

*Memo raising issues of
business entities as
sources of income.*

Memorandum

To : Opinion Request Meeting Participants

Date : April 7, 1981

27103(c)

M-81-156

From : **FAIR POLITICAL PRACTICES COMMISSION**
Bob Leidigh *KL*

Subject: Policy on Partnerships, Associations and Corporations,
etc., as "Source of Income"

During the last three weeks I have encountered several advice requests which involve similar fact patterns and which pose interesting Conflict of Interest questions. Each seems to be a variation on the same theme. I will set out the relevant facts of each below and then discuss a proposal for a policy to deal with them and how it would apply to each situation.

Fact Situation No. 1

"The potential officeholder is a member of an Association which engages in the practice of real estate appraisal. The rights and duties of members of the Association are set out in the enclosed Articles of Association and Bill of Sale. A member of the Association other than the potential officeholder has as a client the entity whose governing body the potential officeholder would like to join. As I understand it, there is neither fee splitting nor profit-sharing among members of the Association."

The Articles of Association provide that the "purpose of the association shall be for the pooling of resources and for the sharing of expenses incurred in the business ..." Those articles also reflect that, at the time of its formation, each of the four members made an initial contribution valued at \$12,500, including "case files, statistical information, furniture, fixtures," etc. Upon dissolution as a result of death or withdrawal of any associate, "the remaining Associates shall have an option to purchase the interest of the deceased or withdrawing Associate in the assets and goodwill of the Association." (Emphasis added.) The associates rotate management duties every 6 months. There is no direct compensation for these duties. "Each associate shall have an equal voice in any decision to expend Association funds."

Fact Situation No. 2

"I request an opinion as to whether or not a conflict of interest exists in respect of a Planning Commission sitting in judgment on an application to convert a 9 acre mobilehome park into condominium residential development, where the Planning Commissioner is a limited partner with the developer in another condominium development in the City.

"Enclosed is the typical form of Limited Partnership Agreement used by this developer, indicated as "General Partner" thereon, for a project outside of our City.

"The Commissioner in question has indicated on his disclosure statement that his interest is more than \$10,000 in this other project within the City. Additionally, he has acknowledged that he has made similar form of investment with the same developer in the neighboring City of Monterey.

"The Commissioner in question insists that he has no conflict of interest. Although he abstained and absented himself from the first consideration of this project (because of newspaper reports of his relationship), it is conceivable that he would again sit in judgment on some phase of the proposed development. Or, as he suggested to me, he might appear as an unpaid advocate of the developer's application at a hearing before his own commission or before the City Council."

The "typical form of Limited Partnership Agreement used by this developer" reveals, inter alia, the following provisions:

"In the event that the General Partner should determine, in his sole discretion, that reasonable financing is not available, but that it is advisable to retain the property until such financing is available, each of the Limited Partners may be required, upon written notice by the General Partner, to contribute additional capital.... At any point the General Partner believes, in his sole discretion, that suitable financing will not be available within a reasonable time, he shall so notify the Limited Partners and the Partnership shall be terminated as provided...." (Emphasis added.)

The partnership may be dissolved for a number of specified reasons, among them: "The determination, in the sole discretion of the General Partner, that is is advisable to incorporate the entire Partnership." (Emphasis added.)

The agreement goes on to provide:

"The General Partner shall have the full power and authority to manage, control and operate the business of the Partnership.... In particular, the General Partner shall have the following, rights, powers, privileges and authority:"

* * *

"To negotiate and enter into leases, construction contracts, deeds of trust, security agreements, joint venture agreements, management agreements, and to negotiate and execute loans and guarantees, on behalf of the Partnership, in connection with the development, construction and operation of the project."

* * *

"To hire, discharge and otherwise control employees who, in the judgment of the General Partner are advisable or appropriate to the operation of the Partnership business...."

* * *

"To contract with third parties upon whatever terms are deemed advisable by the General Partner in order to produce services, equipment, material or any other items which, in the judgment of the General Partner, are advisable or appropriate to the operation or growth of the Partnership."

* * *

"To expend Partnership funds for the above purposes or for any other lawful purpose, not otherwise forbidden by this Agreement, which in the business judgment of the General Partner is appropriate or advisable in furtherance of the operation or development of this Partnership, and to negotiate and produce loans and extensions of credit and to pledge, mortgage, encumber or assign the properties of the Partnership when deemed necessary by the General Partner...."

* * *

"To otherwise supervise and manage the overall development of the Partnership and to do such other lawful acts in his name or and in furtherance of the operation and development of the Partnership not otherwise forbidden, which in the business judgment of the General Partner is appropriate or advisable."

* * *

"The General Partner shall have the right, in his sole discretion, to set aside from time to time portions of the net income of the Partnership for use as working capital. Such working capital, which may vary from time to time as necessary, need not be distributed to the General and Limited Partners until the General Partner believes it is no longer required."

* * *

"The net profits of the Partnership shall be divided among the Partners ... in direct proportion to the ... percentages of interest...."

* * *

"Net losses of the Partnership shall be borne by the Partners in the same proportions ... provided, that the Limited Partners shall not, in any event, be required to pay any share of the losses of the Partnership beyond their respective capital contributions.... No Limited Partner shall be personally liable for any debts of the Partnership. The General Partner shall be responsible for any losses of the Partnership in excess of said amounts, and any such losses shall be allocable to the General Partner."

* * *

"The General Partner shall not be personally liable for the return of the capital contributions of the Limited Partners.

"The Partners (both General and Limited) have only the right to receive cash in return for their contributions to the capital partnership."

Fact Situation No. 3

" A member of the City Council of the City of Manhattan Beach is a Certified Public Accountant and is a shareholder in an accountancy corporation (CPA firm), holding shares constituting approximately 11% of the ownership. The CPA firm will be providing accounting services for a corporation which operates a restaurant. Yearly fees to the CPA firm will approximate \$4,000 but may be as much as \$6,000.

"Historically, the profits to the CPA firm have been about 30% of gross receipts after expenses. Accordingly, the Councilmember's income from the client operating the restaurant will be approximately \$4,000 x 30% x 11%, or \$132 per year; assuming that the projected figures mentioned above are correct.

"An individual, who is designated Mr. Z, is a 10% limited partner in the restaurant corporation. Mr. Z is also a developer of certain property within the city which is proposed for a tennis court complex. The tennis court complex will be on property owned by the City and leased to a tennis club operation of which Mr. Z will be a principal."

Fact Situation No. 4

Mr. P. is a City Councilmember in a large community in Orange County. Mr. S. is a land developer in the same city. Mr. P. and Mr. S. form a partnership and own homes together in Riverside County. This partnership and purchase was made after Mr. P. became a councilmember. Mr. S. frequently brings "projects" before the City Council and Mr. P. for their approval.

Fact Situation No. 5

See my memo re: Charles Chatfield, discussed at Opinion Request Meeting of April 2, 1981. Please note that since we discussed this I have learned that it is customary under such circumstances to extend some gratuity (usually not a cash payment) to the "finder." Oftentimes, this will amount to 1% of the commission. However, no direct payment can be made where the person participates in the negotiations, unless that person is a licensed real estate agent or broker.

BACKGROUND LAW

A. Partnerships

1. General

The law of partnership is very ancient, dating back to the code of Hammurabi in 2300 B.C.^{1/} However, relatively recently states have enacted the Uniform Partnership Act,^{2/} including California.^{3/} The Act specifically supplanted preexisting common law on the subject.^{4/} Under the Act a partnership is defined as "an association of two or more persons to carry on as co-owners a business for profit."^{5/} The fundamental elements of a partnership involve a community of interest in the business and a sharing of profits;^{6/} and the right of joint participation in the management and control of the business.^{7/} Parties may incur liability of partners notwithstanding their intention to the contrary,^{8/} and the intent to form a partnership may be implied from the actions of the parties. Furthermore, the benefits need not be of equal value or kind, and the losses may consist of money to one and loss of time or labor or property to the other.^{9/} All partners are liable jointly and severally for all debts and obligations of the partnership. Corp. Code §15015. "The property rights of a partner are (1) his rights in specific partnership property, (2) his interest in the partnership, and (3) his right to participate in the management." Corp. Code §15024. "A partner's interest in the partnership is his share of the profits and surplus, and the same is personal property." Corp. Code §15026.

^{1/} Barrett & Seago, Partners and Partnerships; Law & Taxation (1956) Vol. I, p.1.

^{2/} Id., Vol. II, p.448-49.

^{3/} Title 2, Division 3, Chapter 1, (Commencing with Section 15001) of the Corporations Code, first adopted in 1949.

^{4/} Corp. Code §15004.

^{5/} Corp. Code §15006(1).

^{6/} Swofford v. Indus. Acc. Comm., 121 Cal. App. 2d 400 (1953); and Stoddard v. Goldenberg, 48 Cal. App. 2d 319 (1942).

^{7/} Bank of California v. Connolly, 36 Cal. App. 3d 350 (1973).

^{8/} Oscar Krenz Copper & Brassworks v. England, 109 Cal. App. 747 (1931).

^{9/} Martter v. Byers, 75 Cal. App. 2d 375 (1946).

"Every partner who is not a special or limited partner nor a member of a mining partnership is a general partner." Corp. Code §15044.

2. Limited

California has also adopted the Uniform Limited Partnership Act.^{10/}

"A limited partnership is a partnership formed by two or more persons under the provisions of Section 15502, having as members one or more general partners and one or more limited partners. The limited partners as such shall not be bound by the obligations of the partnership." Corp. Code §15501. "A limited partner shall have the right to receive a share of the profits or other compensation by way of income, and to the return of his contribution as provided in Sections 15515 and 15516." Corp. Code §15510. "A limited partner may receive from the partnership the share of the profits or the compensation by way of income stipulated for in the certificate; provided, that after such payment is made, ... the partnership assets are in excess of all liabilities of the partnership except liabilities to limited partners on account of their contributions." Corp. Code §15515. "A limited partner's interest in the partnership is personal property." Corp. Code §15518. In setting priorities for distribution upon dissolution Section 15523 states, in part, "to limited partners in respect to their share of the profits and other compensation by way of income on their contributions...."

3. Association

"The interest of a member of an unincorporated association is personal property." Corp. Code §20000.

"Any unincorporated ... association ... may, without incorporation, purchase, receive, own, hold, lease, mortgage, pledge ... and sell all such real estate and other property as may be necessary for the business purposes and objections of the ... association...." Corp. Code §20001. "A nonprofit association is an unincorporated association of natural persons for religious, scientific, social, literary, educational, recreational, benevolent, or other purposes not that of pecuniary profit." Corp. Code §21000. "Members of a nonprofit

^{10/} Title 2, Division 3, Chapter 2 (commencing with Section 15501) of the Corporations Code.

association are not individually or personally liable for debts or liabilities contracted or incurred by the association ... to be used for the purposes of the association." Corp. Code §21100.

Lastly, for purposes of filing with the Secretary of State, Corp. Code §24000(a) defines an "unincorporated association" as "any partnership or other unincorporated organization of two or more persons, whether organized for profit or not, but does not include a government or governmental subdivision or agency."

B. Corporations

A corporation is a legal person or entity, recognized as having an existence separate from that of its shareholders. The shareholders are not the owners of corporate property, and the corporation and a shareholder are distinct parties in contracts made by one or the other.^{11/} When a corporation is used by an individual or individuals to circumvent a statute, or accomplish some other inequitable purpose, a court may disregard the corporate entity and the acts as if they were done by the individuals themselves—it will "pierce the corporate veil."^{12/} It is not necessary that the control be by a single individual; the same result may be reached where two or more persons own all the stock and control the corporation.^{13/} The issue is not whether the corporate entity should be disregarded for all purposes, nor whether its very purpose was to circumvent a statute or accomplish some other inequitable purpose. Rather, the issue is whether, in the particular case presented and for the purpose of such case, justice and equity can best be accomplished and unfairness defeated by a disregard of the distinct entity of the corporate form.

C. Conflict of Interest - Source of Income

The key terms involved in any discussion on "source of income" issues are "Business Entity," "Profit," "Income" and "Foreseeable Material Financial Effect."

^{11/} Witkin, Summary of California Law, 8th Ed., p.4316.

^{12/} Id., at 4317.

^{13/} Id.

"Business Entity" is defined under the Political Reform Act (PRA) as "any organization or enterprise operated for profit, including but not limited to a proprietorship, partner-ship, firm, business trust, joint venture, syndicate, corporation or association. Gov. Code §82005.

The Moscone Governmental Conflict of Interests and Disclosure Act (Moscone Act) defines it in slightly different terms as "any undertaking operated for economic gain...." Gov. Code. §3610(a).^{14/}

"Income" is defined in the PRA as "a payment received, including but not limited to any salary, wage, advance, dividend, interest, rent, proceeds from any sale, gift ... loan, forgiveness or payment of indebtedness received by the filer, reimbursement for expenses, per diem, ... and including any community property interest in income of a spouse. Income also includes an outstanding loan. Income of an individual also includes a pro rata share of any income of any business entity or trust in which the individual or spouse owns, directly or indirectly or beneficially, a 10-percent interest or greater...." Gov. Code §82030(a).

The Moscone Act defines income as "... income of any nature from any source derived, including but not limited to any salary, wage, advance, payment, dividend, interest, rent, return of capital, forgiveness of indebtedness, rebate of money, or anything of economic value. 'Source of income,' as used in [the Moscone Act] ... means the business entity or activity of the official which earned or produced the income." Gov. Code §3610(e).^{15/}

"Profit" is defined variously as follows:

"A valuable return: Gain ... the compensation accruing to entrepreneurs for the assumption of risk in business, enterprise as distinguished from wages or rent."^{16/}

^{14/} Bob Stern advises that the difference in choice of words is not significant and does not indicate a different intent.

^{15/} Id.

^{16/} Webster's New Collegiate Dictionary, 1975.

"Gain," in turn, is defined as follows:

"Resources or advantage acquired or increased:
Profit ... an increase in amount, magnitude or degree."^{17/}

"Foreseeable Material Financial Effect" is described in our regulations, 2 Cal. Adm. Code §18702, as follows:

"(a) The financial effect of a governmental decision on a financial interest of a public official is material if the decision will have a significant effect on the business entity, real property or source of income in question."

Subsection (b) of Section 18702 sets forth some detailed guidelines for "determining whether it is reasonably foreseeable that the effects of a governmental decision will be significant within the meaning..." of the regulation.

PROPOSED POLICY

When analyzing conflict of interest situations involving various "income" questions, where the amount clearly exceeds \$250, the following shall be considered to be a "source of income" to the officeholder (filer), in addition to the business entity itself:

- 1) Any general partner in a partnership or association, the purpose of which is economic benefit to the filer, where the filer is either a general partner or associate, or a limited partner, but not a limited partner where the filer is also a limited partner in a limited partnership.
- 2) Where the partnership or association is operated on a profit-sharing/loss-sharing basis, then a client/customer of the partnership by way of allocation pursuant to the Carey opinion.^{18/}
- 3) Where the source of income is a corporation, the corporate identity will be pierced only if the individual in question was/is "controlling" as to the financial transaction which results in the income or economic benefit, or was/is an officer or a director.
- 4) Where the source of income is a closely-held corporation, then any shareholder holding at least 10% is presumed to be "controlling" as to any transaction.

^{17/} Id.

^{18/} Carey, 3 FPPC Opinions 99, at 101-104.

APPLICATION TO THE
FACT SITUATIONS

Fact Situation No. 1

Both the Association and the other Associates are a "source of income" to the potential officeholder. He receives a benefit of "economic value" by way of reduced overhead. This also constitutes a "gain" or "profit" because it results from "resources or advantage acquired or increased" since that is the precise purpose for which the Association was formed—to increase the appraiser's resources. As such, the Association is ^{19/}a "business entity" because it is operated "for profit."

Because there is specifically no profit-sharing, the clients of his associates do not constitute a source of income to him. Therefore, in order for a decision involving such a client to have the requisite effect on him it would have to have a foreseeably significant effect upon the associate's ability to make his/her monthly payment to the association for the overhead. This is quite remote and only an extreme situation would create such foreseeability.

The Association, while very close to a partnership, would seem to fail to meet all the tests of a partnership and thus would not require the income from the associate's client to be allocated.

Fact Situation No. 2

Both the partnership and the general partner are "sources of income" to the planning commissioner. "Those operating a business often desire and need to secure capital from others. Where the lender, in lieu of interest, takes a share in the profits of the business, there exists a reason for the use of the statutory limited partnership."^{20/} Clearly, the planning commissioner is in this position. He has bankrolled (together with others) the general partner. The planning

^{19/} Operating "for profit" is not the same as operating "at a profit," the purpose of the association is to be profitable for the associates by reducing their costs of doing business, increasing their resources in terms of shared files, statistics, etc., and clearly it does not meet the test of a nonprofit association.

^{20/} Barrett & Seago, supra, Vol. II, p.483.

commissioner's income is entirely dependent upon the general partner, who can do virtually anything and everything at his sole discretion. Consequently, in this other project, he will foreseeably have a conflict, since his decision will have a material financial effect upon the general partner.

Fact Situation No. 3

Mr. Z is not a "source of income" to the city council-member. Even assuming an allocation from the restaurant corporation in excess of \$250,^{21/} the limited partner (or corporate shareholder, Mr. Z) is not "controlling;" consequently, his separate, personal transaction would not give rise to a foreseeable conflict. This would change if the facts included information to the effect that the restaurant corporation was a closely-held corporation.

Fact Situation No. 4

If P. and S. are both general partners, or if S. is a general partner and P. is a limited partner, then both the partnership and S. would be sources of income, although the partnership might not be since it is not doing business within the jurisdiction; clearly, S. is.

Fact Situation No. 5

Arnold would be a source of income to Chatfield by virtue of his "controlling" corporate role in the transaction. In addition, under the specific language of the Moscone Act, Gov. Code §3610(e), Chatfield has derived something of economic value from Arnold as its source since Arnold was the source of Illini Beef as Chatfield's client.

DISCUSSION

The proposed policy seeks to clarify an existing "grey area" by determining, consistent with the laws of partnership, etc., that those who are in a close fiduciary, business relationship are, in fact, sources of income to one another, since their income is dependent upon the activities of the other. Thus, two general partners are clearly a source of income to one another, much as in a community property marriage. However, in Fact Situation No. 1, while the associates are a

^{21/} Carey opinion, supra.

source of income because of the monthly payments made into the association which are shared by the associates, their clients are not sources of income because there is no allocation of increments of income through profit-sharing or fee-splitting.

With respect to corporations, officers, directors and "dominant or controlling stockholders or groups of stockholders" occupy positions with a fiduciary relationship and are "agents entrusted with the management of the corporation for the benefit of the shareholders collectively."^{22/} Consequently, when the corporation, as a business entity is a source of income to a governmental decision-maker, so too should be the directors, officers and controlling shareholders,^{23/} for they really affect what that corporation does. This is even more the case with a closely-held corporation.

In the case of a law firm partnership, the partners would be a source of income to one another and to the associates; however, the associates would not be a source of income to the partners, unless there was a profit-sharing or fee-splitting.

BL:plh

^{22/} Knepper, Liability of Corporate Officers and Directors, 2 Ed. (1973), §1.02.

^{23/} This would not be the case if the decision-maker was a less-than-10% shareholder in the corporation and derived income only from dividends.