Office of
The City Attorney
City of San Diego

MEMORANDUM
MS 59

(619) 533-5800

DATE: March 3, 2009

TO: Honorable Mayor, Council President Ben Hueso and Councilmembers

FROM: City Attorney

SUBJECT: Redevelopment Agency and City Relationship to CCDC and SEDC

INTRODUCTION

The City Council established the Redevelopment Agency of the City of San Diego [Agency] in 1958 by Resolution No. 147378. A redevelopment agency is a public body, corporate and politic, that exercises governmental functions and has the powers prescribed in the Community Redevelopment Law. Cal. Health & Safety Code § 33100. It is a creature of statute, and direct or implied authority for its actions must be found within the Community Redevelopment Law. A redevelopment agency is "an agency of the state for the local performance of governmental or proprietary function within limited boundaries." *Kehoe v. City of Berkeley,* 67 Cal. App. 3d 666, 673 (1977). Although the City Council declared itself the Redevelopment Agency pursuant to California Health and Safety Code section 33200, the City and the Agency are two entirely separate and distinct legal entities.

In 1969, pursuant to Redevelopment Resolution No. 5, the Agency made the following elections and appointments: the Mayor of the City of San Diego was elected as Chairman of the Agency; the City Manager was appointed as the Executive Director of the Agency; and the City Attorney was appointed as General Counsel for the Agency. The Redevelopment Agency has designated the Mayor as the Executive Director of the Agency since the implementation of the strong mayor form of governance.

Centre City Development Corporation [CCDC] was created in 1975 and Southeast Economic Development Corporation [SEDC] was created in 1980. Both are independent corporations incorporated under and pursuant to the California General Public Nonprofit Corporation Law.

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QUESTION PRESENTED

This office has been asked to provide a review from a legal risk standpoint of the current relationship between the City and CCDC and SEDC, the relationship between the Agency and CCDC and SEDC, and whether there is an option for more Agency or City control of these corporate entities.

SHORT ANSWER

The current relationship between the Agency and CCDC and SEDC does not provide adequate protection of Agency assets. Should there be evidence of wrongdoing by CCDC or SEDC, Agency funds would be used to finance both the Agency's and the corporations' legal bills. This office leaves to the policymakers consideration of policy reasons for maintaining the two corporate entities. However, the best way to protect the Agency's assets is to eliminate the corporate entities, transfer their redevelopment functions to the Redevelopment Agency, and institute internal controls.

The Agency could establish more Agency control in the corporations through amendments to the agreements between the Agency and CCDC and SEDC. Additionally, the City may establish more oversight of CCDC and SEDC through amendments to the Bylaws of each corporation. However, the more control that is taken by the Agency and the City, the more risk of falling within the "alter ego" doctrine or having the corporate entity deemed an agent of the Agency.

This office will provide future input as policy decisions are made.

ANALYSIS

I. SEDC/CCDC CORPORATE GOVERNANCE

A. Articles Of Incorporation And Bylaws

Both CCDC and SEDC are independent corporations formed pursuant to the General Nonprofit Corporation Law of the State of California and are exempt from taxation pursuant to Section 501(c)(3) of the Internal Revenue Code. A corporation may be exempt from taxation pursuant to Section 501(c)(3) if no part of the net earnings of the corporation inures to the benefit of any private shareholder or individual, if no substantial part of the activities of the corporation involves carrying on propaganda, or otherwise attempting to influence legislation, and if the corporation does not participate in, or intervene in, any political campaign on behalf of (or in opposition to) any candidate for public office. 26 U.S.C. § 501(c)(3) (2009).

Both CCDC's and SEDC's Articles of Incorporation state that the corporations were formed to provide "[r]edevelopment services which can, under California law, be done by contract with the Redevelopment Agency of the City of San Diego." (CCDC Articles of Incorporation, Article II

(1); SEDC Articles of Incorporation, Article II (1)(b)). SEDC included the additional purpose of providing "economic development services." (SEDC Articles of Incorporation, Article II (1)(a)).

Both corporations' Bylaws make clear that the City is the sole member of the respective corporations:

> The City of San Diego shall be the sole member of this Corporation and shall act through its City Council in accordance with the City Charter, the City's Municipal Code and the applicable state laws.
>
> The function of the member shall be to elect the Board of Directors and to perform other such duties as the Board of Directors may from time to time assign or establish with the prior approval of the member.

(CCDC Amended and Restated Bylaws, Article II, section 1; SEDC Amended and Restated Bylaws, Article II, section 1).

In addition, the City, not the Board of Directors, has the authority to adopt, amend or repeal Bylaws:

> New Bylaws may be adopted or the Bylaws may be amended or repealed by the member.

(CCDC Amended and Restated Bylaws, Article IX; SEDC Amended and Restated Bylaws, Article XII).

The Bylaws for both CCDC and SEDC give the Board of Directors the power to select and remove the officers of the corporations. The CCDC Bylaws specifically give the Board of Directors the power to select and remove the President and Chief Operating Officer. (CCDC Amended and Restated Bylaws, Article III, section 1; SEDC Amended and Restated Bylaws, Article III, section 1).

Pursuant to both CCDC's and SEDC's Bylaws, a director may be removed by a two-thirds vote of the governing body of the member. (CCDC Amended and Restated Bylaws, Article III, section 3; SEDC Amended and Restated Bylaws, Article III, section 4).

The elected officers of CCDC and SEDC are the Chairman of the Board and Chief Executive Officer, Vice Chairman, Secretary, and Treasurer. The elected officers are chosen annually by the Board of Directors and they hold office until he/she resigns, is removed or otherwise disqualified to serve, or a successor is elected and qualified. CCDC's Bylaws do not contain a provision for the removal of an elected officer. SEDC's Bylaws provide that an elected officer may be removed, with or without cause, by a two-thirds vote of the directors at the time in office.

(CCDC Amended and Restated Bylaws, Article IV, sections 1 and 2; SEDC Amended and Restated Bylaws, Article IV, sections 1, 2, and 4).

The Board of Directors of CCDC appoints the President and Chief Operating Officer to serve on such terms and conditions of employment as may be agreed upon by the President and the Board. Subject to the rights, if any, of an appointed officer under any contract of appointment, the President and Chief Operating Officer may be removed, with or without cause, by the Board of Directors. (CCDC Amended and Restated Bylaws, Article IV, sections 1, 3 and 4).

The Board of Directors of SEDC may, at its discretion, appoint one or more additional Vice Chairmen, one or more Assistant Secretaries, one or more assistant Treasurers, and other officers of the Board. An appointed officer may be removed, with or without cause, by the appointing authorities subject, in each case, of the rights, if any, of any officer under contract of employment. (SEDC Amended and Restated Bylaws, Article IV, sections 1, 2, and 4).

B. CCDC And SEDC Are Funded By The Agency

When CCDC and SEDC were created, the Agency supplied both with "seed" money. In addition, the Agency provides the resources for all the corporations' day-to-day expenses. The Agency has entered into Operating Agreements with CCDC and SEDC in which the Agency agrees to reimburse CCDC and SEDC for all Eligible Expenses incurred in connection with staff services to implement redevelopment functions. Eligible Expenses include, but are not limited to, salaries for services of its officers, agents and employees together with customary employer contributions to social security and unemployment compensation; employee benefits, including contributions to a pension plan and payments for hospitalization insurance; office expenses and overhead, including rent, taxes, furnishings, office supplies and equipment (all supplies and equipment purchased are and shall remain the property of the Agency), repairs, duplicating services, postage, telephone, liability, casualty and fidelity insurance; printing and graphics; and general business expenses, including travel, entertainment, membership dues, attendance at meetings and conferences, subscriptions, technical books and materials, garage expenses, transportation, including taxi fares, mileage and automobile rental. (CCDC/Agency Amended Operating Agreement, Sec. 3.03; SEDC/Agency Operating Agreement, Sec. 3.03).

C. Separate Corporations With Separate Legal Advisors

The City Attorney is General Counsel to the Redevelopment Agency. The City Attorney, along with outside counsel hired by the Redevelopment Agency, advises and represents the Agency, including CCDC and SEDC, in redevelopment matters.

CCDC and SEDC retain their own corporate counsel, funded with Agency money, because they are independent corporations. Communications with their corporate counsel are privileged and confidential and are not disclosed to the Agency or the City. There have been, and there will continue to be, situations in which a lawsuit is filed naming both the Agency and either CCDC or

SEDC. In these situations, the City Attorney defends the Agency, but outside counsel normally represents CCDC or SEDC. The costs of that outside counsel is borne by the Agency.

II. THE AGENCY'S REMEDIES IN THE EVENT OF WRONGDOING

The current relationship between the Agency and CCDC and SEDC does not provide adequate protection of Agency assets. As stated above, the Agency funds every aspect of the operations for both CCDC and SEDC. However, CCDC and SEDC do not provide the Agency with any security, bonding, insurance or personal guarantees for those assets.

Should there be evidence of wrongdoing by CCDC or SEDC, the Agency's remedy would be to file a lawsuit and seek damages, the appointment of a receiver, or other equitable remedies. The City Attorney would represent the Agency. The corporations' defense costs, including hiring defense lawyers, would be borne by the Agency. Should a receiver be appointed, the receiver would also be paid by the Agency. Any judgment obtained against CCDC or SEDC would likely be satisfied from Agency assets. Since Agency assets would be used to both initiate and defend a lawsuit, the remedy of litigation is not generally effective in protecting the Agency's interest.

III. THE AGENCY/CITY'S OPTIONS

A. Eliminate The Corporate Entities And Transfer All Redevelopment Tasks Performed By The Corporations To The Redevelopment Agency

This office leaves to the policymakers consideration of policy reasons for maintaining the two corporate entities. However, the best way to protect the Agency's assets is to eliminate the corporate entities, transfer their redevelopment functions to the Redevelopment Agency, and institute internal controls. If the corporations were dissolved and their functions brought within the Redevelopment Agency, the City Attorney's office would represent and advise all parties and there would be no need for separate corporate counsel. This option would also significantly reduce litigation costs.

B. Retain One Or More Corporate Entities And Increase Agency Control [See Section "C" For A Discussion On Increasing The City's Control].

The only way the Agency can increase its control in CCDC and SEDC is to amend the Operating Agreements with the corporations to grant that greater influence. Although amending the Operating Agreements would help protect the Agency's assets, there is a risk that this step could result in the Agency's direct liability for actions of the corporations under the theories of "alter ego" or "agency". The greater the control, the more the risk.

1. Potential Alter Ego Liability

The two requirements for application of the "alter ego" doctrine are 1) that there be such a unity of interest and ownership that the separate personalities of the corporation and the individual no

longer exist and 2) that, if the acts are treated as those of the corporation alone, an inequitable result will follow. With respect to the second requirement, it is sufficient that it appear that recognition of the acts as those of a corporation only will produce inequitable results. *Associated Vendors, Inc. v. Oakland Meat Co., Inc.,* 210 Cal. App. 2d 825, 837 (1962). The general rule of the "alter ego" doctrine is:

> Before a corporation's acts and obligations can be legally recognized as those of a particular person, and vice versa, it must be made to appear that the corporation is not only influenced and governed by that person, but that there is such a unity of interest and ownership that the individuality, or separateness of such person and corporation has ceased, and that the facts are such that an adherence to the fiction of the separate existence of the corporation would, under the particular circumstances, sanction a fraud or promote injustice. *Id.*

The courts have looked at a variety of factors to determine if both the requirements exist. Some of those factors include the following: commingling of funds and other assets, failure to segregate funds of the separate entities, and the unauthorized diversion of corporate funds or assets to other than corporate uses; the treatment by an individual of the assets of the corporation as his own; the failure to maintain minutes or adequate corporate records, and the confusion of the records of the separate entities; the identical equitable ownership in the two entities; the use of the same office or business location; the employment of the same employees and/or attorney; the failure to adequately capitalize a corporation; the disregard of legal formalities and the failure to maintain arm's length relationships among related entities; the use of the corporate entity to procure labor, services or merchandise for another person or entity. *Associated Vendors, Inc.*, 210 Cal. App. 2d at 838-840.

The determination of whether both these requirements exist is a question of fact and is not a question of law. The existence of the two requirements must be supported by substantial evidence. *Id.* at 840.

If the corporate veil is pierced, each defendant as to whom it is pierced is jointly and severally liable for the full amount of the corporation's obligation. Alter ego liability is not apportioned according to the ownership of interests of each defendant. A person who is not made a defendant or against whom alter ego liability is not established does not have to contribute to payment of the corporate obligation. *Minnesota Mining & Manufacturing Co. v. Superior Court,* 206 Cal. App. 3d 1025, 1028-1029 (1988).

In the case of wrongdoing by CCDC or SEDC, the courts would look at the facts of the particular case to establish if both prongs of the *Associated Vendors* case are met to determine any liability of the Agency under the "alter ego" theory.

2. Potential Liability of Corporations as Agents of the Agency

The Agency could face potential liability if CCDC or SEDC is deemed an agent of the Agency. Pursuant to the SEDC/Agency Operating Agreement, SEDC is an independent contractor and not an agent for the Agency. (SEDC/Agency Operating Agreement, section 2.01(c)). However, pursuant to the CCDC/Agency Operating Agreement:

> In the performance of its duties hereunder, Corporation shall be under the direction of Agency, and shall abide by actins taken, directives given, and policies adopted with respect to Project by Agency. Corporation shall report as required by Agency on all activities for which it is responsible.

(Agency/CCDC Amended Operating Agreement, section 2.01(c)).

An agent is anyone who undertakes to transact some business, or manage some affair, for another, by authority of and on account of the latter, and to render an account of such representation, the authority to act for and in the place of the principal for the purpose of bringing him or her into legal relations with third parties. *Woolley v. Embassy Suites, Inc.*, 227 Cal. App. 3d 1520, 1531 (1991). An agency exists where the agent has the ability to alter the principal's legal relationships, acts as a fiduciary, and where the principal has the right to control the agent, whether or not it actually does so. *Id.*

One may be both an independent contractor and an agent. *Mottola v. R.L. Kautz & Co.*, 199 Cal. App. 3d 98, 108 (1988). Whether a person performing work for another is an agent or an independent contractor depends primarily upon whether the one for whom the work is done has the legal right to control the activities of the alleged agent. *Malloy v. Fong*, 37 Cal. 2d 356, 370-372 (1951).

A principal is liable for all acts by the agent within the scope of the agency. "An agent represents his principal for all purposes within the scope of his actual or ostensible authority, and all the rights and liabilities which would accrue to the agent from transactions within such limit, if they had been entered into on his own account, accrue to the principal." Cal. Civ. Code § 2330.

Therefore, if SEDC has the ability to alter the Agency's legal relationships and act as a fiduciary and if the Agency has the right to control SEDC, SEDC could be found to be an agent of the Agency even though it claims it is an independent contractor. In the case of wrongdoing by either CCDC or SEDC, the Agency could be found liable for that wrongdoing.

C. Retain One Or More Corporate Entities And Increase City's Control

The City, as the member of each corporation, is empowered to amend the Bylaws of each corporation as long as the Bylaw amendments do not conflict with the Articles of Incorporation. (CCDC Amended and Restated Bylaws, Article IX; SEDC Amended and Restated Bylaws,

Article XII). Accordingly, the City is empowered through Bylaw amendments to assume greater oversight of the corporate entities. The following are some options the City may want to consider to assume greater oversight. The City could amend the Bylaws of the corporations to assume authority to : 1) select and remove the President and Chief Financial Officer and to limit the term of office of these Officers to a set number of years; 2) appoint a member of the City's administration to the Board of Directors of the corporations; 3) inspect all corporate documents and records without advance notice; 4) order an annual performance audit to be paid for by the corporations and require the results of the audit to be submitted to the City's Chief Financial Officer. The City could also amend the Bylaws of the corporations to give the City's Chief Financial Officer the authority to approve financial and administrative statements or materials prior to those statements or materials being presented to the Agency Board.

Again, in the case of wrongdoing by CCDC or SEDC, the courts would look at the facts of the particular case to establish if both prongs of the *Associated Vendors* case are met to determine any liability of the City under the "alter ego" theory.

D. The Corporations' Status As Non-Profits

Before adopting a specific policy direction, we suggest that tax counsel be consulted to confirm that the measures taken will not jeopardize the corporations' status as non-profits. A 501(c)(3) corporation may lose its exemption from taxation if it violates any of the restrictions listed in 26 U.S.C. § 501(c)(3), which are listed in Section I.A. of this memorandum. In addition, a 501(c)(3) corporation may lose its tax-exempt status if it engages in any of the following prohibited transactions:

> 1) lends any part of its income or corpus, without the receipt of adequate security and a reasonable rate of interest to; 2) pays any compensation, in excess of a reasonable allowance for salaries or other compensation for personal services actually rendered to; 3) makes any part of its services available on a preferential basis to; 4) makes any substantial purchase of securities or any other property, for more than adequate consideration in money or money's worth, from; 5) sells any substantial part of its securities or other property, for less than an adequate consideration in money or money's worth, to; or 6) engages in any other transaction which results in a substantial diversion of its income or corpus to; the creator of such organization (if a trust); a person who has made a substantial contribution to such organization; a member of the family . . . of an individual who is the creator of such trust or who has made a substantial contribution to such organization; or a corporation controlled by such creator or person through the ownership, directly or indirectly, of 50 percent or more of the total combined voting power of all classes of stock entitled to vote or 50

percent or more of the total value of shares of all classes of stock of the corporation. 26 U.S.C. § 503(b) (2009).

CONCLUSION

The assets of the Redevelopment Agency are not adequately protected under the current relationship between the Agency and CCDC and SEDC. Should there be evidence of wrongdoing by CCDC or SEDC, Agency funds would be used to finance both the Agency's and the corporations' legal bills. This office leaves to the policymakers consideration of policy reasons for maintaining the two corporate entities. However, the best way to protect the Agency's assets is to eliminate the corporate entities, transfer their redevelopment functions to the Redevelopment Agency, and institute internal controls.

Alternatively, the Agency could amend the Operating Agreements of both corporations in order to grant the Agency more control in the corporations. Additionally, the City could amend the Bylaws of both CCDC and SEDC in order to exercise more oversight in the corporations. However, the more control that is taken by the Agency or the City, the more risk of falling within the "alter ego" doctrine or having the corporate entity deemed an agent of the Agency.

This office will provide further input as policy decisions are made.

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