

First Supplement to Memorandum 89-13

Subject: Study L-3012 - Uniform Management of Institutional Funds Act
(Comments of Attorney General's Office)

Attached to this supplement is a letter from James R. Schwartz, Deputy Attorney General, concerning the revised staff draft of the *Tentative Recommendation Relating to Revision of the Uniform Management of Institutional Funds Act*, which is attached to Memorandum 89-13. Mr. Schwartz makes the following points:

Corporations Code § 5240 - Relation of UMIFA to Nonprofit Public Benefit Corporations Law

In its first numbered paragraph, the letter suggests that the statute is not yet clear in resolving potential conflicts between UMIFA and the Corporations Code provisions. Mr. Schwartz suggests adding language from draft Probate Code Section 18508 to Corporations Code Section 5240. This new language is to the effect that nothing in UMIFA alters the duties and liabilities of directors under other laws, which would include Corporations Code Section 5240, as the Comment to draft Section 18508 makes clear.

The staff believes that further tinkering here is unnecessary, but we have no strong objection to adding the language to Corporations Code Section 5240. This could be done as follows:

5240. (a) This section applies to all assets held by the corporation for investment. Assets which are directly related to the corporation's public or charitable programs are not subject to this section.

(b) Except as provided in subdivision (c), in investing, reinvesting, purchasing, acquiring, exchanging, selling and managing the corporation's investment, the board shall do the following:

(1) Avoid speculation, looking instead to the permanent disposition of the funds, considering the probable income, as well as the probable safety of the corporation's capital.

(2) Comply with additional standards, if any, imposed by the articles, bylaws or express terms of an instrument or

agreement pursuant to which the assets were contributed to the corporation.

(c) No investment violates this section where it conforms to provisions authorizing such investment contained in an instrument or agreement pursuant to which the assets were contributed to the corporation. No investment violates this section or Section 5231 where it conforms to provisions requiring such investment contained in an instrument or agreement pursuant to which the assets were contributed to the corporation.

(d) In carrying out duties under this section, each director shall act as required by subdivision (a) of Section 5231, may rely upon others as permitted by subdivision (b) of Section 5231, and shall have the benefit of subdivision (c) of Section 5231, and the board may delegate its investment powers as permitted by Section 5210.

(e) Nothing in this section shall be construed to preclude the application of the Uniform Management of Institutional Funds Act, ~~Chapter--3 Part 7~~ (commencing with Section 2290-1 18500) of ~~Title 8 of Part 4 of~~ Division 3 9 of the Civil Probate Code, if that act would otherwise be applicable, but nothing in the Uniform Management of Institutional Funds Act, Part 7 (commencing with Section 18500) of the Probate Code alters the status of governing boards, or the duties and liabilities of directors, under this part.

Comment. Subdivision (e) of Section 5240 is revised to correct a cross-reference and to add language consistent with Probate Code Section 18508.

Still, the staff would like to repeat the point made in an earlier memorandum that the Section 5240 is not a model of clarity. Subdivision (a) provides that assets directly related to the corporation's public or charitable programs are not subject to the section. This prompts us to ask where there is a conflict between UMIFA and Section 5240. The Attorney General's Office has continually argued that the proposed extension of UMIFA to charitable and eleemosynary institutions generally would somehow infringe on the carefully drafted rules in the Corporations Code. When we examine the relevant section, we find that it does not apply to the very assets with which we are concerned (charitable endowment funds) and that in subdivision (e) it makes clear that UMIFA does apply to nonprofit public benefit corporations if they otherwise fall under the scope of UMIFA.

Probate Code § 18501(e) - Application of UMIFA to governmental entities

Paragraph (2) of the attached letter objects to inclusion of governmental organizations within the scope of UMIFA. The argument is presented that governmental entities are subject to even stricter standards regarding investments and therefore should be omitted. The conclusion does not follow from the argument presented. If these governmental organizations are subject to more stringent standards of investment, then it is simple enough to make clear that UMIFA does not change this body of law.

On the other hand, Mr. Schwartz tells us that "millions of dollars in taxpayer monies have been lost" through imprudent investment of public funds. Obviously, UMIFA cannot be blamed for this state of affairs. In fact, the overly restrictive rules on investments may be the cause of the problem. But this is really a peripheral matter. We do not even know if the type of funds at issue in these cases is the sort governed by UMIFA. Once again, it appears that the Attorney General's Office is seeking to solve a problem with imprudent behavior under other law by opposing the extension of UMIFA. Imprudent behavior, like death and taxes, will always be with us.

In short, we see no reason to distinguish between private educational, religious, governmental, charitable, or other eleemosynary institutions in the effort to permit them the prudent use of appreciation in their endowment funds over historic dollar value. We have not been given any reason for excluding governmental organizations; in fact, the argument that governmental entities are subject to stricter standards of investment decisions cuts in the opposite direction. Finally, a review of the variation notes following Section 1 of UMIFA indicates that only one other state (Oregon) has omitted governmental entities from coverage out of the other 29 that have enacted UMIFA.

Probate Code § 18506 - Standard of care in investment decisions

Paragraph (3) of Mr. Schwartz's letter urges modification of the language from the Trust Law concerning the standard of care in investment decisions. We cannot agree with Mr. Schwartz that

Corporations Code Section 5231 provides a higher standard. We see it as the same. We do not believe that it is wise to create yet another variation in wording. If the standard is sufficient for private trusts in general, we believe it is sufficient for UMIFA purposes. Finally, the standard as set out in draft Section 18506 is existing law.

The staff suggests that we cut through this controversy, however, by prefacing Section 18506 with the following proviso: "Except as otherwise provided by statute." This will preserve whatever higher or lower or different standards of care in making investments exist in any other law applicable to the particular organization. It also avoids the need to continue the argument about whether the standards are different or better or stricter or higher.

Probate Code § 18507 - Cy pres standard

We apparently have arrived at a compromise on the *cy pres* issue, although Mr. Schwartz would add reference to "illegal" in the statutory statement. We have no objection to this, although it is not really necessary.

Respectfully submitted,

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CA LAW REV. COMMISSION

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Dear Stan:

Re: Study L-3012
Uniform Management of Institutional Funds Act ("UMIFA")

This is to acknowledge receipt of Memorandum 89-13 (dated 1/25/89) relating to the proposed extension of UMIFA to all charitable organizations. We recognize that the Commission has made the decision, in principle, to extend UMIFA to cover all charitable organizations. However, our concerns over the potential for abuse, and the concurrent loss of public trust assets, requires us to urge that the standards of duty and care in the Act be sufficiently clear and rigorous so as to protect the public's interest. While we do not feel that the current proposed language accomplishes this goal, there are specific additions or changes in the statutory language which would, we believe, afford a highly improved level of protection without impairing the Commission's intent re UMIFA.

The specific sections with which we are concerned are Corporations Code section 5240, Probate Code section 18501(e), Probate Code section 18506(a) and Probate Code section 18507. I have taken the liberty of setting forth below examples of specific language which would assuage this office's major concerns with respect to each of these sections.

(1) Corporations Code section 5240

In footnote 9 (page 2) of the revised staff draft regarding No. L-3012 (1/19/89), you indicate that "the proposed law would provide that UMIFA does not alter the duties and liability of governing boards under other laws." (Citing by

example, Corp. Code §§ 5231-5231.5 etc.) In that the Office of the Attorney General is far less sure of this conclusion as it relates to public benefit corporations covered by Corp. Code § 5000 et seq., we would urge the inclusion within the statute of explicit language to this effect. In this regard, we would respectfully suggest that the quoted language could simply be added to Corp. Code § 5240(e) or made a new subsection (f) thereunder. This would partially eliminate the problem of conflicting standards with which we are concerned.

(2) Probate Code section 18501(e)

We are particularly concerned with the extension of UMIFA to governmental entities, as provided in the last clause of subsection (e). Governmentally controlled public funds held for investment purposes are already the subject of a substantial body of statutes regarding proper investments - statutes with standards far more stringent than those applied to privately-held funds. (See Gov. Code §53601-2; Penal Code § 424-6). Moreover, this office is currently involved in both investigations and litigation arising out of the imprudent investment of public funds in which literally millions of dollars in taxpayer monies have been lost. Having seen these abuses firsthand, we are adamantly opposed to the relaxation of fiduciary standards in this area. As such, we would respectfully urge that section 18501(e) be limited in scope to private charitable assets and that the last clause in subsection (e) beginning "or a governmental etc. . . ." be stricken.

(3) Probate Code section 18506

With respect to the standard of care applicable to investment decisions, we remain convinced that the language contained in Corp. Code § 5231 provides a higher level of public protection than that contained in proposed Probate Code § 18506. It is my understanding that your view is that the standards of care are not substantially different. The office of the Attorney General would, therefore, respectfully suggest that the addition of 22 words from Corp. Code 5231 to Probate Code section 18506 would alleviate our concerns without significantly altering the statute under your interpretation. Section 18506 would then read as follows (with added words underlined):

Draft § 18506

"(a) When investing, reinvesting, purchasing, acquiring, exchanging, selling, and managing property, appropriating appreciation, and delegating investment management for the benefit of an institution, the members of governing board shall act in good faith, in a manner the board believes to be in the best interests of the institution, and with the care, skill, prudence, and diligence under the circumstances then prevailing, including reasonable inquiry, that a prudent person acting in a like capacity and familiar with these matters would use in the conduct of an enterprise of like character and with like aims to accomplish the purposes of the institution. In the course of administering the fund pursuant to this standard, individual investments shall be considered as part of an overall investment strategy.

(b) In exercising judgment under this section, the members of the governing board shall consider the long and short term needs of the institution in carrying out its educational, religious, charitable or other eleemosynary purposes, its present and anticipated financial requirements, expected total return on its investments, general economic conditions, the appropriateness of a reasonable proportion of higher risk investment with respect to institutional funds as a whole, income, growth, and long-term net appreciation, as well as the probable safety of funds."

In effect, the standards of care under 18506 and Corp. Code § 5231 would be made consistent - avoiding inherent conflicts, real or imagined.

(4) Probate Code section 18507

With regard to this provision, the compromise language suggested at page 6 of your Memo 89-13 would alleviate our concerns in this area. We would suggest that the standard read "illegal, impossible or impracticable."

Once again, let me express our appreciation for the opportunity to provide our input into the consideration of this matter. Because of the potential effects this proposal

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has on the integrity of public funds held for charitable purposes in this state, it is a matter of utmost concern to this office.

I look forward to seeing you at the February Commission meeting.

Very truly yours,

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Attorney General

JAMES R. SCHWARTZ
Deputy Attorney General

JRS:ft

cc: Carole Kornblum