

STRUCTURE OF BRIDGE LOAN

California philanthropists have expressed a willingness and desire to fund stem cell research in California pending the resolution of litigation concerning the validity of Proposition 71. Although such a loan may be unprecedented, we believe that it is consistent with the mission of Proposition 71 and state law:

- Proposition 71 authorizes the Institute to borrow funds and to accept gifts.
- In order to protect the State from any liability, the funds would be advanced as a loan, the repayment of which would be contingent upon the State's successful issuance of bonds pursuant to Proposition 71. If the State were unsuccessful in defending Proposition 71, either in the action filed by the Life Legal Defense Foundation action or in a bond validation action, should the Finance Committee decide to initiate such an action, the loan would convert automatically into a gift.
- The loan agreement would expressly provide that the State shall be held harmless in the event that its defense of Proposition 71 is unsuccessful. In addition, the philanthropists would expressly waive any claim against the Institute, the State, or their agents in connection with the loan. This feature is similar to private debt offerings, where it is quite common for investors to agree to waive liability against the issuer.
- The loan could be made to the State or it could be made directly to universities and non-profit research institutions that the Institute has selected to receive research grants. The lenders would agree to hold both the State and grant recipients harmless if Proposition 71 is invalidated. Donors (generally foundations donating to medical/scientific research) to this Bridge Financing would not be eligible as grant recipients.

STATUS OF LITIGATION

On April 7, 2007, the Life Legal Defense Foundation filed a complaint for declaratory and injunctive relief in Alameda County Superior Court on behalf of People's Advocate and the National Tax Limitation Foundation. The complaint names the Independent Citizens' Oversight Committee, its chair, Robert N. Klein, Governor Arnold Schwarzenegger, Lieutenant Governor Cruz Bustamante, Treasurer Phil Angelides, and Controller Steve Westly as defendants. The complaint seeks an order declaring that Proposition 71 is unconstitutional and enjoining the defendants from spending public funds to implement Proposition 71 and from issuing bonds. The Attorney General is representing all of the defendants in this action.

The Life Legal Defense Foundation argues that Proposition 71 violates article XVI, section 3 of the California Constitution, which prohibits the State from appropriating funds to an institution that is not under the exclusive management and control of the State as a State institution. As the Governor's legal counsel, Paul Dobson, noted, however, Proposition 71 amended the California Constitution to provide, among other things, that "[n]otwithstanding other provisions of the Constitution, the Institute . . . is created in state government." In addition, Proposition 71 was carefully drafted with the most recent appellate decision involving article XVI, section 3 in mind. In 2003, the Fourth District Court of Appeal rejected a similar challenge to Proposition 10, which imposed an additional tax on cigarettes and tobacco products in order to fund early childhood development programs. The court of appeal held that:

exclusive management and control by the state means the existence of sufficient controls over the commissions by the executive and legislative branches of the state government to assure that state funds are used to further state purposes without unduly inhibiting innovative programs that serve those purposes.

(California Assoc. of Retail Tobacconists v. State
(2003) 109 Cal.App.4th 792, 817.)

The court found that Proposition 10 was "replete with controls, including the manner of appointment of members of both the CCFC and county commissions, the specificity regarding how tax revenues must be spent, and the annual audit and reporting requirements." (*Id.* at 820.)

Proposition 71 includes a host of features designed to ensure that the ICOC and the CIRM operate under the exclusive management and control of the state as state institutions. The members of the ICOC are appointed by elected officials, and in the case of the five members from the University of California, by the chancellors of the University of California campuses with medical schools who are themselves public officials. (Health & Saf. Code, § 125290.20.) At the ICOC's organizational meeting on December 17, 2004, convened by the State Controller and the State Treasurer, the members of the ICOC each took an oath to uphold the Constitution of the State of California. (Cal. Const., art. XX, § 3.) The employees of the CIRM are "at will" employees of the State of California. (*Id.*, art. XXXV, § 7.) ICOC members and CIRM employees are subject to California's conflict of interest laws and must file Fair Political Practices Commission Form 700 to disclose their economic interests. (Health & Saf. Code, § 125290.30(g).) The ICOC is governed by the Bagley-Keene Open Meeting Act and is expressly required by Proposition 71 to approve all grants, loans, contracts and to adopt all standards in open, public hearings. (*Id.*, 125290.30(d).) Like other state agencies, the ICOC and the CIRM are, with limited exceptions, governed by the Administrative Procedure Act and the Public Records Act. (*Id.*, §§ 125290.30(e), 125290.40(k).)

Proposition 71 also mandates accountability in the expenditure of public funds. The CIRM's expenditure of funds, including administrative expenditures, is delineated by statute, and its contracting is governed by the competitive bidding laws applicable to the University of California. (*Id.*, §§ 125290.70, 125290.30(f).) Like the state and county Children and Families Commissions established by Proposition 10, the CIRM is required to prepare an annual public report regarding its finances and performance and it is subject to an annual independent audit, which must be reviewed by the State Controller. (*Id.*, § 125290.30(a) & (b).) The CIRM is also subject to review by the Citizens' Financial Accountability Oversight Committee, which is chaired by the Controller, and which is required to review and report on the Institute's financial practices and performance. (*Id.*, § 125290.30(c).) And, of course, the CIRM cannot issue bonds without the approval of a majority of the members of the California Stem Cell Research and Cures Finance Committee, which includes the Treasurer, who is the designated chair of the committee, the Controller, the Director of Finance, the Chair of the ICOC and two other members of the ICOC. (*Id.*, § 125291.40.)

In addition to these internal controls, there are numerous external controls that serve to ensure that the ICOC and the CIRM are accountable to the citizens of California. These control mechanisms range from the broad oversight authority of the Legislature to the control exercised by other state agencies over minute details. The CIRM can only spend funds through a warrant issued by the Controller. (Cal. Const., art. XVI, § 7.) The Controller also has the authority to audit the CIRM's disbursement of funds, and the Department of Finance may initiate an audit at any time. (Gov. Code, §§ 12410, 13070.) Likewise, the Legislature can direct the State Auditor to conduct an audit (Gov. Code, § 8545.2), and after 2007, the Legislature can amend the Act in furtherance of its purposes by a vote of 70 percent of its members.¹ (Prop. 71, § 8.) And like other state agencies, the CIRM must obtain the approval of the Department of Finance for out-of-state travel and the approval of the Department of General Services for any lease. (Gov. Code, §§ 11032, 19825.) Thus, the CIRM and the ICOC are firmly under the exclusive management and control of the state as state institutions.

The Institute has requested that its outside counsel, Remcho, Johansen & Purcell, who, along with Nielsen, Merksamer, Parrinello, Mueller & Naylor and Orrick, Herrington & Sutcliffe, was responsible for drafting Proposition 71, prepare a legal analysis of the Life Legal Defense Foundation's action. In addition, Munger, Tolles & Olson has offered to prepare an analysis on a pro bono basis. Based on our discussions, we believe that both firms will conclude that the legal challenge is meritless. We intend to share these legal analyses with lenders, with an express statement, included in both the analyses as well as the loan documents, that lenders are not entitled to rely on the opinions, but must instead seek independent legal advice.

PROPOSED PLAN OF ACTION

¹ This feature distinguishes the Act from many initiatives, which can only be amended by another vote of the people. (Cal. Const., art. II, § 10(c).)

We are meeting with the staffs of the Treasurer, the Controller, the Attorney General and the State Director of Finance to ensure that all of the constitutional officers responsible for the State's finances and its legal obligations concur with this proposal. As those meetings proceed, we are working with the staff for the Treasurer and the Attorney General to draw up appropriate loan documents.