

I. FDSC's Proposed Resolution to Disputed Finding No. 3

Although FDSC and Comerica contend that they have not violated Business & Professions Code §7737, and do not admit liability in any way by seeking to settle this finding with the Bureau, they are willing to work towards a resolution to the Bureau's required corrective actions.

Between December 31, 2006 and March 31, 2010, a total of 721 preneed contracts had deposited a book value of \$1,753,670.95 in the CMT. Those 721 contracts were paid out at market value of \$1,729,863.86 when they were either serviced or canceled during that time period. The difference in market and book value of those 721 contracts is \$23,807.09. FDSC and Comerica are willing to resolve this disputed finding by returning to the trustors or their legal representatives their pro rata share of the \$23,807.09 difference in market to book value for these contracts.

On a going forward basis, the CMT seeks guidance from the Bureau and a letter of opinion from the Attorney General about how to resolve the obvious and unresolved conflict that exists between GAAP and Business & Professions Code §7737, which demands full return of a corpus that is permitted to be invested under the Bureau's regulations.

4. RESPONSE TO AUDIT FINDING NUMBER FOUR: Trust paid unauthorized "Participation Distributions" to Funeral Establishments in violation of BPC §7735

A percentage of the annual income earned by the CMT is paid to the FDSC for the purpose of covering administrative costs. FDSC then pays to some funeral establishments a participation distribution out of the administrative fees it collects, which are permitted fees paid to FDSC and the trustee from the annual income of the CMT. (Code Reg. tit. 16, § 1265.)

Pursuant to the trust agreement executed by FDSC and Comerica, FDSC is the program administrator for the CMT. The FDSC participates in the administration of the CMT on behalf of the CFDA. Many funeral establishments throughout California are members of the CFDA. Those funeral establishments enter into various agreements provided by the CMT program with individuals desiring to provide for funeral services and merchandise in advance of need. Those services include both guaranteed programs and non-guaranteed programs.

If a consumer decides to participate in a guaranteed program, the consumers choose the services they desire to have paid for at the time of death. The amount paid by the consumer to the funeral establishment is guaranteed to cover the cost of those specific services chosen at the time the preneed agreement was entered into by the parties. If at the time of the beneficiary's death, the chosen services cost more than the corpus of the trust and the income accrued in the CMT, the funeral establishment covers the remaining expense. If the amount of the corpus of the trust and its accrued income from the CMT is more than what is necessary to cover the funeral services chosen in the guaranteed plan, the funeral establishment is entitled to keep the remaining funds.

The non-guaranteed plans are simply savings accounts. The consumer selects a funeral arrangement with the associated costs marked at the current price. The price for the funeral selected is not locked in, which means at the time of the beneficiary's death, the corpus of the trust and the income that has accumulated, if any, will be applied toward the price of the funeral at that time. If there are insufficient funds to cover the price of the funeral upon the beneficiary's death, the consumer would make up the difference. If there are funds in excess of the cost of the funeral at the time of the beneficiary's death, the remaining funds are returned to the beneficiary's legal representative.

The funeral establishments incur administrative costs in conjunction with these preneed agreements. They are given an option to receive a small percentage of the administrative fees FDSC receives each year from the annual trust income to cover those administrative expenses incurred by them for the costs they bear in administering the contracts. The amount that these funeral establishments receive as reimbursement for the costs they incur while administering the contracts is then deducted from the payment made to the funeral homes at the time of the beneficiary's death.

In order to maintain and grow each individual funeral establishments' preneed trust business, the funeral establishments must provide facilities to sell the contracts, incur costs to advertise and market the preneed contracts, and maintain storage areas to house the preneed contracts and other corresponding documentation. Growth in the amount of preneed participants leads to more efficient cost sharing among the trustors. The participation distributions that the funeral establishments receive do not even cover the cost of these administrative expenses.

The Bureau contends that the FDSC is in violation of Business & Professions Code §7735 and Code of Regulations §1265 for having paid \$4,231,376 in participation distribution fees to the funeral establishments and reporting the costs as administration fees. This total is from fees paid to the funeral homes between 2000 and 2009.

Code of Regulations §1265 is entitled "Use of Income". Since 1977 there have been 3 versions of said regulation. The current version became operative on February 11, 1990 and is listed as registered 90, no. 3.

The actual total amount of administrative fees allocated to payment of the participation distribution to the funeral establishments is \$4,267,660.00. That total was paid between January 1, 2000 and December 31, 2008. The Bureau include: the 2009 reporting year in its analysis, but at the time the Audit Report was released, March 18, 2010, the CMT's full report for 2009 had not yet been submitted to the Bureau.

The funds paid to the funeral establishments receiving participation distributions totaled the following for each year from 2000 to 2008:

2000- \$749,514.00
2001- \$572,686.00
2002- \$423,444.00
2003- \$419,284.00

2004- \$410,563.00
2005- \$433,094.00
2006- \$442,979.00
2007- \$420,835.00
2008- \$395,261.00

Each of these yearly totals can be found in Note 4 of the annual reports for 2000 through 2005. The totals for 2006 through 2008 can be derived by subtracting the administrative fees paid to the FDSC according to Note D from the totals administrative fees paid out according to the Statement of Revenues and Expenses portion of those reports. (See Annual Reports 2000-2008 attached hereto as **Exhibit G.**)

The funds paid to the funeral establishments each year accounted for the following percentages of the trust value:

2000- .89%
2001- .69%
2002- .53%
2003- .53%
2004- .53%
2005- .56%
2006- .58%
2007- .55%
2008- .53%

These figures were arrived at by dividing each year's fees paid to the funeral establishments by the trust balance on the maturity date during that year of all payments deposited into the trust, plus the prior years accumulated income as allowed under Code of Regulations §1265.

I. "Administrative Fee" is Not Defined in the Current Statutory and Regulatory Scheme Regarding Use of Trust Income

FDSC may be paid a reasonable fee for administering the CMT. [See legal argument made in Response to Audit Finding Number 2, Section I, Subsection A, on page 14, which starts by quoting Business & Professions Code §7735 and ending on page 15 quoting Code of Regulations §1265, which argument is incorporated herein by reference as though fully set forth.]

A. The Bureau's interpretation of the term "administrative fee" is incorrect as a matter of law

1. Business & Professions Code §7735

When an agency decision involves an interpretation and application of an existing regulation, "a court must determine whether administrative agency applied the proper legal

standard in evaluating the evidence before it.” (*Carmona v. Division of Industrial Safety* (1975) 13 Cal.3rd 303, at 310.) “An interpretation of a regulation, like the interpretation of a statute is of course a question of law. [citation omitted] And while an administrative agencies’ interpretation of its own regulation obviously deserves great weight [omitted citation] the ultimate resolution of such legal question rests with the courts.” (*Id.*) “In the construction of a statute . . . the office of the judge is simply to ascertain and declare what is in terms or in substance contained therein, not to insert what has been omitted, or to omit what has been inserted; in where there are several provisions or particulars, such a construction is, if possible, to be adopted as will give effect to all.” (Code Civ. Proc. § 1858.)

The reasonable annual fee for trust administration is paid from trust income. Business & Profession Code §7735 does not define what cost or expenses can be paid for by the annual fee for administering the trust. Furthermore, it only prohibits payments of commissions, taxes or trust expenses to be made from the corpus of the trust.

The Bureau’s allegation that FDSC has violated Business & Professions Code §7735 is incorrect as a matter of law. That section does not prohibit the payment of any funds for administrative costs to the funeral establishments. By finding that such payments violate Business & Professions Code §7735, the Bureau has inserted a limitation of the use of administrative fees which was omitted from Business & Professions Code §7735. Therefore, the Bureau’s interpretation of this section is incorrect as a matter of law.

2. California Code of Regulations, Title 16, Division 12, Article 8, §1265

Pursuant to Business & Professions Code §7606 the Bureau has promulgated regulations regarding the administrative fee referenced in Business & Professions Code §7735. The corresponding regulation is Code of Regulations Title 16, Division 12, §1265. That regulation allows an annual fee for administering the trust to be recovered by withdrawals from the current trust income. The only limitation placed on administrative fees is the amount which can be withdrawn in a year. The total amount is limited to 4%. How those administrative fees can be used is not limited by that section.

Again, like the Bureau’s interpretation of Business & Professions Code §7735, the Bureau’s interpretation of Code of Regulations §1265 is incorrect as a matter of law. Nowhere within that regulatory section is a limitation placed on the use of those administrative fees. The Bureau’s interpretation of the regulation inserts a limitation within the regulation on the use of those fees which was omitted from the regulation at the time it was promulgated through procedures required by the APA. Therefore the interpretation is incorrect as a matter of law and should not be enforced against FDSC or the CDFA.

Furthermore, the amount of the distribution fees paid to the funeral establishments does not violate the 4% limitation. The most paid in any one year to the funeral establishments was the equivalent of .69% of the CMT’s value. That year’s total payment to FDSC, including the distribution to the funeral establishments for administrative fees was only 2.81%. Every year’s payment of participation distributions to the funeral establishments has equated to less than 1% of the value of the CMT.

3. Previous Versions of California Code of Regulations, Title 16, Division 12, Article 8, §1265

The previous versions of Code of Regulations Title 16, Division 12, Article 8, §1265 are indicative of the position that FDSC can use the administrative fees collected from the CMT to pay the distributions to the funeral establishments. In pertinent part, the version of Code of Regulations §1265, which was in effect from October 5, 1981 until October 11, 1990, reads as follows:

“Actual expenses for administering the trust, include a trustee fee, may be recovered from the income of the preneed trust but shall in no event exceed two and one-half percent (2.5%) per annum of the corpus. All remaining income must be credited to the trust corpus.

None of the trust corpus or income there from shall be used to pay any sales commission, rent, or salary.” (Register 81, No. 41.)

This version which was in effect immediately prior to the current version of Code of Regulations §1265 and does not include a definition of “administrative fees.” Unlike the current version of the regulation, this version in effect immediately prior to the current version, contained a limitation on what can be paid for with income from the trust. However, it does not state that the administrative fee allowed there under could not be used for certain purposes.

The current version of the regulation does not include the above-referenced limitation on use of income. So, it can be implied from the removal of that language in the regulation the Bureau intended to broaden the scope of what the administrative fees could be used for pursuant to the regulation. Therefore, pursuant to the evolution of this regulation section even the Bureau itself has indicated that administrative fees collected from the income of a trust can be used for any purpose regarding trust expenses as long as the amount of the fee does not exceed that which is allowed under the regulations. Furthermore, the Bureau’s current allegation that the administrative fees taken by FDSC from the trust income cannot be used to pay the small distribution fees to the funeral establishments is inapposite of its prior proclamation liberalizing the regulation.

Even the version in effect from June 18, 1977 to October 10, 1991 does not limit the use of administrative fees collected from income. That version of the regulation reads as follows:

“An annual fee for administering the trust from which all preneed trust operational costs must be recovered including, but not limited to, sales commissions, accounting, rent, salaries and trustee fees shall be computed as of December 31st of each year or at the end of the fiscal accounting year. . .” (Register 77, No. 25.)

That version is even more expansive. It includes the language "all preneed trust operational costs must be recovered including, but not limited to" and then lists examples of costs that can be paid out of the annual administration fee. Therefore, even going back to the 1977 version of the regulation, the use of administration fees to pay any type of costs was not limited by the Bureau. Furthermore, the Bureau's current allegations are in conflict with its stance regarding use of the administrative fees to pay expenses for the past 30 years, and are derived from a less specific regulation.

II. The Bureau's Enforcement of Its Interpretation of "Administrative Fee" on the FDSC and the Funeral Establishments is an "Underground Regulation."

The Bureau's interpretation of "Administrative Fees" and its enforcement of said interpretation constitutes an "Underground Regulation"[See legal argument made in Response to Audit Finding Number One, Section II on page 10, second sentence starting with "The Bureau is authorized to enforce. . ." and ending on page 11 with the sentence: "These procedurally deficient regulations are void for failing to comply with the APA. (*Tidewater Marine Western, Inc. v. Bradshaw*, at 576)," which argument is incorporated herein by reference as though fully set forth.]

Administrative fees are allowed to be paid out of the income generated by the CMT. (Bus. & Prof. Code §7735.) The current version of Code of Regulations §1265 does not include a definition of "administrative fee." It also does not include a limitation of the use of those administrative fees. The Bureau alleges that payment of participation distributions to the funeral establishments is a violation of Business & Professions Code §7735 and Code of Regulations §1265. That is an interpretation of the statutory section and the Bureau's own regulation. This interpretation is of universal application since it pertains to a definition and limit on the use of "administrative fees." It is also applied to all funeral establishments participating in the CMT Program.

These interpretations have not been promulgated through the procedures required under the APA. So, the interpretations are "underground regulations." The Bureau is requiring the FDSC to implement 3 corrective actions, so it is trying to enforce its interpretations of Business & Professions Code §7735 and Code of Regulations §1265 on the FDSC and the CFDA. Therefore, the Bureau's interpretations are void and cannot be enforced against FDSC or the funeral establishments.

III. FDSC and Comerica's Proposed Resolution to Disputed Finding No. 4

On a going forward basis, and without conceding in any aspect that past "participation distributions" to funeral establishments were unauthorized or in violation of Business & Professions Code §7735 or Code of Regulations §1265, FDSC and Comerica agree that they will develop and require a form to be completed by each funeral establishment electing to take participation distributions, which will list the funeral establishment's actual administrative costs, with backup documentation, related to its costs of administration of the trusts to its trustors.