

Fourth Supplement to Memorandum 88-65

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

We have received another letter from Deputy Attorney General James R. Schwartz, supplementing and expanding his earlier letter concerning the Uniform Management of Institutional Funds Act. (See the First Supplement to Memorandum 88-65.) Mr. Schwartz discusses the following issues:

Conflict Between UMIFA and Nonprofit Corporation Law

Mr. Schwartz writes that one of the "primary problems with the proposed extension of UMIFA is that it creates a second conflicting set of standards regarding director investment decisions which are at odds with the carefully drafted provisions of the Corporations Code." (See Exhibit 1, pp. 1-2.)

The staff recognizes that this is a confusing and inconsistent area of the law. This is not a consequence of how carefully the various laws are drafted -- the Corporations Code, the Trust Law, UMIFA, or any other -- but because different rules may apply to a charitable organization depending upon how it is organized or whether it is formally organized at all. It is too late now to attempt to make a seamless web of corporation, association, trust, and charities law.

The issue raised by Mr. Schwartz is discussed in the note following Section 18506 in the draft tentative recommendation attached to Memorandum 88-65. That note suggests that it would be advisable to make clear that the rules stated in the Corporations Code should probably prevail as to a corporation covered by a rule in the Nonprofit Public Benefit Corporation Law, the Nonprofit Mutual Benefit Corporation Law, or the Nonprofit Religious Corporation Law. (However, in saying this, we do not mean to concede that this is necessarily the only sensible approach. It might also make sense to apply UMIFA to all charitable organizations, including corporations, to the extent of

their charitable operations.)

It should also be remembered that this situation exists now for educational organizations that are subject to UMIFA. Hence, it does not appear to be a fatal flaw in UMIFA.

Standard of Care

The staff is not persuaded that there is a marked difference between the standards applied under Section 5231 in the Nonprofit Public Benefit Corporation Law and UMIFA. (The text of Section 5231 and related provisions is set out in Exhibit 2.) We disagree that the standards of care under the Corporations Code are "higher" than that stated in UMIFA. In any event, the history of the standards in the Nonprofit Corporations Law, as cited by Mr. Schwartz, reminds us that it was partly an attempt to relieve the perceived strictness of the trust law standards that supported the revision of the nonprofit corporations statutes. This same idea is one reason UMIFA was originally proposed. (See the Prefatory Note to the official text of UMIFA, at 706-09, attached as Exhibit 2 to Memorandum 88-65.)

Investment Authority

The letter also suggests that the investment standard of Corporations Code Section 5240 is at odds with the UMIFA standard in draft Section 18504. However, it is a telling point that the drafters of the investment provision applicable to public benefit corporations under Corporations Code Section 5240 provided that nothing in the section is to be construed to preclude application of UMIFA if it would otherwise apply. (The full text of Corporations Code Section 5240 is set out in Exhibit 2.)

Cy Pres

Mr. Schwartz writes that they are "extremely concerned" over draft Section 18507 and argues that it would substantially change the law with respect to the doctrine of *cy pres*. As noted in an earlier memorandum, the UMIFA rule is intended to be a clarification and a limited relaxation of *cy pres*. (See the First Supplement to Memorandum 88-65, at 3-4.) We do not see how the UMIFA rule could be any more

subjective and uncertain than the doctrine of *cy pres* itself. *Cy pres* is riddled with exceptions and qualifications. A doctrine that depends on notions of impossibility, impracticability, charitable purpose, donor intent, and the like, cannot help but contain a significant subjective element.

The lament of the court in *Estate of Loring* (cited by Mr. Schwartz) is instructive in this connection: "The *cy pres* doctrine has meant many things to many courts and its limits have rarely been defined." (29 Cal. 2d at 436) It should also be noted that the Restatement rule is not limited to illegality or impossibility, but also includes impracticability. Comment g to Section 399 of the Restatement (Second) of Trusts reads in part as follows:

The doctrine of *cy pres* is applicable even though it is possible to carry out the particular purpose of the settlor, if to carry it out would fail to accomplish the general charitable intention of the settlor. In such a case it is "impracticable" to carry out the particular purpose, in the sense in which that word is used in this Section. This is particularly likely to be the case where there has been a change of circumstances after the creation of the trust. . . .

Thus, if a testator bequeaths property in trust to establish and maintain an institution of a particular kind, and owing to the fact that a similar institution already exists, or is subsequently created, so that to establish or to maintain the institution as directed by the testator would serve no useful purpose, the court will not compel the trustee to establish or maintain the institution.

So also, if a settlor establishes a school and directs that certain subjects only shall be included in the curriculum, and in course of time this restriction prevents the school from affording a proper education, the court will permit changes in the curriculum.

So also, the directions of the settlor with respect to the mode of government or the conduct of an institution created by him may be dispensed with by the court, where these directions seriously impede the usefulness of the institution.

The staff does not see a crucial difference between the concept of impracticability as here outlined and the concept of obsolescence. Nor, more importantly, do we see a persuasive policy reason for requiring the continuance of obsolete and impracticable limitations. Finally, it should also be remembered that under UMIFA we are concerned

only with removing certain limitations on gifts to specific institutions. Unlike the doctrine of *cy pres*, the UMIFA provision for releasing restrictions does not permit selecting a different charitable organization to receive the gift.

Expenditure of Unrealized Gains

Mr. Schwartz reaffirms his concern over "potential problems in permitting expenditures of unrealized gains in appreciation of principal assets." This goes to the essence of UMIFA as promulgated by the Uniform Commissioners and adopted in 28 other states. While we understand the concern, we are not convinced that it is a significant problem absent a showing from other jurisdictions where UMIFA has been in effect or in California as to private educational institutions.

Respectfully submitted,

Stan G. Ulrich
Staff Counsel

EXHIBIT 1

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CA LAW REV. COMM'N

October 31, 1988

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R E C E I V E D

Stan Ullerich
California Law Revision Commission
4000 Middlefield Rd., Suite D-2
Palo Alto, CA 94303-4739

Dear Stan:

Re: Memorandum 88-65; Study L-3012
Uniform Management of Institutional Funds Act ("UMIFA")

At the request of the Commission Chairman and John DeMouilly, I am writing to expand on the comments previously made by the Office of the Attorney General with respect to this matter. It is my understanding that "UMIFA" is now scheduled for discussion at the Commission's December, 1988 meeting.

As I indicated in my discussion with John DeMouilly on October 24, 1988, while the Office of the California Attorney General is not unalterably opposed to any modification of the current system, we are extremely concerned that the present proposal has far greater ramifications than are being anticipated. By way of background UMIFA was originally enacted in 1973 and made applicable to a very limited range of charities. In 1973, California had no comprehensive statutory scheme establishing appropriate fiduciary standards for charitable corporations. Rather, general trust law standards were applied to such charities. People v. Larkin 413 F.Supp. 978 (N.D. Cal. 1976).

Because of concerns on the part of many charitable organizations that the strict fiduciary standards contained in the trust law were too stringent for directors of charitable corporations, considerable study was given to creating a comprehensive statutory system establishing appropriate standards of conduct for charitable corporations. In 1978, the Legislature enacted the New Non-Profit Corporations Law (Corp. Code 5000 et seq.) which contained a set of carefully conceived fiduciary standards covering both director's duties of care (Corp. Code § 5231) and investment decisions (Corp. Code § 5240).

One of our primary problems with the proposed extension of UMIFA is that it creates a second conflicting set of standards regarding director investment decisions which are

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at odds with the carefully drafted provisions of the Corporations Code. For example, a comparison of Corporations Code section 5231 and proposed section 18506 indicates that the "good faith," "best interests of the corporation" and "reasonable inquiry" provisions contained in Corporations Code section 5231 are not present in proposed section 18506. These provisions are, however, key to the protections built into the non-profit corporations law to protect the interests of the charitable beneficiaries. Similarly, the standards for investments contained in Corporations code section 5240 are at odds with the provisions contained in proposed section 18504. We feel that the Legislature, in enacting the new non-profit Corporations Code five years after UMIFA, believed that the higher standards of care contained therein were the appropriate fiduciary standards, i.e. that the charitable beneficiaries were entitled to this level of protection. As such we are opposed to creating a second, weaker fiduciary standard of care in the investment area.

We are also extremely concerned over the provisions of proposed section 18507 which substantially changes California's law with respect to the doctrine of cy pres. At present, California law is reasonably clear that the terms of a trust must be adhered to unless it would be illegal, impossible, or defeating of the trust purpose to do so. Estate of Loring 29 Cal.2d 423; Estate of Maybury 54 Cal.App.3d 969; Restatement of Trusts (2d), §399; Bogert, Trusts and Trustees (2d ed.) section 439. Proposed section 18507 would replace these long-standing rules with a test of "obsolescence" - a much more subjective and uncertain term. We feel strongly that the present standards have served the public well and safeguarded the integrity of trust asset and purposes. As such, we oppose a gratuitous change in this standard absent a strong showing of significant problems under existing legal standards.

Finally, as we expressed in our September 26, 1988 letter, we remain concerned over potential problems in permitting expenditures of unrealized gains in appreciation of principal assets particularly since this is, by definition, in violation of the express restriction under which the trustee accepted the gift. Moreover, in light of the increasing volatility of the stock markets, we believe far more inquiry should be conducted in this regard before the expansion of the UMIFA provisions to all charities, regardless of size or nature.

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We appreciate the opportunity to provide input with respect to this issue and I will look forward to seeing you at the December meeting.

Very truly yours,

JOHN K. VAN DE KAMP
Attorney General

JAMES R. SCHWARTZ
Deputy Attorney General

JRS:ft

cc: John DeMouilly

EXHIBIT 2

Selected Corporations Code Sections

From Nonprofit Public Benefit Corporation Law:

§ 5230. Duties and liabilities of directors of nonprofit public benefit corporation

- (a) Any duties and liabilities set forth in this article shall apply without regard to whether a director is compensated by the corporation.
- (b) Part 4 (commencing with Section 16000) of Division 9 of the Probate Code does not apply to the directors of any corporation.

§ 5231. Director to perform duties in good faith: Good faith reliance on official corporate information, opinions, and records: Liability of directors

(a) A director shall perform the duties of a director, including duties as a member of any committee of the board upon which the director may serve, in good faith, in a manner such director believes to be in the best interests of the corporation and with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances.

(b) In performing the duties of a director, a director shall be entitled to rely on information, opinions, reports or statements, including financial statements and other financial data, in each case prepared or presented by:

(1) One or more officers or employees of the corporation whom the director believes to be reliable and competent in the matters presented;

(2) Counsel, independent accountants or other persons as to matters which the director believes to be within such person's professional or expert competence; or

(3) A committee of the board upon which the director does not serve, as to matters within its designated authority, which committee the director believes to merit confidence, so long as, in any such case, the director acts in good faith, after reasonable inquiry when the need therefor is indicated by the circumstances and without knowledge that would cause such reliance to be unwarranted.

(c) Except as provided in Section 5233, a person who performs the duties of a director in accordance with subdivisions (a) and (b) shall have no liability based upon any alleged failure to discharge the person's obligations as a director, including, without limiting the generality of the foregoing, any actions or omissions which exceed or

defeat a public or charitable purpose to which a corporation, or assets held by it, are dedicated.

§ 5231.5. Liability of nonpaid director for good faith performance of duties

Except as provided in Section 5233 or 5237, there is no monetary liability on the part of, and no cause of action for damages shall arise against, any nonpaid director, including any nonpaid director who is also a nonpaid officer, of a nonprofit public benefit corporation based upon any alleged failure to discharge the person's duties as director or officer if the duties are performed in a manner that meets all of the following criteria:

- (a) The duties are performed in good faith.
- (b) The duties are performed in a manner such director believes to be in the best interests of the corporation
- (c) The duties are performed with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances.

§ 5240. Applicability; Investment criteria

(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 investments, 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 (commencing with Section 2290.1) of Title 8 of Part 4 of Division 3 of the Civil Code, if that act would otherwise be applicable.

§ 5241. Authority of court to direct or permit deviations from trust or other agreement: Notice to Attorney General

Nothing in Section 5240 shall abrogate or restrict the power of the appropriate court in proper cases to direct or permit a corporation to deviate from the terms of a trust or agreement regarding the making or retention of investments. Notice of such action or proceeding shall be given to the Attorney General who may intervene.

From Nonprofit Mutual Benefit Corporation Law:

§ 7230. Duties and liabilities of directors of nonprofit mutual benefit corporation

- (a) Any duties and liabilities set forth in this article shall apply without regard to whether a director is compensated by the corporation.
- (b) Part 4 (commencing with Section 16000) of Division 9 of the Probate Code does not apply to the directors of any corporation.

§ 7231. Director to perform duties in good faith: Good faith reliance on official corporate information, opinions, and records: Liability of directors

(a) A director shall perform the duties of a director, including duties as a member of any committee of the board upon which the director may serve, in good faith, in a manner such director believes to be in the best interests of the corporation and with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances.

(b) In performing the duties of a director, a director shall be entitled to rely on information, opinions, reports or statements, including financial statements and other financial data, in each case prepared or presented by:

- (1) One or more officers or employees of the corporation whom the director believes to be reliable and competent in the matters presented;
- (2) Counsel, independent accountants or other persons as to matters which the director believes to be within such person's professional or expert competence; or
- (3) A committee of the board upon which the director does not serve, as to matters within its designated authority, which committee the director believes to merit confidence, so long as, in any such case, the director acts in good faith, after reasonable inquiry when the need therefor is indicated by the circumstances and without knowledge that would cause such reliance to be unwarranted.

(c) A person who performs the duties of a director in accordance with subdivisions (a) and (b) shall have no liability based upon any alleged failure to discharge the person's obligations as a director, including, without limiting the generality of the foregoing, any actions or omissions which exceed or defeat a public or charitable purpose to which assets held by a corporation are dedicated.

§ 7231.5. Monetary liability of volunteer director or volunteer executive committee officer

(a) Except as provided in Section 7233 or 7236, there is no monetary liability on the part of, and no cause of action for damages shall arise against, any volunteer director or volunteer executive committee officer of a nonprofit mutual benefit corporation based upon any alleged failure to discharge the person's duties as a director or officer if the duties are performed in a manner that meets all of the following criteria:

- (1) The duties are performed in good faith.
- (2) The duties are performed in a manner such director or officer believes to be in the best interests of the corporation.
- (3) The duties are performed with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances.

(b) "Volunteer" means the rendering of services without compensation. "Compensation" means remuneration whether by way of salary, fee, or other consideration for services rendered. However, the payment of per diem, mileage, or other reimbursement expenses to a director or executive committee officer does not affect that person's status as a volunteer within the meaning of this section.

(c) "Executive committee officer" means the president, vice president, secretary, or treasurer of a corporation who assists in establishing the policy of the corporation.

(d) This section shall apply only to trade, professional, and labor organizations incorporated pursuant to this part which operate exclusively for fraternal, educational, and other nonprofit purposes, and under the provisions of Section 501(c) of the United States Internal Revenue Code.

§ 7238. Directors: Standard of conduct in respect to its assets held in charitable trust

Where a corporation holds assets in charitable trust, the conduct of its directors or of any person performing functions similar to those performed by a director, shall, in respect to the assets held in charitable trust, be governed by the standards of conduct set forth in Article 3 (commencing with Section 5230) of Chapter 2 of Part 2 for directors of nonprofit public benefit corporations. This does not limit any additional requirements which may be specifically set forth in this part regarding corporations holding assets in charitable trust.

§ 9240. Duties and liabilities of directors of nonprofit religious corporation

- (a) Any duties and liabilities set forth in this article shall apply without regard to whether a director is compensated by the corporation.
- (b) Part 4 (commencing with Section 16000) of Division 9 of the Probate Code does not apply to the directors of any corporation.
- (c) A director, in making a good faith determination, may consider what the director believes to be:
 - (1) The religious purposes of the corporation; and
 - (2) Applicable religious tenets, canons, laws, policies, and authority.

§ 9241. Director to perform duties in good faith: Good faith reliance upon corporate information, opinions, and records: Liability of directors

- (a) A director shall perform the duties of a director, including duties as a member of any committee of the board upon which the director may serve, in good faith, in a manner such director believes to be in the best interests of the corporation and with such care, including reasonable inquiry, as is appropriate under the circumstances.
- (b) In performing the duties of a director, a director shall be entitled to rely on information, opinions, reports, or statements, including financial statements and other financial data, in each case prepared or presented by:
 - (1) One or more officers or employees of the corporation whom the director believes to be reliable and competent in the matters presented;
 - (2) Counsel, independent accountants, or other persons as to matters which the director believes to be within such person's professional or expert competence;
 - (3) A committee of the board upon which the director does not serve, as to matters within its designated authority, which committee the director believes to merit confidence; or
 - (4) Religious authorities and ministers, priests, rabbis, or other persons whose position or duties in the religious organization the director believes justify reliance and confidence and whom the director believes to be reliable and competent in the matters presented, so long as, in any such case, the director acts in good faith, after reasonable inquiry when the need therefor is indicated by the circumstances, and without knowledge that would cause such reliance to be unwarranted.
- (c) The provisions of this section, and not Section 9243, shall govern any action or omission of a director in regard to the compensation of directors, as directors or officers, or any loan of money or property to or guaranty of the obligation of any director or officer. No obligation, otherwise valid, shall be voidable merely because directors who

benefited by a board resolution to pay such compensation or to make such loan or guaranty participated in making such board resolution.

(d) Except as provided in Section 9243, a person who performs the duties of a director in accordance with subdivisions (a) and (b) shall have no liability based upon any alleged failure to discharge his or her obligations as a director, including, without limiting the generality of the foregoing, any actions or omissions which exceed or defeat any purpose to which the corporation, or assets held by it, may be dedicated.

§ 9250. Standards required of board

In investing, reinvesting, purchasing, acquiring, exchanging, selling, and managing a corporation's investments, the board shall meet the standards set forth in Section 9241.

§ 9251. Authority of court to direct or permit corporation to deviate from trust or other agreement

Nothing in Section 9250 shall abrogate or restrict the power of a court in proper cases to direct or permit a corporation to deviate from the terms of a trust or agreement regarding the making or retention of investments.