associated with each option;
• whether to use principal or interest; and
• how best to administer the funds.

Trust Funds, Endowments, and Foundations: Choices for the State
These instruments provide tools for settlement fund management outside of the regular state appropriation process. States can use trust funds, endowments, and foundations for reasons including segregating funds within the budget, codifying policy and fund intentions, and preserving funds for future use.

Examples of specific fund uses being proposed in states include health care for the uninsured, tobacco prevention and cessation programs, medical research, health care-related infrastructure projects, education scholarships, and financial aid to tobacco farmers.

There are few differences between trust funds, endowments, and foundations, and the terms have similar meanings. They are all instruments by which funds or assets may be reserved for specific purposes. In the case of government, they benefit a group of people or the public at-large. They also have guiding principles or a governing instrument that dictate their management. The Governor or author of the governing instrument has broad discretion in naming the type of fund. The governing instrument, not necessarily the term used to describe the fund or entity, is the critical component of successful fund administration.
The terms have different connotations, however. An endowment usually implies an intention to preserve the principal in perpetuity and is, therefore, more permanent. A trust fund may or may not be permanent. The terms of a trust fund can be more amendable and flexible. Foundations also are often considered more permanent entities, and their fund duration can vary according to long-term needs and mission. Foundations and endowments may be viable options for Governors wishing to highlight an issue or create a special entity to address certain problems. These entities may operate beyond a Governor’s term and therefore continue important initiatives into the future. However, strict measures of accountability must be developed because foundations are often separate from government.

**Trust Funds**

Governmental trust funds usually are created to reserve certain revenue for specific purposes. They can have varying degrees of oversight and management. For example an appointed board or commission can manage a fund. In some cases, the state treasurer distributes the assets. In other cases, there is an annual appropriation through the regular legislative process. Trust funds are useful budget tools and often are simply separate, designated accounts in the state treasury. Typically all of the monies are available for expenditure for their specified purposes. States have used trust funds in the past to designate specific revenue for special projects or ongoing programs. North Dakota’s Common Schools Trust Fund, which was established in the state constitution, receives revenues and uses its interest income solely to maintain and support schools.

A trust fund’s specific purpose will vary according to its goals and a state’s political climate. All types of trust funds usually have a governing instrument, or set of guiding principles that direct fund expenditures and that describe fund management and responsibilities. Trust funds, in general, are broadly defined mechanisms that enable states to reserve and designate monies for particular purposes and may be more easily altered than other fund mechanisms. This option would allow Governors to segregate these revenues and apply them to special initiatives or projects, while potentially maintaining some control over the funds. Some state examples follow.

**Alabama.** Alabama created a trust fund in 1998 to receive any funds from the yet-to-be-resolved tobacco settlement. The Children’s First Trust Fund will receive $85 million from the settlement and support Children’s First Foundation’s efforts. A group of family and child advocates created the foundation to support issues related to juvenile justice, foster care, multiple-needs children, and the Children’s Health Insurance Program (CHIP), which is called ALLKids in Alabama. The state treasury will maintain an account for the fund, and the Juvenile Justice Coordinating Council will oversee disbursements. The remainder of the tobacco settlement money will go into the general fund for legislative appropriation.

**Michigan.** Governor John Engler proposed the Michigan Merit Award Trust Fund, which will be established in the department of treasury to receive revenues from the tobacco settlement. Revenues will support the proposed Michigan Merit Award program, a merit-based scholarship program for high school seniors pursuing higher education. It will offer a $2,500 award to students who meet or exceed state standards in reading, math, science, and writing, and it may be used at any two-year or four-year higher education institution in
Michigan or for federally approved apprentice programs. Students who pass the seventh- and eighth-grade achievement tests will be awarded an additional $500. A trust fund board also will be established to administer the program.

**Virginia.** Governor James S. Gilmore III and the general assembly worked together to craft a constitutionally sound bill that will create two trust funds in the state treasury—one for tobacco farmers and their communities and one for youth smoking prevention and cessation. The legislation establishes the Tobacco Indemnification and Community Revitalization Commission and the Virginia Tobacco Settlement Foundation. These entities will administer 60 percent of the monies received by Virginia under the master settlement agreement. Fifty percent of that money is directed to the Revitalization Commission to make payments to tobacco farmers and to promote economic growth and development in tobacco dependent communities. Ten percent of the money will be administered by the settlement foundation and deposited in a fund to finance health-related programs. The remaining 40 percent of the settlement monies will be appropriated by the legislature.

Governor Gilmore specifically recommended creating the trust funds, or nonreverting funds that are segregated from the rest of the budget. Constitutionally, monies due Virginia under the master settlement agreement are required by the state constitution to be deposited into the state treasury and may not be spent except by specific legislative appropriation.

The general assembly will appropriate the tobacco payments to the two funds every year. This method allows the Governor to have some control over expenditures through the appointment of members to the commission and foundation and allows the state to spend monies without time constraints. The legislature also has the power to appoint members to the new entities.

Governor Gilmore also created a commission, through executive order, designed to coordinate the master settlement agreement monies and the monies from the National Tobacco Community Trust. This private trust was established among the major tobacco manufacturers and the Governors of the largest tobacco growing states. The Commission on the Economic Development, Protection, and Growth of Virginia’s Tobacco Dependent Communities will advise the Governor on matters related to the uses and distribution of any funds received under the master settlement agreement and the National Tobacco Community Trust to avoid double indemnification.

**Washington.** Governor Gary Locke proposed the creation of a trust fund and increased expenditures for health coverage for the uninsured. His initiative creates two separate accounts in the state treasury, one to receive all tobacco settlement funds and one to be used only for tobacco prevention and control. The latter account is called the Tobacco Prevention Trust Fund and would be administered by the department of health in consultation with the new Tobacco Prevention and Control Advisory Board. At its inception, the trust fund would receive $100 million, which would be transferred from the overall tobacco settlement account by the state treasurer. The remainder of the tobacco settlement funds would go to the health services account, an existing account that finances health care coverage for children and uninsured adults.
Endowments
Endowments are used when parties wish to preserve a base amount of funds in perpetuity or for some long period of time. The funds are usually kept apart from other assets. Only the interest income, or portion of the income, is used to support specific purposes or objectives outlined in a charter or governing instrument. The principal is left untouched and invested for further growth. The goal of an endowment is long-term stability and viability. Boards often manage these fund expenditures and set spending priorities. Universities often have endowments for capital expenditures and long-term development needs, and internal boards manage and distribute those funds. Endowments may be a part of an institution, such as a university, or a separate, stand-alone organization. An endowment would allow states to benefit from settlement funds for longer than the years of settlement payments. Some state examples follow.

Florida. Governor Jeb Bush announced his proposal to establish the Lawton Chiles Tobacco Endowment for Children and Elders. Over four years it will set aside more than $2 billion of the state’s tobacco settlement funds. Governor Bush elected to establish an endowment to secure the future of three specific programs affecting children and seniors.

The state’s department of banking and finance receives settlement monies and clears them through a tobacco settlement trust fund. It then statutorily transfers the appropriate funds to the endowment, which is managed by the state board of administration (SBA). The SBA has the authority to invest funds in a manner similar to how it invests the state’s retirement funds and to transfer monies derived only from the endowment’s interest to three program areas housed in separate departments: children’s health programs, including Kidcare; child welfare programs; and elder programs. The legislation establishing the endowment will mandate that all incoming settlement dollars be used exclusively for these programs.

Minnesota. Governor Jesse Ventura proposed using the one-time tobacco settlement payments to Minnesota, totaling $1.3 billion over five years, to create a foundation and three endowments. Governor Ventura chose this method to preserve these funds in perpetuity. He recommended spending only part of the investment income and preserving the principal for future growth.

- The Minnesota Families Foundation, a nonprofit entity created to finance activities to help families and individuals become self-sufficient, will receive almost half of the funds. A board will monitor and guide the foundation’s expenditures and activities. It will sunset and return the funds to the state after ten years to allow the legislature to reassess the foundation’s purpose and accomplishments. It has been allocated 46 percent of the funds.
- The Health Professional Education and Medical Research Endowment will support the University of Minnesota and will be managed by the university’s Minnesota Medical Foundation. It will receive 27 percent of the settlement funds.
- The Medical Education and Research Costs (MERC) Endowment will use the existing MERC Trust Fund for grant distribution to support the graduate medical education system and the medical research infrastructure. It has been allocated 7 percent of the funds.
The final 20 percent of the one-time funds will establish the Local Public Health Endowment to strengthen the operation of Minnesota’s forty-nine community health boards. The Governor will separately recommend funding for local health boards’ tobacco prevention efforts. An existing community health services grant will distribute earnings beginning in fiscal 2002.

**Foundations**

Foundations are nonprofit, philanthropic entities established to aid and maintain charitable activities. They often make grants to other nonprofit organizations to carry out these purposes. Whereas trust funds and endowments reserve funds for specific purposes, foundations are actual organizations that receive and disperse funds according to their charter, trust instrument, or enabling legislation. Foundations are often in the form of a trust, and some foundations have endowments. Some state examples follow.

**Alabama.** Alabama has a trust fund that is managed by the Children’s First Foundation. The foundation, in conjunction with the Juvenile Justice Coordinating Council, is the trustee and responsible for the management and disbursement of funds.

**Minnesota.** Governor Ventura proposed the creation of Minnesota Families Foundation to be the entity responsible for guiding and monitoring almost half of the state’s one-time tobacco payments.

**Virginia.** The Virginia Tobacco Settlement Foundation will oversee the trust fund established to prevent and combat youth smoking.

Foundations are separate from government and answer only to the entity outlined in a charter or trust agreement. The term “foundation,” however, does not have a fixed, precise meaning and is not found in many state statutes governing their operation.

**Issues to Consider**

Governors face many decisions as they prepare to use tobacco settlement funds. A myriad of constituencies wants to be included in spending plans. Successful fund management will depend on establishing precise goals and accountability measures.

**Constitutional Issues**

States may have specific spending procedures that Governors will need to examine before developing a proposal. North Dakota Governor Edward T. Schafer proposed a constitutional amendment in his State of the State address that would lock in settlement fund distribution percentages for their duration to prevent future officials from tampering with current intentions. As mentioned above, Virginia Governor James S. Gillmore III intervened in the tobacco debate when he saw constitutional difficulties with a legislative proposal. Washington Governor Gary Locke suggested establishing two separate accounts in the state treasury to accommodate Initiative 601, a budgetary law that states any receipt of revenue automatically reduces the legislature’s spending limit. Separate accounts prevent the initiative from affecting the tobacco funds.
Principal versus Interest
Depending on a state’s economic needs, the Governor may want to spend the tobacco funds as they come. On the other hand, the Governor may want to preserve part or the entire principal by spending only the interest the funds generate. Trust funds simply set aside monies for a specific purpose, whereas endowments reserve the principal for continued growth and use interest to fund initiatives. A trust fund can be designed to protect the principal through its governing instrument.

Fund Administration
Since states will presumably receive settlement funds over the next twenty-five years, and possibly in perpetuity, Governors should consider three important aspects of future fund administration and purpose—governing instruments, fund management mechanisms, and evaluation tools.

Governing instruments. Overly strict wording in guiding principles, trust instruments, and charters may hamper states’ abilities to meet legitimate, unforeseen needs in the future. Alternatively, a loosely worded governing instrument may allow for spending on activities inconsistent with the fund’s purposes. Clearly stated goals and purposes will allow states to set priorities and manage them effectively.

Fund management mechanisms. In addition to foundations, some states are establishing governing boards or commissions to guide spending and initiative development. These management tools are often separate from government and are solely dedicated to advancing a fund’s purpose and mission. Explicit board requirements and gubernatorial input on these appointments will ensure accountability and proper fund management. For example, Governor Gilmore will appoint the majority of Virginia’s commission and foundation members, and the enabling legislation specifically outlines their responsibilities.

Evaluation tools. Measuring the benefits of fund use also will challenge states. Many constituencies will want to see where tobacco monies have positively affected problem areas and communities. Smoking prevention and cessation programs will obviously warrant performance measures, but so will programs that provide health insurance to children, assist farmers, and provide educational opportunities to youth. Governors will set the standard for getting results and explaining them to the public.

Conclusion
With the flexible characteristics of trust funds, endowments, and foundations, Governors have broad latitude to design and name fund management entities. They can design entities according to their states’ short- and long-term needs and priorities through the governing instruments. Governors have a number of goals. A well-constructed governing instrument is the deciding factor to successfully achieve those goals.

Several external variables could affect state payment amounts and expenditure plans. The tobacco industry is in perpetual litigation, and state legislatures continue to pass additional tobacco taxes. The master settlement agreement also will affect the tobacco-use landscape
with its restrictions on marketing and lobbying. It has already increased the price of cigarettes and other tobacco-related products. Experts have not yet determined the impact of these lawsuits, the additional taxes, or the settlement components on the long-term viability of the industry.

Given the uncertainty of the settlement payments to states, Governors should consider protecting some of the funds for the future or at least postponing payment expenditures until they are in state possession. Endowments are excellent tools to preserve funds. Governing instruments of trust funds and foundations can also dictate long-term management principles, such as spending only part of the principal or using only the interest income.

The various options to receive and manage settlement funds provide Governors with numerous opportunities to address their states’ needs and pressing issues. Many Governors have already developed their proposals and are designing options that will enable them to manage funds effectively, garner public support, and produce positive results.

Endnotes

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