

## Memorandum 77-21

Subject: Study 77.600 - Nonprofit Corporations (Work of Assembly Select Committee--Organization and Bylaws)

## INTRODUCTION

This is the first of a series of memoranda that will analyze the working drafts of the nonprofit corporations statute being developed by the staff of the Assembly Select Committee on Revision of the Nonprofit Corporations Code. The objective of the analysis is not to point out differences in wording or drafting technique from the Commission's bills, or even at this point to identify every substantive difference; this will be done at a later time. Rather, the analysis will focus on significant policy decisions which the Commission may not have previously considered in whole or in part, with the view to amending the Commission's bills to incorporate any useful ideas found in the Select Committee working drafts. The analysis is not exhaustive but is intended to serve simply as a framework for discussion at the Commission meeting.

The Commission should be aware of two important limitations on the analysis. (1) The working drafts are still in the process of development, and ideas contained in the drafts may ultimately be altered or deleted. (2) Many important policies lie buried in the definitions of key terms used in the drafts, and the policies cannot be identified until the definitions have been developed.

## ANALYSIS

This memorandum analyzes the provisions relating to organization and bylaws. The discussion of particular provisions below includes the text of the most recent Select Committee working draft of the provisions.

Incorporation of Unincorporated Association

Section 5221 of the working draft sets out provisions for incorporating an unincorporated association.

Section 5221. Unincorporated Association. (a) An existing unincorporated association or organization may be incorporated under this section, but this section does not preclude the formation of a corporation under any other provisions of law, including Section 5220 of this division, that would otherwise apply.

(b) Where an existing unincorporated association or organization chooses to incorporate pursuant to this section, the articles of incorporation shall

(1) set forth the name of the existing unincorporated association or organization, and

(2) be accompanied by a verified statement of the presiding officer, or a majority of the governing board, then in office, of the association or organization, stating that the membership of the association or organization has duly authorized the filing of the articles and the application of this section. The affidavit may further state that the membership has agreed to waive subdivision (f) of this section, but such waiver shall be effective only if agreed to by the unanimous vote of all members of the association.

(c) The person or persons submitting the verified statement required in subdivision (b)(2) shall sign, acknowledge, execute and file the articles.

(d) The corporate existence begins upon the filing of the articles and continues perpetually, unless otherwise expressly provided by law or in the articles.

(e) The members of the association or organization incorporated pursuant to this section shall become participants of the corporation so created, and all property held by the association or organization shall belong to and vest in the corporation so created upon filing of the articles of incorporation, subject to all pre-incorporation encumbrances and claims as if incorporation had not taken place.

(f) Neither the initial articles nor the initial bylaws of the corporation shall distribute voting rights or rights in the property of the corporation, in a manner which reduces the rights of any participant below those enjoyed as a member in the predecessor association, nor shall the obligations of any member be increased. Any subsequent changes in the articles or bylaws shall be governed by the applicable provisions of this division.

For comparable provisions in the Commission's bill, see Section 5311. The Select Committee materials identify a number of difficulties with these provisions: (1) They make clear that the provisions are optional and normal incorporation procedures can be followed; (2) they deal directly with problems relating to the vesting of property in the newly-formed corporation and the preservation of preexisting claims and encumbrances; (3) they make an effort to protect voting and property rights of members. The Select Committee materials indicate that their resolutions of these problems are not entirely satisfactory, however, (see Exhibit 1--pink) and note that they have tentatively determined to delete the provision altogether.

### Corporate Name

Subdivision (b) of Section 5222 of the working draft precludes a corporation from using the word "nonprofit" (or words of similar import) in its name unless it is a charitable or religious corporation.

(b) The Secretary of State shall not file articles setting forth a name in which the word "nonprofit" or any variant thereof [sic] appears, or which may create the impression that the purpose of a nonstock corporation is charitable or religious or that it is a charitable foundation, unless the corporation is a charitable corporation.

The Commission's bill (Section 5222) precludes only use of the word "charitable" (or its equivalent). Although the Select Committee materials do not specify a reason for this broad preclusion, apparently there is some concern that a nonprofit corporation may trade on its "non-profit" status.

In this connection, it should be noted that the working draft is not phrased in terms of nonprofit corporations, but in terms of "non-stock" corporations, a phrase which is yet undefined.

### Required Contents of Articles

Section 5230 of the working draft requires that a charitable corporation identify itself as charitable in the articles but adds a provision to the effect that a failure to identify itself as charitable does not preclude application to it of rules governing charitable corporations:

(e) Nothing in this section or in any provision of the articles adopted pursuant to it shall be construed to limit the equitable power of a court to impress a charitable trust upon any or all of the assets of a nonstock corporation not electing to be a charitable corporation or otherwise treat it as a charitable corporation.

The Commission's bill likewise has the requirement that a charitable corporation identify itself as charitable, and the Comment to Section 5410 states:

Where the articles do not designate the corporation as one organized for charitable purposes, but the corporation is in fact one organized for charitable purposes, nothing in subdivision (c) precludes the application to such corporations of provisions relating to corporations organized for charitable purposes.

Perhaps this point is sufficiently critical that it belongs in the statute itself in the manner of the Select Committee draft.

Permitted Contents of Articles

Section 5232 of the working draft contains a listing of provisions which may be contained in the articles and which are not effective unless contained in the articles.

Section 5232. Permitted Contents. (a) The articles of incorporation may set forth any or all of the following provisions, which shall not be effective unless expressly provided in the articles:

- (1) a provision granting, with or without limitations, the power to levy assessments upon the members or participants;
- (2) a provision limiting the duration of the nonstock corporation's existence to a specified date;
- (3) a provision requiring, for any or all corporate actions (except as provided in [sections dealing with cumulative voting, removal of directors and dissolution]) the vote of a larger proportion of, or of all of, the members or participants of any class, or of a larger proportion of, or all of, the directors, than is otherwise required by this division;
- (4) a provision limiting or restricting the activities in which the nonstock corporation may engage or the powers which the nonstock corporation may exercise or both;
- (5) a provision conferring upon the holders of any evidences of indebtedness, issued or to be issued by a noncharitable corporation organized or existing under this division, the right to vote in the election of directors and on any other matters on which participants may vote under this division even if the noncharitable corporation does not have participants;
- (6) a provision conferring upon participants the right to determine the consideration for which participations shall be issued;
- [(7) a provision which would allow any member or participant to have more or less than one vote in any election or other matter presented to the members or participants for a vote, except that no such provision may be put into effect without first complying with §[x];]
- (8) in the case of a subordinate body instituted or created under the authority of a head organization, a provision setting forth either or both of the following:
  - (a) That the subordinate body thus incorporated shall dissolve whenever its charter is surrendered to, taken away by, or revoked by the head organization granting it, in accordance with [sections governing decision to dissolve], but

without the necessity of obtaining a vote of its participants, as would otherwise be required.

(b) that in the event of its dissolution pursuant to an article provision allowed by subdivision (8)(a) of this section, or, in the event of its dissolution for any reason, any assets which would otherwise be distributed in accordance with [sections governing distribution of assets] shall instead be delivered to the head organization, but the dissolution shall otherwise be governed by [sections on dissolution] insofar as they apply, except that the head organization shall stand in the place of participants for the purpose of Section [section making participants liable for any surplus wrongfully distributed to them].

(b) Nothing contained in subdivision (a) shall affect the enforceability, as between the parties thereto, of any lawful agreement not otherwise contrary to public policy.

(c) The articles of incorporation may set forth any or all of the following provisions:

(1) The names and addresses of the persons appointed to act as initial directors.

(2) Provisions concerning the transfer of membership interests, in accordance with Section 5412.

(3) The classes of members or participants, if any, and if there are two or more classes, the rights, privileges, preferences, restrictions and conditions attaching to each class.

(4) Any other provision, not in conflict with law, for the management of the activities and for the conduct of the affairs of the nonstock corporation, including any provision which is required or permitted by this division to be stated in the bylaws.

The provisions required to be stated in the articles to be effective include the right to levy assessments on members, the imposition of super-majority vote requirements, variations from the rule of one vote per member, and a number of other provisions that existing law leaves to the bylaws. The Commission's bill, following existing law, does not require such provisions to be stated in the articles.

The Select Committee materials give no justification for this change in the law other than it parallels provisions of the business corporation law. Perhaps the thought is that these provisions are of such a fundamental nature that, for the better protection of the members, they belong in the articles.

### Distributions to Members

Section 5241 (page 30 of the working draft) precludes "distributions" to members:

Section 5241. No Distributions. A charitable corporation shall not make any distributions to its members, and a noncharitable corporation may make no distributions to its participants except as authorized by [section on dissolution].

The Select Committee materials indicate that this would preclude a corporation from providing goods and services at a discount. The materials do not indicate any reason for this change in the law. "The committee may consider at a later date, whether rebates could be given based on the amount of purchases from a nonstock corporation."

The Commission's bill (Section 5316) prohibits the distribution of gains, profits, or dividends to members but states that "conferring benefits upon members in conformity with the purposes for which the nonprofit corporation is formed" is not deemed to be a distribution of gains, profits, or dividends to members. To my knowledge, the Commission has not previously entertained the suggestion that a nonprofit corporation might not be able to provide goods and services to its members at a discount.

### Defense of Ultra Vires

Section 5243 of the working draft permits actions to enjoin a breach of a charitable trust.

Section 5243. Charitable Trust Exception. (a) Notwithstanding Section 5242, in the case of a nonstock corporation holding assets in charitable trust, a director, participant, holder of a reversionary interest in the trust property or otherwise having an interest in it, the Attorney General, or other person as designated by subdivision (b), may bring an action to enjoin, correct, obtain damages for or to otherwise remedy a breach of the charitable trust.

(b) A member or donor [or other person with an interest in the matter] may bring an action under this section upon authorization granted by the Attorney General.

(c) In an action under this section, the court may

(1) enjoin the performance of a contract, if all of the parties to the contract are parties to the action, if no party has yet parted with anything of value pursuant to the contract or in reliance upon it, and if it is otherwise equitable to do so;

(2) require rescission of a contract, as allowed by subdivision (d);

(3) require reimbursement to the trust, by persons responsible for the breach, for losses incurred by it, as allowed by subdivision (e).

(d) Rescission may be allowed if all parties to the contract are parties to the action, there was no party to the contract who was without notice of the breach of trust, and where it is otherwise equitable.

(e) Where a contract entered into by or on behalf of the corporation constitutes or requires breach of a charitable trust, but the contract cannot be rescinded or its performance enjoined under this section, then the persons responsible for binding the corporation to the contract may be ordered by the court to reimburse the corporation for all losses incurred by virtue of the breach of trust.

Section 5314 of the Commission's bill is comparable, but is much more limited in character--it permits only injunction of ultra vires acts of charitable corporations. Moreover, the working draft adds a number of limitations and qualifications on the authority of the court to provide remedies, which the Commission should consider. In general, the Commission has previously resisted the temptation to jump into the trust law thicket.

#### Number of Directors

The Commission's bill (Section 5511) permits the bylaws to state a variable number of directors with a stated minimum and a stated maximum, with the limitation that the stated maximum be not more than one less than twice the stated minimum. The Select Committee draft (Section 5251(a) of the working draft) identifies a technical bug in this scheme --under the formula, a corporation would be unable to have a minimum of one director and a maximum of two or three, since one less than twice one is one. To enable a corporation to have a variable number of directors with a stated minimum of one, the working draft provides that "the number of directors shall be not less than a stated minimum or more than a stated maximum (which shall not be greater than three, or two times the stated minimum minus one, whichever is larger)."

#### Bylaws Relating to Admission and Expulsion of Members

Subdivision (d) of Section 5251 of the working draft requires the bylaws to provide the manner of admission, withdrawal, suspension, and expulsion of members.

(d) The bylaws shall provide for the manner of admission, withdrawal, suspension, and expulsion of participants or voting members, consistent with the requirements of Section 5441 of this division.

The Commission's bill (Section 5442) makes these bylaw provisions permissive rather than mandatory. The reason given for the mandatory provisions in the Select Committee materials is that due process requires "that the rules--whatever they are--are set out in advance rather than created on an ad hoc basis."

Respectfully submitted,

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EXHIBIT 1

DISCUSSION: This provision has no analogue in the CC.

The basic question for the Committee is whether there is a need for such provisions. Most are continued from current law, which scatters them throughout the code (§§9202, 9300(f), 9304(b), 9604). One could obviously incorporate an unincorporated association without such a section, by merely forming a new corporation to which is transferred the property of the old association upon its dissolution. The articles of the new corporation could even provide for automatic participation for the members of the defunct association.

To the extent a section such as this might be thought necessary to establish that the incorporation of an association is an allowable "purpose" (see current law §9202), it is obviously now superfluous with the broad purpose language provided in §5210. The only reason for retaining such a section, then, is to provide a simpler method of incorporation. This section probably does accomplish that purpose, although the difference may be marginal -- and may not be worth the potential problems, as explained below.

Some problems of the current law are cured by this section. First, it should be noted that the section is framed as an alternative method of formation available to the association, thus allowing the association to proceed, if it wishes, under §5220 instead, avoiding the application of this

section where it does not prove convenient for the particular association. Where the association chooses to proceed under this section, however, the required affidavit must explicitly state that the membership has approved its application. The principal results of the choice of this section are the provisions contained in subsections (e) and (f).

Subsection (e) is different from current law in a number of ways. First, it provides for automatic vesting of property, which would seem to be a principal convenience that could be achieved by such a section. The current law in this area is uncertain, although the meager authority which exists is consistent with this section. See Security First National Bank v. Cooper, 62 Cal.App.2d 653, 670 (1944); CEB, California Nonprofit Corporations, §2.6.

Where documents are fraudulently filed, asserting approval of the association which has not in fact been obtained, case law indicates that the new corporation can continue to exist, but that equity will require it to reconvey the property to the predecessor association which it purported to supplant. Barber v. Irving, 226 Cal.App.2d 560, 30 Cal.Rptr. 192 (1964). Without evaluating the merits of this rule, we recommend that this problem be left with the courts, and this section does not address it.

The language used in (e) -- preserving all pre-incorporation claims upon the property -- is taken from §403 of the new New York law. There may remain, however, difficulties under the recording acts which need be addressed here.

Second, subdivision (e) provides for automatic transfer of membership, but drops the language of the current law providing that individual members may "file their dissent in writing" to avoid this result. There is no need for a special provision allowing for the resignation of membership; §5415, in the chapter on members, covers the right to resign in general language that would apply here. Moreover, the special provision regarding "dissent" is troublesome, since it appears to create a right without elaboration of its nature. Nor are there cases construing this language.

This draft takes a different approach. It assumes that the fact of incorporation, alone, cannot possibly prejudice the rights of individual members in some way entitling them to special protection against the will of a majority which wishes to incorporate. Instead, they require protection, if at all, from changes in the internal structure of the organization, which may occur incidentally to its incorporation and which reduces their rights in it. Subsection (f) addresses this concern by simply prohibiting such changes as part of the process of incorporation, although they may of course be made later under the same rules that apply to any other nonstock corporation -- with appropriate safeguards for the minority. The only exception to the mandate of subdivision (f) is where the members are unanimous, as provided in subdivision (b)(2). This is to allow the convenience of this section to an organization where it has been demonstrated that there is no internal controversy at all regarding the proposed changes, so that there is no group of members requiring the protection of subdivision (f).

As noted above, this section is not without potential problems. First of all, subdivision (f), while solving the difficulty that might otherwise arise with potential dissenters, may set a standard for the new bylaws and articles which is too uncertain to allow counsel to assure a client association that it is in conformity. The automatic vesting of property may produce recording act problems, as noted above. Nor does the section answer the question of the means by which the association "duly authorizes" its incorporation. "Duly authorized" can mean here, as it does in current law, a method of authorization that is proper under the law governing the association. This will ordinarily be a majority vote as set out in the association's bylaws.

On the other hand, few problems will probably arise in the majority of cases in which there is no internal controversy concerning the incorporation. Unanimous consent could be obtained, thus waiving (f), or the identical rules could be adopted for the corporation as the association. And in such cases this section would be of some convenience.

Question

Does this section, on balance, fulfill some useful function which calls for its continuation?