

#77

5/13/74

Memorandum 74-31

Subject: Study 77 - Nonprofit Corporations

BACKGROUND

In 1970, the Commission was authorized to study the law relating to nonprofit corporations. The staff has now completed its background study on this matter and a staff draft of a new general nonprofit corporation law has been prepared.

To aid in the preparation of the draft and to advise the Commission at its meetings, the Commission retained Mr. G. Gervaise Davis III, Monterey lawyer, in November 1973, as a consultant on this topic. Unfortunately, we were not able to work out a time when Mr. Davis could review the draft; however, it is hoped that he will be able to attend the meetings when the draft is considered.

MEETING OBJECTIVE

We are providing you with a draft of a major portion of the new code (the portion containing special provisions relating to special nonprofit corporations has not yet been drafted). We plan to devote one full day to this at the May meeting, and we believe that the Commission should be able to cover at least the first 151 pages of the staff draft. Accordingly, please read at least the first 151 pages of the staff draft.

Mr. McQuinn, who has prepared the staff draft, and other background materials, leaves the staff in July so we want to cover the entire draft at the May and June meetings.

STAFF BACKGROUND STUDY

Attached is a background study prepared by the staff. This study concentrates on the major policy questions in the proposed revision. It presents (1) a preliminary discussion of the nature of nonprofit corporations, (2) a discussion of the present law and its inadequacies, and (3) a general outline of the major decisions involved in the staff draft.

The central conclusion of the staff study is that a comprehensive revision of corporate law governing nonprofit corporations is necessary to fill the many gaps existing in the present law and also to address with more sensitivity the particular problems of nonprofit corporations. Moreover, the new law should provide additional protection for the public interest and also for the members of these organizations.

Besides a comprehensive revision of the general law regulating nonprofit corporations (General Nonprofit Corporations Law, Corp. Code § 9000 et seq.), the staff recommends that a new Nonprofit Corporation Code should be drafted encompassing the provisions relating to specialized nonprofit corporations (presently located at the end of Division 2 and interspersed throughout Division 3 of the Corporations Code). Those special provisions which become unnecessary in view of the provisions of the revised general law (Not-for-Profit Corporation Law, Division 2 of the draft) should not be continued, and the rest should be located for convenience in a separate division of a new Nonprofit Corporations Code. Our study of these special provisions has not been completed at this time, and the complete outline of the proposed new code will be presented at a later date.

STAFF DRAFT OF NEW NONPROFIT CORPORATIONS CODE

The staff draft of the general portion of the new code is presented in a separate binder. Certain features of this material should be noted. Comments are provided for almost every section as in other Commission drafted statutes. In some cases, you will find a Section or Article Analysis. This analysis presents a discussion of a major policy issue or drafting alternatives inherent in the individual section or article. For an example, see pages 20-22 of the staff draft. Where appropriate, a list of policy questions presented by an individual section is listed after the Comment to the section under a heading "ISSUES TO BE RESOLVED." The staff recommendation (the recommendation that has been adopted in the staff draft) is noted after each such issue.

ADDITIONAL BACKGROUND MATERIALS

In addition to the background study which is attached to this memorandum, you will be provided the following background materials:

- (1) Chapter Summaries (attached to this memorandum). This summary is designed to give a brief overview of the staff draft.
- (2) Sources and Comparable Provisions. This material is in preparation and will show the origin of each section of the staff draft and also list comparable statutory provisions which might be of interest to the Commission. The text of source provisions and some comparable provisions is set out so these provisions may be compared with the draft statute. Where present law has been altered only slightly, the changes made in the present section by the staff draft are shown.

Respectfully submitted,

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Legal Counsel

BACKGROUND STUDY ON REVISION OF
NONPROFIT CORPORATIONS LAW

The following study explains the general approach taken in the proposed staff draft of the Not-for-Profit Corporation Law. The study is divided into three parts: (1) a preliminary discussion of the nature of nonprofit corporations, (2) an explanation of present law and its inadequacies, and (3) a general outline of the major policy decisions of the proposed draft.

Nonprofit Corporations

Before examining the inadequacies of the present corporate law regulating nonprofit corporations or discussing the general approach taken by this proposed revision, it is essential to get firmly in mind a picture of the type of organization which is classified as a nonprofit corporation and an idea of its particular problems. It should be noted that there is very little written about these corporations and what has been written is not very analytical.¹ Consequently, some of the assumptions underlying this discussion are untested and are based largely upon common sense and upon hints discovered here and there in the various sources consulted concerning the usual problems confronting nonprofit organizations.²

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1. The best sources of information on nonprofit corporations and their legal problems are: California Nonprofit Corporations (Cal. Cont. Ed. Bar 1969)[hereinafter cited as California Nonprofit Corporations]; Leshner, Non-Profit Corporations: A Neglected Stepchild Comes of Age, 22 Bus. L. 951 (1967); H. Oleck, Non-Profit Corporations and Associations (1956) [hereinafter cited as Oleck]; Note: New York's "Not-for-Profit" Corporation Law, 47 N.Y.U.L. Rev. 761 (1972)[hereinafter cited as N.Y.U. Note].
 2. See Oleck, Ch. XIV, "Form of the Bylaw," at 183.

In general, nonprofit corporations have one attribute in common: they are organized primarily for some nonbusiness, nonpecuniary purpose although in most states these organizations may earn profits which are incidental to the main purposes of the corporations and supportive of those purposes.³ These nonbusiness purposes may be classified into three main types:

(1) Charitable purposes (the corporation exists to advance the religious, educational, political, or general social interest of mankind where the ultimate recipients of the benefits are either the community as a whole or an unascertainable and indefinite portion of the community).

(2) Membership or associational purposes (the corporation exists primarily to provide nonmonetary benefits or services to the members as, for example, the average country club or an incorporated trade association).

(3) Public or quasi-public purposes (the corporation exists to provide a benefit to a particular group within the community. These organizations engage in activities very similar to those which are normally associated with government, and they are often heavily supported by government funds. Moreover, they represent a new concept in societal organization, part public and part private, and are a fast developing phenomena.⁴ A California example is the job creation corporation.⁵).

There are three basic reasons why these diverse types of organizations seek corporate status.⁶ Perhaps the primary reason is that, under the corporate

3. Corp. Code § 9200; see also Oleck at 1-3.

4. See N.Y. Joint Legislative Comm. to Study Revision of Corporation Laws, Special Study No. 2, Seventh Interim Report to 1963 Session of N.Y. State Legislature, Legis. Doc. 29, at 414-415 (1963).

5. Corp. Code § 14000 et seq.

6. California Nonprofit Corporations, Kasner, Characteristics of Nonprofit Organizations § 1.6.

form, participants in the corporation such as members are not personally liable for the debts or obligations of the corporation. Moreover, the corporate form permits centralized management and the power to delegate authority to representatives. Thus, nonprofit corporations may engage more effectively in business activities which support their main purposes as centralized management facilitates a better and more efficiently run organization. Finally, corporate status places the organization under the more completely developed legal framework of the corporation law. The law of unincorporated associations is incomplete and creates much unwanted uncertainty concerning the rights of members and the precise legal status of the association.⁷

Because nonprofit corporations often provide public benefits which serve as an alternative to governmental programs or which are supportive of those programs, they receive various indirect public subsidies and also special legal treatment. Society has to this point deemed it advantageous to encourage in an affirmative manner the activities of most of these organizations. A good portion of the spectrum of nonprofit corporations are exempt from federal income tax and from California income and franchise taxes.⁸ Some of these organizations are also exempt from California property tax and others from the sales tax.⁹ Moreover, many nonprofit corporations qualify to receive

7. Id. § 1.4.

8. A list of nonprofit organizations exempt from income and franchise taxes may be found in California Nonprofit Corporations, Grant & Leydorf, Tax Problems of Nonprofit Organizations, §§ 3.2-3.6; see also Bromberg, Non-Profit Corporations: Organizational Problems and Tax Exemption, 17 Baylor L. Rev. 125 (1965).

9. California Nonprofit Corporations, Kasner, Characteristics of Nonprofit Organizations §§ 1.20, 1.21.

tax-deductible contributions.¹⁰ It should be noted that neither tax deductibility nor tax exemption flow automatically from nonprofit corporate status. Every organization which receives these benefits must specifically qualify under the applicable tax provisions of state or federal law, and special applications must be filed with the appropriate authorities.¹¹ The limitations and qualifications placed upon the receipt of tax benefits by the tax laws are sufficiently detailed that the corporation law need not be overly concerned with regulating this matter. Nevertheless, the tax benefits received by many of these organizations do illustrate the special nature of nonprofit corporations and their close relationship to the public interest--an important justification for special treatment under the corporations law.

Besides tax benefits, nonprofit corporations receive other benefits which flow more directly from their special status under the corporation laws. While there is no empirical evidence verifying this conclusion, it seems that the public is generally less apprehensive about donating time and money to support organizations which are supposedly not tainted with the acquisitive motive. Moreover, corporations which are nonprofit are exempted from aspects of the detailed government regulation which affects profit oriented corporations. For example, they are often exempt from the operation of the federal antitrust laws and also the state corporate securities laws.¹² Furthermore, as will be

10. Id. § 1.23.

11. See California Nonprofit Corporations, Grant & Leydorf, Tax Problems of Nonprofit Organizations, §§ 3.1-3.26.

12. See Note: Privileges and Immunities of Non-Profit Organizations, 17 Clev. State L. Rev. 264 (1970); also California Nonprofit Corporations, Gould, Relations With Governmental Agencies, § 5.9.

discussed in greater detail later, many of the requirements of the General Corporation Law (Division 1 of the Corporations Code) have been relaxed for nonprofit corporations.

The special benefits and treatment afforded by society to these organizations causes them to be imbued with a public trust. Therefore, the law regulating nonprofit corporations must be structured to assure that their affairs are carried out in a manner consistent with their nonprofit status and, moreover, the law should encourage and facilitate the overall effectiveness of these organizations.

Effectiveness is a special problem for nonprofit corporations, for without the profit guideline there is no objective measure of effectiveness. A profit oriented corporation must continue to provide adequate profits or face a loss of investment. Eventually, the pressure of unprofitability will cause an ineffective corporation to be overhauled under new management or dissolved. Thus, where profits are at issue, society is guaranteed that in the long run efficiency will prevail. This assertion cannot be made with any confidence for nonprofit corporations.

The only real measure of a nonprofit corporation's effectiveness is how well it serves its intended purposes. This measure is qualitative and subjective and not reducible to a firm standard. Members of the corporation and other closely interested persons such as donors are the only and best judges of a corporation's success. Given this problem, the corporate law must be carefully structured to provide these interested persons with access to all relevant information concerning the corporation's activities in order that they may make a proper decision on whether or not the corporation merits continued support. In addition, the law needs to be structured to give members more authority over the fundamental decisions of the corporation. However, these

objectives should be accomplished without unnecessarily sacrificing daily managerial efficiency. The recommended approach to these problems will be summarized in a discussion to follow.¹³

A possible alternative solution to the problem of corporate inefficiency would be direct governmental regulation by some government body or agency. Under present law, the Attorney General is empowered by the Uniform Supervision of Trustees for Charitable Purposes Act to oversee the affairs of charitable corporations or corporations which hold assets in trust; however, the primary focus of this regulatory power is directed at active abuses of trust property and is not concerned with the question of corporate effectiveness.¹⁴ In general, without a firm, objective standard by which to measure efficiency, government regulation in this area invites administrative arbitrariness and is probably contrary to our society's notion of the freedom of association.¹⁵

The absence of a profit motive has other effects upon nonprofit corporations besides removing an obvious constraint on ineffective activities. It increases the likelihood of considerable membership apathy. Without the financial incentive, it can, for example, be difficult for many organizations to generate much interest or turnout at meetings of the members.¹⁶ Therefore, if these organizations are not to be hamstrung, flexible voting procedures are mandated. It should be noted that membership apathy and the foregoing discussion on the need to grant more authority to members to govern the

13. See attached summary of Not-for-Profit Corporation Law.

14. Govt. Code § 12580 et seq.

15. See Dwight, Objections to Judicial Approval of Charters of Non-Profit Corporations, 12 Bus. L. 454 (1957).

16. See Oleck at 220-231.

corporation are not necessarily inconsistent. To protect society's interest in corporate efficiency, those members who are in fact interested and active should be permitted to assume more control over the fundamental decisions of the corporation. Of course, limitations must be established on this control to protect all factions of the membership.

Furthermore, flexibility is a necessary feature of any general nonprofit corporation law for another reason. As previously stated, nonprofit corporations are created for diverse purposes and, while they may be united in desiring the advantages of corporate status, each type requires a differing organizational structure to best accomplish its particular objective. For example, some corporations such as traditional charities do not have members, and others such as fraternal clubs have their own unique governing structure. Any general law which attempts to govern these diverse organizations must necessarily be flexible.

Present Law Governing Nonprofit Corporations

The main body of law presently governing nonprofit corporations is the General Nonprofit Corporation Law (Section 9000 et seq. of the Corporations Code); moreover, an important group of nonprofit corporations is governed by the law of corporations for charitable or ~~eleemosynary~~ purposes (Section 10200 et seq. of the Corporations Code). In 1947, this whole body of law was removed from the Civil Code during the general revision of the corporation law and placed in its present location. Since that time, it has undergone only one substantial revision. In 1949, the terminology was tightened, and a few new substantive provisions were created such as one which empowers 10 percent of the members to call a meeting of the members.¹⁷

17. Corp. Code § 9600 (General Nonprofit Corporation Law).

The overall approach of the present law is extremely flexible concerning both the types of organizations which may lawfully incorporate as nonprofit corporations and the manner in which these organizations may carry out their activities. A corporation may be formed for "any lawful purposes which do not contemplate the distribution of gains, profits or dividends to the members."¹⁸ Moreover, many of the required procedures of the General Corporation Law have been relaxed; for example, members may vote by other means than at a meeting of the members.¹⁹ Furthermore, many of the mandatory requirements for profit corporations such as cumulative voting are optional for these corporations.²⁰ The flexibility of the present law, as previously discussed, is in keeping with the basic nature of nonprofit corporations. This approach is continued and even expanded in the proposed revision.

However, despite the flexible approach, present law is seriously in need of major reform. It would be futile to summarize here the many proposed changes. Major alternatives are set forth in the attached summary of the proposed Not-for-Profit Corporation Law. Moreover, all the important changes are discussed in the Comment and Analysis to each individual section of the proposed draft. This discussion will focus instead on the basic problems which affect the entire body of the corporate law regulating these organizations as opposed to the flaws in any individual part or section of the present law.

18. Corp. Code § 9200 (General Nonprofit Corporation Law).

19. Corp. Code § 9402 (General Nonprofit Corporation Law).

20. Corp. Code § 9402. Cumulative voting is mandatory for business corporations (Corp. Code § 2235).

In general, the nonprofit corporation law is fragmentary and incomplete, has major interpretive difficulties, and fails to adequately address many of the specific problems of nonprofit corporations.

Section 9002 of the General Nonprofit Corporation Law provides that "the provisions of the General Corporation Law, Division 1 of this title [Corporations Code], apply to corporations formed under this part [General Nonprofit Corporation Law], except as to matters, specifically otherwise provided for in this part." The effect of incorporating the business corporation law by reference is that a lawyer attempting to resolve even the most fundamental issues affecting nonprofit corporations is often confronted with an interpretive dilemma.

Since the General Nonprofit Corporation Law contains only a few basic rules, the General Corporation Law must be continually consulted for additional requirements affecting the particular area under consideration. Once these requirements are located, the attorney is faced with the difficult question of whether or not they apply. Does the "except as specifically otherwise provided" language of Section 9002 mean that the more detailed requirements of the General Corporation Law do not apply to matters which are handled in a general fashion by the General Nonprofit Corporation Law even though the General Corporation Law provisions are not strictly inconsistent? For example, Section 9600 of the General Nonprofit Corporation Law provides rules for calling a meeting of the members but says nothing about whether an annual meeting is mandatory whereas Section 2200 of the General Corporation Law requires an annual meeting of all "shareholders" (defined by Section 103 to include members of a nonstock corporation). Therefore, does the annual meeting requirement of Section 2200 apply to nonprofit corporations or should the

absence of such a provision in Section 9600--which deals generally with the subject--be interpreted to satisfy the "specifically otherwise provided for in this part" exception to the general applicability of the General Corporation Law? This question has not been resolved nor does it appear to ever have been litigated. It illustrates a basic interpretive quagmire which results from the statutory overlap between the General Corporation Law and the General Nonprofit Corporation Law.

The overlapping provisions of the General Nonprofit Corporation Law and the General Corporation Law are more than just inconvenient for the practicing attorney. This approach fosters uncertainty which is particularly harmful in the nonprofit situation because the small monetary amounts involved often preclude clarifying litigation. Certainly, few people can afford to litigate an issue purely for principal. Lingering uncertainty encourages legitimate claims to go unanswered and rights unprotected, and it is inconsistent with an important advantage normally associated with corporate status--the right to be governed under the corporation law by a comprehensive set of legal rules that smoothly guide the administration of the corporation's affairs and establish clearly the rights and liabilities of the interested parties. It should be noted that charitable corporations formed under the law of corporations for charitable or eleemosynary purposes (Section 10200 et seq. of the Corporations Code) face even more uncertainty, for that law contains only a handful of special provisions and, unlike the General Nonprofit Corporation Law, it makes no reference to a more complete body of law.

To make matters worse, many of the provisions of the General Corporation Law are not appropriate for nonprofit corporations even when they clearly apply, for the General Corporation Law is not tailored to address the particular problems of these organizations. For example, there are no provisions in the

General Nonprofit Corporation Law regarding members' rights during merger with another corporation so, obviously, pursuant to Section 9002, the rules of the business corporation law apply to this matter. However, under that law, minority interests are protected from unfair mergers via the exclusive remedy of dissenter's appraisal rights, but such rights are of little help in the nonprofit situation where a member owns nothing of estimable value prior to a distribution of the assets upon final dissolution of the corporation.²¹ For nonprofit corporations, a different remedy should be developed for protection of dissenting members during a merger of the corporation. The merger example is but one illustration of the result which occurs when many of the rules of the General Corporation Law are applied without any modification to the problems of nonprofit corporations.

An additional defect in the present law is that it does not provide sufficient protection for the public from potential abuse of the special nonprofit status. While it is true that this status does not automatically entitle a corporation to receive many public benefits such as preferential tax treatment, the public interest still requires that these corporations be foreclosed from engaging in illegitimate conduct which results in direct benefits being passed to members, directors, or officers. Misuse of the nonprofit status effectively defrauds donors and the general public who rely on this status when bestowing special private benefits on nonprofit corporations. Moreover, a justification for the relaxed requirements of the corporation law is that many of the rules which are needed to regulate profit corporations are not required in the nonprofit situation. For example, the required annual meeting of the shareholders helps assure ultimate control over the affairs

21. See the Comment and Analysis to draft Section 1312.

of the business corporation by the shareholders who, after all, are the owners of the capital. This control is vital to our competitive economic system, for it assures that management will be responsive to the profit-making motive.²² While this rationale does not apply to a legitimate non-profit organization which is not supposed to be responsive to the profit motive, the public interest in promoting a competitive economy suffers if the protective formalities of the General Corporation Law can be circumvented by the device of incorporating as a nonprofit corporation.

Under existing law, profits or benefits may be channeled to members, officers, or directors in the form of loans or by selling them bonds which pay more than normal returns. Neither of these practices is expressly prohibited under present law.²³ No statistics have been located which show that such tactics have been used successfully, but as long as the possibility exists, this problem must be considered.

Moreover, under existing law, clearly illegal conduct can easily go unnoticed and uncorrected. The Attorney General has special supervisory powers over charitable corporations and trust property pursuant to ~~the~~²⁴ Uniform Supervision of Trustees for Charitable Purposes Act. However,

22. For a critical discussion of this rationale, see Hetherington, Fact and Legal Theory: Shareholders, Managers, and Corporate Responsibility, 21 Stan. L. Rev. 248 (1969).

23. Presently, loans may be made to directors if two-thirds of the members approve. Corp. Code § 823.

24. Govt. Code § 12580 et seq.

given the overworked and undermanned status of this public agency, very little active supervision is possible. ²⁵ Other means must be developed to help in the task of correcting illegal conduct. For example, members or other interested persons must be given additional powers and incentives to sue to correct abuses, and these persons must be given access to information concerning the corporation's affairs so that abuses may be discovered and remedied in court. ²⁶

In general, there is a great need for a comprehensive, modernized set of rules which is specially adapted to the particular needs of nonprofit corporations and which is located in one place for the convenience of the practicing lawyer.

Outline of Proposed Revision

The general approach taken by the recommended draft is to create for each basic situation a specific rule which will govern so long as an alternative rule is not expressly provided in the corporation's articles or bylaws. ²⁷ In this manner, a guideline is presented which can be altered if necessary to fit the particular needs of the corporation but, in the absence of an express provision, the statutory rule governs. This approach eliminates

25. See Howland, The History of Supervision of Charitable Trusts and Corporations in California, 13 U.C.L.A. L. Rev. 1029 (1966).

26. See pp. 15-16.

27. Of course, sound policy requires some rules to be inflexible; for example, membership voting requirements for certain fundamental changes in the corporation (e.g., merger or dissolution) must be invariable downward.

the uncertainty which occurs when a corporation fails to adopt any rule covering a basic matter; moreover, it provides a guideline of normal practice by which members and others can measure their own corporate provisions. At the same time, this flexibility recognizes the wide range of purposes and needs of nonprofit corporations.

The following is an example of draft's basic approach: An annual meeting of the members to elect directors is required unless the articles or a bylaw adopted by the members provide otherwise and, as a corollary provision, the articles or bylaws adopted by the members may specify a method of voting other than at a meeting of the members. Thus, a corporation which is burdened by substantial membership apathy may make appropriate provision for this apathy and avoid being hamstrung. Nevertheless, the traditional annual meeting of the members is the legal norm to be followed by most corporations. 28

Many of the specific rules chosen for this revised code are derived in large part from three recent nonprofit codes: New York's Not-for-Profit Corporation Law, Pennsylvania's Corporation Not-for-profit Code, and the ABA-ALI Model Non-Profit Corporation Act. These are the best modern statutes in the area. In particular, a great deal of money and effort was spent studying the background issues and formulating the New York code,²⁹ and the recommended draft relies heavily on the New York model. However, for reasons which are set forth in the Comments and Analyses³⁰ to the draft sections, many aspects of the New York statute are not recommended. In general, this draft was

28. See draft Sections 751 and 758.

29. See N.Y. Joint Legislative Comm. to Study Revision of Corporation Laws, 11th Interim Report to 1967 Session of N.Y. State Legislature, Legis. Doc. 12, Appendix 4 at 48-54 (1967)(outline of research studies).

30. In general, the New York code suffers from what Professor Stanley Seigal calls "big city law." It is at times unnecessarily detailed.

created by selecting from the various statutory alternatives the provisions which the staff believes are most consistent with sound policy and also, where practical, present California law.

Where strong reasons do not mandate a change, the staff recommends that existing law should be followed to avoid any unnecessary disruption in the ongoing activities of established organizations. Moreover, for the convenience of the practicing attorney, it is wise to adopt the rules of the General Corporation Law in areas where there is no compelling reason for treating nonprofit corporations differently. For example, the General Corporation Law requirements for qualification of foreign corporations have been substantially followed.³¹ Uniformity is an important goal of this code, and many sections have only been revised to reflect nonprofit terminology.

To balance against the permitted flexibility, the draft proposes additional protection for members and for society. Basic to these new protective measures is public disclosure by the corporation of information regarding its affairs and finances. The draft recommends that all nonprofit corporations be required to prepare an annual report which is to be available to the public upon written request. The purpose behind this new required annual report is to provide the necessary information for members and other interested persons to assert their rights in relation to the corporation. Moreover, disclosure of basic information concerning the corporation is designed to facilitate educated judgments about the overall success of the corporation.³²

Once a significant number of members deem the corporation to be ineffective, the draft encourages dissolution of the corporation by recommending liberal

31. See draft Section 1751 et seq.

32. For a discussion of annual report provisions, see the Analysis to Article 2 of Chapter 5 of the proposed draft.

procedures which permit voluntary dissolution without court supervision. Moreover, the draft proposes less stringent requirements for an involuntary dissolution action brought by members or directors to dissolve an ineffective or unlawful nonprofit corporation.

Besides the power to initiate judicial dissolution, dissenting members and directors have also been given several special statutory actions which are designed to provide protection for their interests and those of the general public. For example, the Attorney General, any director, or member may bring an action to enjoin or rescind a merger or consolidation which serves as a device to defraud members of the public at large or which is manifestly unfair to either corporation.³³ This cause of action is in lieu of the present ineffective dissenting member's appraisal rights. Moreover, the right of members to sue on behalf of the corporation to correct corporate abuses has been made a more viable remedy by abandoning the security deposit requirements of the General Corporation Law. In their place, new protections have been developed for the "strike suit" danger.³⁴ These are but a few of the protective features recommended by the proposed draft. Again, we request that you consult the attached summaries of each part of the proposed draft and also the Analysis and Comment to each section of the draft for more details.

33. See draft Section 1601 et seq.

34. See draft Section 1312.

35. See draft Section 775 et seq.

CHAPTER SUMMARIESDIVISION 2. NOT-FOR-PROFIT CORPORATION LAWChapter 1. Short Title; Definitions; Application (pages 13-26)

The title of the new general nonprofit corporation law is derived from New York's new code, N.Y. Not-for-Profit Corporation Law § 101. "Not-for-profit corporation" is more accurate than "nonprofit" as this type of organization may make a profit which is ancillary to its main purposes and supportive of them, but it is not organized for profit.

Many of the basic definitions for this division are modeled after the definitions in the ABA-ALI Model Non-Profit Corporation Act. The central definition which establishes the requirements for nonprofit status by defining the term "not-for-profit corporation" or "nonprofit corporation" is derived in large part from Section 102 of New York's Not-for-Profit Corporation Law. It contains substantially the same requirements as existing law with regard to the kind of organization which may incorporate as a nonprofit corporation; however, for clarity, present requirements have been separated into a two-test approach: The purpose of the corporation must be other than to promote financial gain, and no part of its assets, income, or profits may be distributable to members, directors, or officers except as otherwise permitted by this division.

This division is expressly made applicable to all nonprofit corporations as herein defined which presently exist or are hereafter formed. An optional approach permitting existing corporations to operate under the previous law is rejected in favor of the convenience and added protection for members and the general public provided by a uniform application of the new law. See Section 165.

Chapter 2. Formation and Bylaws (pages 27-65)

For the convenience of the practicing attorney, the various provisions governing the formation of the corporation and the establishment of its governing rules have been consolidated into one chapter.

Consistent with the increased flexibility of this proposed revision, Article 1 places no restriction upon the number of incorporators; however, to aid in discovering the real parties at interest, corporations may no longer serve as incorporators. See Section 201.

The purposes and powers provisions of Article 2 are extremely broad. A corporation may be incorporated for any lawful purpose consistent with the nonprofit definition. See Section 301. However, as is the case for California business corporations, the list of corporate purposes in the articles is binding upon the corporation and may be enforced in an appropriate proceeding. On the other hand, a nonprofit corporation possesses by statutory authority, subject only to a specific limitation in its articles, all the powers which are necessary and expedient for the administration of its affairs and the attainment of its purposes. See Section 303.

The provisions of Article 3 regulating the corporate name are substantially the same as present rules governing these matters. In general, a corporation may not use a name which is misleading to the public or one which trades off the name or reputation of an established organization. See Section 401.

The provisions of Article 4 setting forth the contents and filing requirements for articles of incorporation are much the same as the present law on these matters except that the new rules have been re-organized and rewritten. Corp. Code §§ 9300-9304.5.

Article 5 deals with amendment of articles. A nonprofit corporation may amend its articles of incorporation in any respect it desires as long as the amendment contains only provisions which might lawfully be contained in an original articles of incorporation filed at the time of the amendment. See Section 551. This continues the general grant of authority to amend the articles set forth in the General Corporation Law. Corp. Code § 3602. Amendments must be authorized both by the board of directors and by the membership. The latter requirement may be satisfied in several ways: (1) by vote of two-thirds of a quorum at a meeting of the members provided that this number is not less than a majority of the votes cast, (2) by the written consent or vote of

a majority of the voting power of the corporation, (3) when an alternative manner of voting is used as provided in Section 758, by at least a majority of the votes cast by that procedure unless a greater number is specified in the articles or in a bylaw adopted by the members, or (4) pursuant to a provision in the articles or a bylaw adopted by the members, by two-thirds vote of a policy committee which consists of at least 10 percent of the membership or 30 members, whichever number is smaller. See Section 552. The last alternative is largely derived from existing law governing nonprofit corporations, and it provides a reasonable means of gaining membership participation in the amendment process without placing too great a burden on a corporation with a significant number of uninterested members. Corp. Code § 3632.5. A certificate verifying that proper authorization procedures have been followed during the amendment process and which also includes the approved changes in the articles must be filed with the Secretary of State and other appropriate officials. See Section 556. Moreover, to protect against fraudulent amendments, a special action has been created to enjoin amendments which serve as a device to defraud members or the public at large. This action may be brought by the Attorney General or any member, officer, or director. See Section 561.

The provisions of Article 6 governing the adoption and repeal of bylaws continue much of the substance of present law. Corp. Code §§ 9400-9404. A bylaw may be adopted, amended, or repealed by a majority of the members or, in most cases, by the board. See Section 603. However, to permit members to structure their organization as they desire, an appropriate provision in the articles or bylaws may require a larger percentage of the members to adopt or repeal bylaws or a particular bylaw than would otherwise be required. The articles or a bylaw adopted by the members may also limit the power of the board to adopt, amend, or repeal bylaws. A bylaw may contain any provision, not inconsistent with this code, regulating the affairs of the corporation. Certain fundamental matters such as the liability of members for dues or assessments must be provided for in the bylaws. See Sections 601 and 602.

Chapter 3. Members (pages 66-108)

Consistent with the important goal of providing a rule to cover most circumstances, this chapter clearly defines membership and the contents of certificates or other evidences of membership. Corporations, joint-stock associations, unincorporated associations, partnerships, as well as any person without limitation may be a member of a nonprofit corporation, or a nonprofit corporation may have no members. In the latter case, the board of directors or governing body shall be deemed to be the members or, if there is no such body, its incorporators shall be the members. See Section 701. These two rules essentially codify the common law. Membership certificates shall be labeled "not for profit" and shall be nontransferable in order to eliminate any danger that they may be mistaken or traded for securities. See Section 703.

The rights and powers of members are defined in more detail than under present law. The following are some of the most important provisions: Members are not liable for the corporate debts or obligations, but they may be liable for dues or assessments pursuant to provisions in the articles or bylaws providing for these responsibilities. See Sections 707 and 708. Unless the articles or bylaws expressly state otherwise, no member may be expelled except for cause and upon a hearing before the governing body. The corporation may specify a reasonable procedure for resignation but, in the absence of such a procedure, a member may resign, terminating his future liabilities to the corporation, upon 30 days' written notice. See Section 704. Finally, members may receive distributions of the corporate assets after dissolution of the corporation when the corporate liabilities have been paid or provided for and all trust property protected. See Section 1513.

As explained in the background study, this draft rejects the traditional annual meeting of the members requirement found in most corporate law and makes such a meeting optional. However, to assure that the possibility of a meeting of the members will remain a check on the effectiveness of management, this draft permits 10 percent of the members to call a special meeting of the members to transact any

business permitted for members, and this power may not be abolished by the corporation. See Section 752.

Most of the basic procedures governing meetings of the members--such as quorum requirements, proxy rules, and the selection of inspectors--are derived in large part from the general business corporation law (Division 1 of the Corporations Code). However, some modification is necessary to meet the particular needs of nonprofit corporations; for example, the draft permits a corporation which has more than 500 members to dispense with personal notice of meetings of the members and serve notice instead by publication. See Section 754. This provision makes practical the membership's right to call a special meeting. Moreover, to replace the complex concept of a voting trust which serves no real purpose in the nonprofit situation, a simple provision permitting binding voting agreements under certain conditions is proposed. See Section 765.

A very important aspect of the proposed revision is the new rules for derivative actions by the membership. These actions are an important device for enforcing the fiduciary duties of officers and directors, and they should not be unduly burdened with unnecessary procedures. In particular, the present security for expenses requirement which may be levied against the plaintiffs prior to meaningful discovery should be abolished. Security deposits effectively deter too many legitimate actions. See Section 775. To protect against the danger of "strike" suits brought to harass the corporation, the following measures are proposed: (1) Fifty or more members or at least 10 percent of the membership, whichever number is smaller, must join in the action, (2) there may be no settlement or compromise without court approval, and (3) the court is permitted to award expenses to the defendant or defendants if the action terminates favorably and the court finds that it was brought without reasonable probability for success or that there existed at the time of the action no probable cause that the defendant or defendants participated in the illegal transaction. See Sections 777 and 779.

Chapter 4. Management (pages 109-151)

The proposed draft grants the nonprofit corporation great freedom to structure its governing board and management to fit its particular needs. The corporation through its articles or bylaws may limit the authority of its governing board, and the board may be given any title deemed appropriate. See Section 801. Moreover, the corporation may have such officers as it deems expedient. See Section 819. There are only two basic restrictions on this flexibility: To encourage increased participation and interest in the corporation's affairs, directors or other persons serving on the governing body must be members of the corporation. See Section 804. Also, the corporation, except in a few limited cases, is required to have at least three persons on its governing board unless it is organized for charitable purposes. In that case, it shall have at least nine and not more than 25 governing directors. See Section 802.

Normally, directors are to be elected at an annual meeting of the members, but this formality may be changed pursuant to an appropriate provision in the corporate articles or bylaws. In fact, those provisions may specify a procedure for selecting the governing board other than a vote by the membership. See Section 806(c). Such an alternative is essential for charitable corporations, many of which do not have members. A very important feature of the new proposed election rules is the right to nominate a candidate for election to the governing board. Any director, or 10 members, may nominate a person for that position by submitting a written petition to the corporation 30 days prior to the election of directors. See Section 806(b). This provision is designed to reduce the danger of a self-perpetuating, ingrown board of directors.

The duty of directors and officers to the corporation is to be measured by a flexible standard which is capable of being adjusted to the varying types and circumstances of nonprofit corporations. Directors and officers must discharge the duties of their respective positions in good faith, with a view to the interests of the corporation, and with the degree of diligence, care, and skill which ordinary men would exercise in similar circumstances in like positions. See Section 817. This

adaptable standard of care is designed to incorporate the more restrictive duties for the management of trust property set forth in the Civil Code while at the same time not being overly demanding on directors of the local country club.

Directors and officers who violate their duty to the corporation may be held accountable for their official conduct in an action brought by any director, officer, receiver in bankruptcy, unsatisfied judgment creditor, or by 50 members or 10 percent of the membership pursuant to a member's derivative action and, in particular, directors who concur in certain illegal actions--such as authorizing the corporation to make an unpermitted distribution to members, directors, or officers--are liable to the corporation for any harm caused as long as the director's authorization of the transaction constituted a breach of his duty to the corporation. See Section 824. Certain transactions, such as loans to officers or directors, are prohibited in all circumstances. See Section 822.

Directors may be removed from office without cause by vote of the membership or may be removed for cause by an action brought by the Attorney General, any director, or 50 members or 10 percent of the membership. See Section 808. Officers may be removed by the board for any reason without prejudice to their contract rights, or they may be removed for cause pursuant to a court action essentially the same as that for directors. See Section 820.

This proposed revision recommends the continuance of the basic indemnity provisions of the General Corporation Law which, in part, provide for indemnity from the corporation for litigation expenses incurred by directors or officers in successfully defending actions brought against them for breach of their duty to the corporation. See Article 2. However, given the high cost of litigation, a right of indemnity is not sufficient protection. Officers and directors should not be compelled in derivative actions to bear the cost of litigation prior to a court decision that their conduct warrants censure. Therefore, this proposal permits the corporation to advance litigation expenses subject to the officer or

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director's undertaking to pay back all amounts advanced which are subsequently determined to be in excess of his right to indemnification. See Section 855.

In general, this chapter of the proposed draft merely reorganizes and rewrites existing law; however, there are numerous important changes. See the Comment to each section. One of these changes is inclusion of a provision to permit telephonic board meetings; the Corporations Code Revision Committee has determined to include a similar provision in the new Corporations Code.

Chapter 5. Corporate Records and Reports (pages 152-176)

Chapter 5 contains important disclosure rules, many of which are new. Article 1 establishes for members and directors a right to inspect the corporate books and records under reasonable circumstances. It contains basically the same provisions as those governing California business corporations on this matter. Corp. Code §§ 3003-3005.

Article 2 requires corporate disclosure through an annual report and is an important aspect of the proposed revision. Every nonprofit corporation is required to prepare and preserve as a public record a comprehensive report outlining its affairs and finances for the last annual period. This report combines the financial disclosure requirements of Section 519 of New York's Not-for-Profit Corporation Law with the activities report requirements of Section 81 of the ABA-ALI Model Non-Profit Corporation Act. It is designed to facilitate enforcement of the provisions of this code and also to provide the information which is necessary for members and other interested persons to make an educated judgment concerning the success of the corporation in carrying out its purposes. See the Analysis to Article 2.

A copy of the annual report must be sent by the corporation to any person who makes a written request. In this way, public dissemination of the corporate information is assured without unduly burdening the corporation by requiring it to send a copy to each member, some of whom will not be interested. See Section 954.

The provisions of Article 2 are enforceable in a special statutory action to compel compliance. Moreover, the court is required to award plaintiffs their reasonable expenses, including reasonable attorney's fees, as a consequence of an order compelling the corporation to comply with the annual report provisions. See Section 955. In this manner, the enforcement action is made practical by reducing the burden on a person seeking to gain his legal rights under this article.

Article 3 continues a requirement of existing law that nonprofit corporations file with the Secretary of State a statement listing their officers and offices. In the same statement, an agent may be designated for service of process. See Corp. Code § 3301. This filing requirement is designed to provide an easy means for discovering corporate management and location for the purposes of customer or member complaints or for service of process. Moreover, the supplemental statement which must be filed at least every five years is a means for determining whether or not the corporation is actively functioning and permits the destruction of absolute records.

Chapter 6. Corporate Finance (pages 177-204)

Rules are set forth in this chapter to protect society from potential abuse of the nonprofit status. A nonprofit corporation may not issue stock nor may it pay dividends or make other distributions to members, except it may confer benefits in conformity with its purposes or make other distributions permitted by this division such as distributions upon final dissolution of the corporation. See Section 1006. However, a corporation is expressly permitted to make an incidental profit if it is applied to the maintenance, expansion, or operation of its lawful activities and is not distributed to members, directors, or officers. See Section 1005.

Furthermore, this part establishes firm rules regulating member's capital contributions and the sale or issuance of corporate bonds. Specifically, bonds may not be issued to members except when they are part of a public offering if they pay more than a normal return which is defined as the prime rate of interest then prevailing in the Federal Reserve. See Section 1004.

A new method for funding nonprofit corporations is recommended. It is called a subvention, and it permits a nonprofit corporation under limited conditions to receive unsecured, nonprofit-oriented loans from individuals or organizations which are to be repaid upon the occurrence of a specified event unless repayment at that time impairs the corporation's activities or harms its creditors. To protect the principal of this loan from being diminished in value by inflation prior to the repayment date, the corporation may pay annual interest to the subvention certificate holders in an amount not to exceed five percent of the value of the subvention. The subvention device gives the nonprofit corporation increased flexibility in the matter of raising capital, and it is designed to encourage individuals, organizations, or government to support the activities of these corporations through loans which, while they are not meant to be profitable, are nevertheless returnable for redeployment at a value which is essentially the same as at the time of the loan. An important advantage of the subvention over other forms of debts is that it does not reduce the borrowing capacity of the corporation or drive the corporation toward bankruptcy. See Section 1002.

Property given to a corporation organized primarily for charitable purposes is deemed to be held in trust to carry out those purposes. See Section 1101. This provision of the proposed draft codifies the common law and reduces the danger that funds will be solicited from the public under the pretense that they will be used for charitable purposes and then diverted to other uses once they have been received by the corporation. Moreover, Article 2 clearly establishes that property held in trust must be invested and handled according to trust principles set forth in the Civil Code. See Section 1103. However, the power to transfer trust property to an institutional trustee is broadened to include all nonprofit corporations, and directors are expressly relieved of all liability for property which is transferred to such a trustee. See Section 1106. A corporation may also invest its assets, including those held in trust in a common trust fund. See Section 1151. Article 3, which sets forth detailed rules for the administration of these funds, is derived from Section 10250 of the Corporations Code.

Chapter 7. Organic Changes (pages 205-234)

This chapter is designed to protect members and the public from hasty, unfair, or fraudulent changes in the fundamental nature of the corporation.

A corporation which is not dissolving may dispose of all or substantially all of its assets only by gaining membership approval. A board resolution recommending such a disposition must be approved by two-thirds of the votes cast by the members on this proposition or by the written consent of two-thirds of the voting power of the corporation. See Section 1201. Then, a certificate verifying this approval may be annexed to any deed or instrument conveying or otherwise transferring these assets, and it is conclusive evidence in favor of any innocent purchaser or encumbrancer for value. See Section 1202.

The merger or consolidation requirements which are recommended are very similar to those set forth in the business corporation law (Division 1 of Corporations Code) which presently also govern nonprofit corporations; however, there are some important changes. To initiate the process of merger or consolidation, the board must adopt a plan listing the terms and conditions of the proposed change. See Section 1303. A copy of this plan or an outline of its material features must then be sent to each member. See Section 1304(b). Before a corporation may merge or consolidate, the plan has to be approved by a vote of two-thirds of the votes cast by the membership on this matter or, in the alternative, it may be approved by the written consent of two-thirds of the voting power of the corporation. See Section 1304(c). After approval, a certificate verifying that this condition has been fulfilled is filed with the Secretary of State whereupon the merger or consolidation becomes effective. See Section 1307. However, a new procedure permits the corporation to vary somewhat the effective date by an appropriate provision in the plan of merger or consolidation. See Section 1305. This enables the corporation to more easily time the merger or consolidation to suit its convenience. After the merger or consolidation is effective, the surviving or consolidated corporation possesses all of the rights, privileges, immunities, powers, and purposes of the constituent corporations which are consistent with its articles; all of the assets of the constituent corporations rest in it, and it assumes all of the liabilities, obligations, and penalties of the constituent corporations. See Section 1309. Moreover,

this draft provides that the Attorney General, or any director or member, may bring an action to enjoin or rescind any merger or consolidation which serves as a device to defraud members or the public at large or which is manifestly unfair to either corporation. Besides being an alternative to dissenters' appraisal rights, this action provides a means to protect trust property from being improperly diverted to nontrust uses through the device of merger or consolidation. See Section 1312.

Article 3 provides an entirely new power for noncharitable nonprofit corporations which is the power to convert into a business corporation. Conversion can be a useful device for developing business activities which are in the public interest. For example, a ghetto business can be helped to get on its feet via the outside support and supervision of a nonprofit corporation. Once the business becomes viable, it may then convert into a profit-oriented corporation owned by the local businessmen.

Following the example of New York's and Pennsylvania's nonprofit corporation law, the procedures for conversion are essentially those governing the merger of a nonprofit corporation (see Section 1402 and Comment) except that all property held in trust by the converting corporation must be transferred to one or more corporations or organizations engaged in substantially similar activities to those of the converting corporation. See Section 1403. The Attorney General, any director, or member is given a statutory action similar to the one discussed above regarding mergers to enjoin or rescind a fraudulent conversion. See Section 1405.

Chapter 8. Dissolution (pages 235-282)

The provisions of this chapter are designed to encourage and facilitate the dissolution of ineffective nonprofit corporations. The draft facilitates voluntary dissolution by providing more complete procedures than existing law for winding up the corporation. Moreover, these procedures do not necessarily require court supervision. For example, a new procedure for the presentation and proof of claims and the barring of unrepresented claims is recommended which does not require judicial involvement.

The voluntary dissolution of a corporation is initiated by the board's adopting a resolution setting forth a general plan for dissolution of the

corporation and distribution of its assets. The concept of a plan of dissolution is derived from New York's Not-for-Profit Corporation Law and is meant to provide only a general outline of the proposed dissolution. The plan does not bind the board to specific details after membership authorization unless it specifically provides otherwise. See Section 1502. Before the corporation may begin to wind up its activities pursuant to the plan adopted by the board, dissolution must be authorized by the vote or written consent of 50 percent or more of the voting power of the corporation. See Section 1503. Once membership authorization is given, winding up commences, and the corporation must discontinue its regular activities except to the extent necessary for the successful winding up of those activities and for the preservation of the value of the corporation's assets pending sale or other disposition. Expanded notice of the commencement of dissolution must also be sent to the Attorney General, all members, and persons believed to be creditors or claimants whose addresses appear on the corporate records, who are known to the corporation, or can with due diligence be ascertained by the corporation. See Section 1507.

This notice may include a time limit and procedure for the presentation of claims against the corporation; for, under the limitations established in Article 1, a corporation may require, upon proper notice, all creditors or claimants to present their claims to the corporation or be forever barred from asserting them. See Section 1510. Previously, the presentation of claims and the barring of tardy claims required court supervision. Corp. Code § 4608.

The draft provides that final windup may proceed without the aid of a court. Directors and officers have full powers to sell the corporate assets and do all other things proper and convenient for the purpose of winding up. However, upon the petition of the Attorney General, any director or officer, five percent of the members, the holders of five percent of the outstanding capital or subvention certificates, or any three creditors, the court may intervene and supervise the process of winding up or any part of it. See Section 1509. In this proceeding, the court has authority to make all orders or decrees and issue all injunctions which are necessary to fairly and properly complete windup. Potential court supervision and action provide a check on improper conduct during the windup process.

Prior to any distribution to the members, the corporation is required to deposit amounts of unmatured, contingent, or disputed claims with a bank or the State Treasurer for the benefit of those creditors or claimants who later come forward and establish their right to these amounts. Moreover, amounts deposited, if they are unclaimed six months after they have become due and payable, may be reclaimed for distribution with the other assets. In this manner, a dissolving corporation is given a practical means to provide for contingent debts which, if unpaid prior to making distributions to members, might result in liability for directors or officers. See Section 1511.

Once all debts or liabilities are paid or provided for, the draft provides that the corporation may distribute the remaining assets to members or otherwise dispose of them according to its articles or bylaws except that property held in trust must be transferred by the dissolving corporation to a corporation or organization engaged in substantially similar activities. Under existing law, a court must direct the disposition of all trust property, and the Attorney General is a necessary party to any proceeding affecting the disposition of the assets of a charitable trust. The new approach reduces the burden on the courts and the Attorney General and recognizes the fact that the corporation is in the best position to know which corporations and organizations have activities most similar to its own. See the Comment to Section 1512.

When the assets have been distributed and windup is complete, the corporation has a choice of procedures to formally dissolve and extinguish its existence. It may file a certificate of final windup and dissolution with the Secretary of State or it may seek a court order of final windup and dissolution. The latter choice entails additional published notice and a waiting period to see if persons will contest the motion; however, it has the advantage of releasing directors and officers from all liability resulting from their decisions during the windup process. See Section 1519.

It should be noted that, besides possible court supervision, two additional protections are proposed to reduce the danger of improper uses of voluntary dissolution. The Attorney General, or any director, officer, member, holder of an outstanding capital or subvention certificate, creditor, or claimant may bring an action to suspend or annul the election to dissolve

if it is improperly authorized or if it serves as a device to defraud. See Section 1517. Moreover, improper distributions may be recovered by the court on motion of the corporation or any creditor or claimant whose debt or claim is due and unpaid. See Section 1515.

Besides encouraging voluntary dissolution, this draft proposes new procedures for involuntary, judicial dissolution of ineffective, illegal, or deadlocked nonprofit corporations. The Attorney General's traditional statutory power to seek judicial dissolution--in the nature of quo warranto--of corporations which seriously offend against the provisions of the law or conduct their activities in a fraudulent manner has been expanded to include the power to seek dissolution of corporations which engage in activities that violate their nonprofit status such as making improper distributions to members, directors, or officers. See Section 1603. The present Corporations Code requirement that the corporation be notified of potential grounds for dissolution 30 days prior to the initiation of court action is continued. Fairness mandates that a corporation be given an opportunity to voluntarily correct its unlawful conduct.

To provide additional protection for members and the general public, this draft proposes a broader and more liberal members' and director's action for judicial dissolution. Any director or 10 percent of the membership may bring an action for judicial dissolution if the corporation is hopelessly deadlocked or being damaged by internal dissention. In addition to these traditional grounds for judicial dissolution, this drastic remedy may be ordered if the court finds that the corporation is unable to carry out its purposes and also, in a members' or director's action, for any ground for which the Attorney General may seek dissolution as previously explained. Granting members and directors a broader power to seek judicial dissolution helps reduce the danger that corporate abuses will go uncorrected. See Section 1602.

During litigation on the issue of involuntary dissolution, the court may appoint a receiver to protect the interests of the corporation or its members. See Section 1605. Once involuntary dissolution has been ordered, the process of winding up the corporation's affairs proceeds in the same manner and under the same rules as voluntary dissolution under court supervision. See Section 1610.

Chapter 9. Foreign Corporations (pages 283-301)

The staff believes that foreign nonprofit corporations should be governed by basically the same rules for the qualification to conduct affairs in this state as foreign business corporations. This matter is not so closely related to the form of the corporation as to warrant the inconvenience of two different sets of rules. However, a few alterations in the business corporation rules are necessary, but these should not significantly detract from the desired uniformity.

Present law requires all foreign corporations which "transact intrastate business" to obtain a certificate of qualification from the Secretary of State, but "business" has never been interpreted in the nonprofit context. See Corp. Code § 6403. It is unclear, for example, whether "business" includes widespread solicitation of members or only commercial activity. The proposed revision changes the terminology to "conduct intrastate affairs" and is designed to reduce that uncertainty. State regulation should extend to all foreign corporations which maintain a substantial connection with this state, commercial or otherwise. See Section 1701.

Furthermore, the draft creates a special action for the Attorney General permitting him to bring an action to annul the authorization of a foreign corporation which conducts its activities in a fraudulent manner or one which seriously offends against the provisions of this code. This new action is meant to protect the public interest by discouraging improper activities on the part of these corporations. See Section 1758.

Finally, the proposed revision alters the standard of liability for officers or directors of a foreign corporation which conducts a substantial part of its principal activities in this state, owns a greater part of its property, or has more than one-half of its members residing in California. Under present law, directors of any foreign corporation are accountable for their conduct only according to the law of the place or state of incorporation. The proposed revision subjects directors or officers of the above closely connected corporations to the laws of California to the same extent as directors or officers of domestic corporations. It is advisable not to allow a corporation which conducts most of its affairs in California to escape the protective features of this code by the device of out-of-state incorporation. See Section 1703 and the Comment thereto.

Chapter 10. Service of Process (page 302)

The staff plans to draft a new chapter in the Code of Civil Procedure to cover service of process and designation of an agent for service of process. This chapter will include both business and nonprofit corporations, domestic and foreign. Chapter 10 will incorporate by reference these new provisions.

Chapter 11. Supervision by Attorney General (pages 303-305)

Chapter 11 provides for increased supervision by the Attorney General. Presently, under the Uniform Supervision of Trustees for Charitable Purposes Act, the Attorney General has general supervisory powers over charitable corporations and corporations which hold property in trust. This chapter expands this authority to cover all nonprofit corporations, for all have a special relationship to the public interest. See the background study. The basic elements of this supervisory power are a right to examine the corporation's activities, including the power to propound interrogatories which must be answered by the corporation in writing and under oath and a series of specific actions which may be brought to correct abuses which are discovered. See Sections 1902 and 1903. It should be noted that, since the Attorney General may pursue his supervisory duties as actively as he deems necessary and practical, other measures have been proposed which are designed to increase the likelihood that corporate abuses will be discovered and corrected--for example, the expanded power of directors and members to bring actions previously reserved for the Attorney General. See Section 1602 (grounds for members' or director's action for dissolution).

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368-217

DIVISION 1. PRELIMINARY PROVISIONS AND CONSTRUCTION

§ 1. Title of code

1. This code shall be known as the Nonprofit Corporations Code.

368-218

§ 2. Code as restatement and continuation of existing statutes

2. The provisions of this code, insofar as they are substantially the same as existing statutory provisions relating to the same subject matter, shall be construed as restatements and continuations and not as new enactments.

Comment. Section 2 is the same as Section 2 of the Corporations Code.

368-219

§ 3. Persons continued in office

3. All persons who, at the time this code goes into effect, hold office under any of the acts repealed by this code, which offices are continued by this code, continue to hold them according to their former tenure.

Comment. Section 3 is the same as Section 3 of the Corporations Code.

§ 4. Common law rule construing code abrogated

4. The rule of the common law that statutes in derogation thereof are to be strictly construed has no application to this code. This code establishes the law of this state respecting the subject to which it relates, and its provisions are to be liberally construed with a view to effecting its objects and promoting justice.

Comment. Section 4 is the same as Section 2 of the Evidence Code which is substantially the same as Section 4 of the Code of Civil Procedure. It adopts the modern approach to statutory construction.

§ 5. Constitutionality

5. If any provision or clause of this code or application thereof to any person or circumstances is held invalid, such invalidity shall not affect other provisions or applications of the code which can be given effect without the invalid provision or application and, to this end, the provisions of this code are declared to be severable.

Comment. Section 5 is the same as Section 3 of the Evidence Code and Section 1108 of the Commercial Code. See also, e.g., Corp. Code § 19; Veh. Code § 5.

368-239

§ 6. Construction of code

6. Unless the provision or context otherwise requires, these preliminary provisions, rules of construction, and definitions govern the construction of this code.

Comment. Section 6 is the same as Section 5 of the Corporations Code and is a standard provision in various California codes. E.g., Evid. Code § 4.

368-240

§ 7. Effect of headings

7. Division, part, chapter, and section headings do not in any manner affect the scope, meaning, or intent of the provisions of this code.

Comment. Section 7 is the same in substance as Section 6 of the Corporations Code. Similar provisions appear in all existing California codes except in the Civil Code, the Commercial Code, and the Code of Civil Procedure. E.g., Evid. Code § 5.

999-312

§ 8. Delegation of power and duties to deputies

8. Whenever, by the provisions of this code, a power is granted to, or a duty imposed upon, a public officer, the power may be exercised

368-242

or the duty performed by a deputy of the officer or by a person authorized, pursuant to law, by the officer, unless this code expressly provides otherwise.

Comment. Section 8 is the same as Section 7 of the Corporations Code.

368-243

§ 9. References to statutes

9. Whenever any reference is made to any portion of this code or of any other statute, such reference shall apply to all amendments and additions heretofore or hereafter made.

Comment. Section 9 is the same in substance as Section 9 of the Corporations Code. See also Evid. Code § 6.

368244

§ 10. "Division," "chapter," "article," "section," "subdivision," and "paragraph"

10. Unless otherwise expressly stated:

(a) "Division" means a division of this code.

(b) "Chapter" means a chapter of the division in which that term occurs.

(c) "Article" means an article of the chapter in which that term occurs.

(d) "Section" means a section of this code.

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(e) "Subdivision" means a subdivision of the section in which that term occurs.

(f) "Paragraph" means a paragraph of the subdivision in which that term occurs.

Comment. Somewhat similar provisions appear in various California codes. E.g., Veh. Code § 11; Evid. Code § 7. Compare Corp. Code § 10.

368-245

§ 11. Present and future tenses

11. The present tense includes the past and future tenses, and the future tense includes the present.

Comment. Section 11 is the same as Section 11 of the Corporations Code.

368-246

§ 12. Gender

12. The masculine gender includes the feminine and neuter.

Comment. Section 12 is the same as Section 12 of the Corporations Code.

368-247

§ 13. Singular and plural numbers

13. The singular number includes the plural, and the plural number includes the singular.

Comment. Section 13 is the same as Section 13 of the Corporations Code.

368-248

§ 14. "County"

14. "County" includes "city and county."

Comment. Section 14 is the same as Section 14 of the Corporations Code.

368-249

§ 15. "Shall" and "may"

15. "Shall" is mandatory, and "may" is permissive.

Comment. Section 15 is the same as Section 15 of the Corporations Code.

368-250

§ 16. "Signature"

16. "Signature" includes mark when the signer cannot write, such signer's name being written near the mark by a witness who writes his own name near the signer's name; but a signature by mark can be acknowledged or can serve as a signature to a sworn statement only when two witnesses so sign their own names thereto.

Comment. Section 16 is the same as Section 17 of the Corporations Code.

368-251

§ 17. "Person"

17. "Person" includes a corporation as well as a natural person.

Comment. Section 17 is the same as Section 18 of the Corporations Code.

368-252

§ 18. "Writing"

18. "Writing" includes any form of recorded message capable of comprehension by ordinary visual means.

Comment. Sections 18, 19, and 20, taken together, are the same as Section 8 of the Corporations Code.

368-253

§ 19. English language

19. Whenever any notice, report, statement, or record is required or authorized by this code, it shall be made in writing in the English language.

Comment. See Comment to Section 18.

368-254

§ 20. Use of certified mail

20. Whenever any notice or other communication is required by this code to be mailed by registered mail by or to any person or corporation, the mailing of such notice or other communication by certified mail shall be deemed to be a sufficient compliance with the requirements of the law.

Comment. See Comment to Section 18.

998-833

§ 20.2. Correction of instruments

20.2. (a) Subject to subdivisions (b) to (d), inclusive, any agreement, certificate, or other instrument relating to a domestic or foreign corporation filed with the Secretary of State pursuant to the provisions of this code may, within three years from the date of such filing, be corrected with respect to any misstatement of fact contained therein, any defect in the execution thereof, or any other error or defect contained

therein, by filing with the Secretary of State a certificate of correction entitled "Certificate of Correction of (insert here the title of the agreement, certificate, or other instrument to be corrected, and name(s) of corporation or corporations)".

(b) No certificate of correction shall alter the wording of any resolution which was in fact adopted by directors or members or effect a corrected amendment of articles of incorporation which amendment as so corrected would not in all respects have complied with the requirements of this code at the time of filing of the agreement, certificate, or other instrument being corrected.

(c) Only one certificate of correction may be filed for the same agreement, certificate, or other instrument. Such certificate of correction shall be signed and verified or acknowledged as provided in this code with respect to the agreement, certificate, or other instrument being corrected. It shall set forth the following:

- (1) The name or names of the corporation or corporations.
- (2) The date the agreement, certificate, or other instrument being corrected was filed with the Secretary of State.
- (3) The provision in the agreement, certificate, or other instrument as corrected or eliminated and, if the execution was defective, wherein it was defective.

(d) The filing of the certificate of correction with the Secretary of State does not alter the effective time of the agreement, certificate, or instrument being corrected, which shall remain as its original effective time, and such filing does not affect any right or liability accrued or incurred before such filing except that any right or liability accrued

or incurred by reason of the error or defect being corrected is extinguished by such filing.

(e) The fee for filing the certificate of correction shall be the greater of (i) the fee which would have been payable for the filing of the agreement, certificate, or other instrument being corrected had it not contained the error or defect referred to in such certificate of correction, less the fee actually paid for the filing of such agreement, certificate, or other instrument and (ii) five dollars (\$5). There is no right to a refund of any portion of the fee paid for the filing of the agreement, certificate, or other instrument being corrected. The fee for recording the certificate of correction is two dollars (\$2).

Comment. Section 20.2 is the same in substance as Section 127 of the Corporations Code.

§ 20.4. Subjection of corporate property to attachment

20.4. Any corporation heretofore or hereafter formed under this code is, as a condition of its existence as a corporation, subject to the provisions of the Code of Civil Procedure authorizing the attachment of corporate property.

Comment. Section 20.4 is the same in substance as Section 126.1 of the Corporations Code.

§ 21. Filing fees of Secretary of State

21. The filing fees of the Secretary of State for filing instruments by or on behalf of nonprofit corporations are prescribed in Article 3 of Chapter 3 of Part 2 of Division 3 of Title 2 of the Government Code.

Comment. Section 21, making reference to the filing fees set forth in the Government Code, is taken from Section 124 of the Corporations Code, which previously applied to nonprofit corporations governed by the former General Nonprofit Corporation Law pursuant to former Section 9002 of that code. Section 21 makes these fees expressly applicable to all nonprofit corporations.

§ 22. Amendment or repeal; reservation of power; savings clause

22. This code, or any division, part, chapter, article, or section thereof, may at any time be amended or repealed. Neither the enactment of this code nor the amendment or repeal thereof, nor of any statute affecting nonprofit corporations, shall take away or impair any liability or cause of action existing or incurred against any corporation, its members, directors, or officers.

Comment. Section 22 is the same in substance as Section 126 of the Corporations Code.

368-257

§ 23. Code becomes operative January 1, 1977

23. This code becomes operative on January 1, 1977.

368-258

§ 24. Savings clause; effect on existing right or action; filing record of action taken before operative date

24. (a) No action or proceeding commenced, and no right accrued, before this code becomes operative is affected by the provisions of this code, but all procedure thereafter taken shall conform to the provisions of this code so far as possible.

(b) Any vote, consent, certification, or action by directors, officers, or members of a nonprofit corporation or by any such persons on behalf of the nonprofit corporation, or any articles of incorporation executed by persons desiring to form a nonprofit corporation, taken, given, or made before this code becomes operative in accordance with the law in force immediately prior to the time this code becomes operative is valid and effective and, if required to be filed in any public office of this state, may be filed under this code on or after the date when this code has become operative.

Comment. Subdivision (a) of Section 24 is the same in substance as Section 4 of the Corporations Code.

Subdivision (b) is the same in substance as the last paragraph of Section 125 of the Corporations Code; it establishes that an action (such as a vote of the membership) which is properly taken prior to the operative date of this code and valid under the prior law is valid and effective and, if it is required to be filed, may be filed on or after the operative date of this code.

DIVISION 2. NOT-FOR-PROFIT CORPORATION LAW

CHAPTER 1. SHORT TITLE; DEFINITIONS; APPLICATION

§ 101. Short title

101. This division shall be known and may be cited as the Not-for-Profit Corporation Law.

Analysis

Section 101 provides a short title which applies only to Division 2. Compare Section 1 (code in which Division 2 is compiled is the "Nonprofit Corporations Code"). This short title avoids confusion with the old law and more accurately reflects the true nature of these organizations. This type of corporation is not organized for profit, but it may make a profit consistent with the provisions of this division.

New York has chosen the same title for its nonprofit corporations law. See N.Y. Not-for-Profit Corporation Law § 101. See also Ill. General Not for Profit Corporation Act § 1; Pa. Corporation Not-for-profit Code § 7101. Most of the states and the Model Non-Profit Corporation Act still use the old "nonprofit" designation, but there is no important reason for retaining this somewhat misleading title.

ISSUE TO BE RESOLVED:

1. Should the "not-for-profit" terminology be adopted? (Recommendation--Yes.)

§ 105. Application of definitions

105. Unless the provision or context otherwise requires, these definitions govern the construction of this division.

368-260

Comment. Section 105 is a standard provision found in the definitional portion of recently enacted California codes.

368-261

§ 110. "Articles"

110. "Articles" includes the articles of incorporation, amendments thereto, amended articles, restated articles, certificates of incorporation, and plans of merger or consolidation.

Comment. Section 110 is very similar to Section 102 of the Corporations Code. The terminology of that section has been altered somewhat to conform to the provisions of this code.

368-262

§ 115. "Board"; "board of directors"

115. "Board" or "board of directors" means the governing board vested with the management of the affairs of the corporation irrespective of the name by which such board is designated.

Comment. Section 115, which is the same in substance as the definition provided by Section 2(g) of the ABA-ALI Model Non-Profit Corporation Act, defines "board" to mean the governing board regardless of its official title. Cf. Section 135 (defining "director").

§ 120. "Bylaws"

120. "Bylaws" means the code or codes of rules adopted for the regulation or management of the affairs of the corporation irrespective of the name or names by which such rules are designated.

Comment. Section 120 is the same as Section 2(e) of the ABA-ALI Model Non-Profit Corporation Act and Section 102(a)(2) of New York's Not-for-Profit Corporation Law.

§ 125. "Charitable purposes"

125. "Charitable purposes" means those purposes which advance the religious, educational, political, or general social interest of mankind where the ultimate recipients are either the community as a whole or an unascertainable and indefinite portion of the community.

Comment. Section 125 defines "charitable purposes" as this term is defined in Lynch v. Spilman, 67 Cal.2d 251, 261, 431 P.2d 636, 642, 62 Cal. Rptr. 12, 18 (1967). This definition is significant because special rules apply to corporations formed for "charitable purposes." E.g., Section 802 (number of directors), Section 1101 (property held in trust), Section 1402 (power of conversion).

ISSUE TO BE RESOLVED:

1. Should the Lynch definition of "charitable" be adopted? (Recommendation--Yes.)

§ 130. "Corporation" or "domestic corporation"

130. "Corporation" or "domestic corporation" means a nonprofit corporation subject to the provisions of this division but does not include a foreign corporation.

Comment. Section 130 is the same in substance as Section 2(a) of the ABA-ALI Model Non-Profit Corporation Act.

404-931

§ 135. "Director"

135. "Director" means a member of the board of directors irrespective of the name by which such members are designated.

Comment. Section 135 defines "director" to mean a member of a "board of directors" (Section 115), whether designated as director, trustee, manager, governor, or other official title. The definition is the same in substance as that provided in paragraph (a)(6) of Section 102 of the New York Not-for-Profit Corporation Law. See Section 801 (title of directors).

404-932

§ 140. "Foreign corporation"

140. "Foreign corporation" means a corporation formed under laws other than the statutes of this state which, if formed in California, would be within the term "not-for-profit corporation" as defined in Section 155.

404-932

Comment. Section 140 is derived from Section 102(a)(7) of New York's Not-for-Profit Corporation Law.

404-974

§ 142. "Incorporator"

142. "Incorporator" includes each person signing the articles of incorporation.

Comment. Section 142 is the same as Section 105 of the Corporations Code.

404-975

§ 143. "Insolvent"

143. "Insolvent" means inability of a corporation to pay its debts as they become due in the usual course of its affairs.

Comment. Section 143 is the same as Section (2)(h) of the ABA-ALI Model Non-Profit Corporation Act. It is made necessary by provisions in this code prohibiting insolvent corporations from making certain distributions. See Section 1006.

§ 145. "Member"; "membership"

145. "Member" means one having membership rights in a corporation in accordance with the provisions of this division, the articles of incorporation, or the bylaws. "Membership" means the total number of members, whether or not entitled to vote.

Comment. The first sentence of Section 145 is the same as Section 2(f) of the ABA-ALI Model Non-Profit Corporation Act except that Section 145 recognizes that, in some instances, membership rights may be derived from provisions of this division absent an applicable provision of the articles or bylaws. See Section 701. "Membership" is defined to eliminate the necessity of repeating the definition in various sections of this division.

§ 150. "Membership corporation"

150. "Membership corporation" means a corporation which has members other than directors entitled to vote on the action being considered.

Comment. Section 150 defines "membership corporation" to provide a convenient means of distinguishing between corporations which have members entitled to vote on a particular matter and corporations which do not. See Section 701 (members).

§ 155. "Not-for-profit corporation" or "nonprofit corporation"

155. "Not-for-profit corporation" or "nonprofit corporation" means a corporation (a) formed under this division, or existing on the date this division becomes operative, and formed under any general law or by any special act of this state, exclusively for a purpose or purposes, not for pecuniary profit or financial gain, for which a corporation may be formed under this division, and (b) no part of the assets, income, or profit of which is distributable to its members, directors, or officers except to the extent permitted under this division.

Comment. Section 155 sets forth the central definition of this division establishing the requirements for nonprofit corporate status. In large part, the section follows the substance of former Section 9200 of the General Nonprofit Corporation Law. However, for clarity, it adopts a two-test approach which is derived from Section 102(a)(5) of New York's Not-for-Profit Corporation Law: a functional test, requiring that the purpose of the corporation be other than to promote pecuniary profit or financial gain, and an economic test, requiring that there be no distribution of assets, income, or profit to the members, directors, or officers except as otherwise permitted by this division. See, e.g., Sections 1006 (certain distributions allowed), 1512 (distribution upon dissolution of the corporation). See also Section 1005 (incidental profit permitted).

Section 155 departs from the New York model by omitting the prohibition against the corporate assets, income, or profits "enuring to the benefit" of members, directors, or officers. This prohibition has been omitted so that Section 155 does not prohibit benefits such as those inuring to the members of nonprofit trade associations, nor does it modify the holding of People v. Sinai Temple, 20 Cal. App.3d 614, 99 Cal. Rptr. 603 (1971) (former Section 9200 did not prohibit a nonprofit corporation from giving members a discount on the price of a cemetery lot even though nonmember customers were denied a similar discount). However, Section

155 prohibits distributions such as those normally associated with cooperative corporations (e.g., providing some form of dividend to members). Corporations providing that kind of distribution may be formed under the General Corporation Law (Division 1 of the Corporations Code) or under the Cooperative Corporations Law (Part 2 of Division 3 of the Corporations Code).

Analysis

Presently, California law does not explicitly define "nonprofit" corporation. Instead, one must turn to Section 9200 of the General Nonprofit Corporation Law which defines the permissible corporate purposes for nonprofit corporations to discover the limits of the "nonprofit" term. Section 9200 permits a nonprofit corporation to be formed for "any lawful purposes which do not contemplate the distribution of gains, profits, or dividends to the members thereof and for which individuals lawfully may associate themselves, such as religious, charitable, social, educational, or cemetery purposes, or for rendering services, subject to laws and regulations applicable to particular classes of nonprofit corporations or lines of activity." The "no distribution" rule of Section 9200 is continued in Section 155; the portion of Section 9200 listing particular nonprofit purposes--"religious, charitable, social, educational, or cemetery purposes, or for rendering services---is continued in Section 201.

The proposed definition in Section 155 does not substantially affect the no "distribution of gains, profits, or dividends" requirement of Section 9200 as it has been broadly interpreted in People v. Sinai Temple, 20 Cal. App.3d 614, 99 Cal. Rptr. 603 (1971). The language has merely been altered to conform to accepted nonprofit terminology and to clarify the rules' meaning.

The two-level test for "not-for-profit" is derived from Section 120(a)(5) of New York's Not-for-Profit Corporation Law, but it adds little of substance to the present "no distribution" rule, for any profit-making purpose necessarily involves passing gains to members, directors, or officers. The New York rule is helpful, however, as it amplifies the meaning of Section 9200 by stating the same thing in two different ways.

The proposal omits the New York prohibition against assets, profits, or income inuring to the benefit of members, officers, or directors. That provision of the New York definition, as it has been interpreted, is unnecessarily restrictive,¹ for the only entities which should be denied the right to incorporate under this code are those which are flagrantly similar to traditional business corporations. Since tax exemptions do not flow automatically from the fact of incorporation as a nonprofit corporation, there are really only two important elements of the public interest which require some scrutiny of who is permitted to incorporate as a nonprofit corporation. Nonprofit status, if unwarranted, may mislead the public regarding donations and related matters. Furthermore, since the Not-for-Profit Corporation Law is more flexible in many of its procedures to accommodate the needs of legitimate nonprofit organizations, there is some danger that this flexibility may be abused by organizations which are in fact formed to benefit their members, directors, or officers. Incorporating as a nonprofit corporation should not be made a means to circumvent the more exacting regulations of the General Corporation Law. While these are important concerns, on balance most corporations which desire nonprofit status should be allowed to incorporate under this code. A broad, liberal definition is advisable.²

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1. See Santos v. Chappell, 65 Misc.2d 559, 318 N.Y.S.2d 570 (Sup. Ct. 1971). In that case, the New York court held that a real estate brokers' association which conducted a multiple listing service violated the Not-for-Profit Corporation Law as that law does not permit a corporation to engage in activities for the profit of all or part of its members.
 2. See Leshner, Non-Profit Corporation: A Neglected Stepchild Comes of Age, 22 Bus. Law 951 (1967). Some states have taken a contrary and more conservative view of the nature of benefits which may permissibly flow from a "nonprofit" corporation. The old Pennsylvania statute prohibited "pecuniary profits, incidental or otherwise." Pa. Stat., Tit. 15, § 7002(3)(1967), amended by Pa. Stat., Tit. 15, § 7553(c)(1972). The old rule was interpreted to deny incorporation to trade associations which indirectly benefit members. In re Fayette Gasoline Retailers Ass'n, 32 Pa. D&C 165 (C.P. 1938). Now, the Pennsylvania statute reads "A nonprofit corporation may confer benefits upon members or nonmembers in conformity with its purposes." Pa. Stat., Tit. 15, § 7553(c)(1972).

It is important to remember that present California law as well as the proposed revision rejects the traditional, totally functional approach whereby nonprofit status is only granted to corporations which serve specifically designated purposes; for example, educational, scientific, and benevolent.³ Under present law and the proposed revision, a "nonprofit" or "not-for-profit" corporation may be established for any lawful nonprofit purpose. This approach is advisable. It avoids the necessity of litigation to define the boundaries of each pigeonhole classification and, as the societies' norms evolve over time, the notion of what is an acceptable purpose for a nonprofit corporation also changes, but a functional approach statute often lags behind this evolution and becomes outdated. However, the most persuasive reason for rejecting the specifically enumerated purposes approach is simply that there are few good reasons, as previously discussed, to deny "nonprofit" status to any organization which desires to be governed by this code. This is not to say that different types of organizations may not be given somewhat different treatment under the nonprofit corporations law,⁴ but the basic right to nonprofit status should not be denied unless the organization is really organized primarily to distribute gains to its members.

ISSUES TO BE RESOLVED:

1. Should there be a detailed definition of the term "nonprofit corporation"? (Recommendation--Yes..)
2. Should the term be defined simply as a corporation incorporated under this division? (Recommendation--No.)
3. Should a more restrictive definition of "nonprofit corporation" be adopted such as would result by adding the "enuring to the benefit" language from New York's code? (Recommendation--No.)

3. Corp. Code § 9200 (General Nonprofit Corporation Law). See Wood, What Are Improper Corporate Purposes for Non-profit Corporations, 44 Dick. L. Rev. 264 (1940); note that California has a special statute for charitable corporations. Corp. Code § 10200 et seq.

4. Special rules for certain nonprofit corporations are set forth in Division 3 of this code.

§ 160. "Voting power"

160. "Voting power" means the total number of members who are entitled to vote except that, if members have unequal voting rights as provided in Section 758, "voting power" means the total number of votes entitled to be cast.

Comment. Section 160 is included to eliminate the necessity of repeating the definition in full in various sections of this division.

§ 165. Scope of division

165. (a) The provisions of this division apply to every not-for-profit or nonprofit corporation now existing or hereafter formed unless the corporation is expressly exempted from the operation of this division.

(b) A special provision applicable to the corporation which is inconsistent with a provision of this division or limits or supplements a provision of this division governs to the extent that it is inconsistent with this division or limits or supplements it.

Comment. Section 165 makes clear that this division applies to all not-for-profit or nonprofit corporations (as defined by Section 155) which are now existing or hereafter formed unless the corporation is one expressly exempted from the operation of this division. This approach is the same as was taken by the former General Nonprofit Corporation Law (Corp. Code § 9001) wherein that law was applied to all previously existing or later formed nonprofit corporations.

Subdivision (b) makes clear that, where a corporation is subject to a special provision, that provision governs to the extent that it is inconsistent with this division or limits or supplements it.

Analysis

A possible approach to the application of the Not-for-Profit Corporation Law to existing corporations is to permit them to operate under the prior law or to incorporate under this division at their option.¹ This approach has several disadvantages including adding to the complexity of the law. Attorneys would forever have to keep straight the date of incorporation in order to determine which law applied. Moreover, since the present law contains many unanswered questions and holes, the courts will most likely fill in these gaps by referring to the legislative policy set forth in the new Not-for-Profit Corporation Law. Therefore, the courts' probable interpretation of the old law will cause it more and more to resemble the provisions of the new. However, the biggest disadvantage of the optional approach is that the new protective provisions of this division which are necessary to protect members and the public interest would not cover all existing corporations.

The principal advantage of the optional approach is that existing corporations would not have to go to the trouble of amending their bylaws and articles to conform to the new law. (But see Section 170(c) and Comment.) Moreover, in some cases, existing corporations will be prohibited from engaging in established practices by the new provisions. However, the overall convenience and protection provided by a uniform application of the new law outweighs these slight problems.

ISSUE TO BE RESOLVED:

1. Should existing corporations be governed by all the provisions of this division? (Recommendation--Yes.)

1. It should be noted that the modern nonprofit codes provide for the mandatory application of the new law to existing corporations. See N.Y. Not-for-Profit Corporation Law § 103; ABA-ALI Model Non-Profit Corporation Act § 3; Pa. Corporation Not-for-profit Code § 7102; contra, alternative provisions ABA-ALI Model Non-Profit Corporation Act § 3A.

§ 170. Existing corporations

170. (a) The enactment of this division does not affect the duration of a corporation which is existing on the operative date of this division, and any existing corporation and its members, directors, and officers shall have the same rights and be subject to the same limitations, restrictions, liabilities, and penalties as a corporation formed under this division and its members, directors, and officers.

(b) Any corporation incorporated under former Part 3 (commencing with Section 10200) of Division 2 of Title 1 of the Corporations Code, relating to corporations for charitable or eleemosynary purposes, shall be deemed to be incorporated under this division.

(c) Except as provided in subdivision (b) of Section 165, any provision in the articles or bylaws of a corporation which is inconsistent with the provisions of this division is void.

Comment. Subdivision (a) of Section 170 makes it clear that the enactment of this division does not affect the duration of an existing corporation and, furthermore, it establishes that existing corporations shall receive the same treatment under this division as corporations which are formed after its operative date. This provision is the same in substance as subdivision (e) of Section 103 of the New York Not-for-Profit Corporation Law.

Subdivision (b) of Section 170 makes this division applicable to all corporations previously formed under the former law governing corporations formed for charitable or eleemosynary purposes.

Subdivision (c) of Section 170 voids any provision in the articles or bylaws of the corporation which is inconsistent with the provisions of this division. In some cases, this will eliminate the need to amend articles or bylaws that are in conflict with the law.

404-940

ISSUE TO BE RESOLVED:

1. Should charitable corporations incorporated under Part 3 (commencing with Section 10200) of Division 2 of Title 1 be covered by the provisions of this division rather than by a separate statute? (Recommendation--Yes.)

404-941

§ 175. Existing claims and actions

175. The enactment of this division does not affect any cause of action, liability, penalty, or action or proceeding which on the operative date of this division is accrued, existing, incurred, or pending. The same may be asserted, enforced, prosecuted, or defended as if this division had not been enacted.

Comment. Section 175 makes clear that the enactment of this division has no effect on any existing cause of action, liability, penalty, or pending action or proceeding. It is substantially the same as subdivision (f) of Section 103 of the New York Not-for-Profit Corporation Law.

404-957

§ 180. Reference to former General Nonprofit Corporation Law

180. Any reference to the former General Nonprofit Corporation Law in the statutes of this state shall be deemed a reference to this division.

Comment. Section 180 remedies any inadvertent failures to make conforming amendments in the references to the former law.

ISSUE TO BE RESOLVED:

1. Is it wise to include a provision picking up missed references? (Recommendation--Yes.)

CHAPTER 2. FORMATION AND BYLAWS

Article 1. Incorporators§ 201. Incorporators

201. One or more natural persons may act as incorporators of a corporation to be formed under this chapter.

Comment. Section 201 alters former law in two respects: (1) By abandoning the requirement of former Section 9200 of the Corporations Code (General Nonprofit Corporation Law) that there must be three or more incorporators, Section 201 makes the Not-for-Profit Corporation Law rule for the number of incorporators conform with Section 300 of the Corporations Code (General Corporation Law); and (2) Section 201 adds the additional requirement that incorporators be natural persons. Existing law, Section 18 of the Corporations Code, defines "persons" to include a corporation; therefore, prior to this change, corporations could act as incorporators under former Corporations Code Section 9200. These changes follow Section 401 of the New York Not-for-Profit Corporation Law and Section 28 of the ABA-ALI Model Non-Profit Corporation Act. It should be noted that the first change makes it possible for corporations sole--former Corp. Code § 10000 et seq.--to be incorporated under the general provisions of the Not-for-Profit Corporation Law.

Analysis

The modern nonprofit codes have abandoned any restriction on the number of incorporators. See N.Y. Not-for-Profit Corporation Law § 401; Pa. Corporation Not-for-profit Code § 7312; ABA-ALI Model Non-Profit Corporation Act § 28. This is consistent with the increased flexibility provided by these acts. The present requirement of "three or more" incorporators is a mere formality and serves no useful purpose. Moreover, it makes impossible the incorporation of corporations sole under this division and, thereby, hinders consolidation, an important function of this code.

404-958

It is recommended that corporations not be permitted to serve as incorporators, a possibility under existing law, because it is more difficult in that case to discover the real parties at interest. See Comment to Section 401 of the New York Not-for-Profit Corporation Law.

Finally, this proposal follows present law by placing no specific age restriction on incorporators. The power of minors to contract is governed generally by the Civil Code. Civil Code §§ 33, 1556, 1557.

ISSUES TO BE RESOLVED:

1. Should the number of persons who may act as incorporators be liberalized? (Recommendation--Yes.)
2. Should corporations be permitted to serve as incorporators? (Recommendation--No.)
3. Should an age limit for incorporators be included? (Recommendation--No.)

404-959

Article 2. Powers and Purposes

§ 301. Purposes

301. Except as otherwise provided by statute and subject to the laws and regulations applicable to the particular class of corporations or line of activity, a not-for-profit corporation as defined in Section 155 may be formed under this division for any lawful purpose other than for pecuniary profit or financial gain, including but not limited to religious, charitable, social, educational, or cemetery purposes or for rendering services.

Comment. Section 301 incorporates by reference the requirements for nonprofit corporate status set forth in Section 155 (defining "not-

for-profit corporation") and thereby establishes the permissible purposes for nonprofit corporations formed under this division as any purpose or purposes not inconsistent with the requirements stated in Section 155 (a corporation may be formed "exclusively for a purpose or purposes, not for pecuniary profit or financial gain, for which a corporation may be formed under this division, and . . . no part of the assets, income, or profit of which are distributable to its members, directors, or officers except to the extent permitted under this division").

Sections 155 and 301 continue the substance of former Section 9200 of the Corporations Code. The language of Section 9200 has been altered for clarity. Like Section 9200, Section 301 lists specifically a number of acceptable purposes for the formation of a corporation under this division, but this listing is illustrative and not restrictive. In this connection, see Section 125 (defining "charitable purposes"). The substance of the portion of former Section 9200 permitting carrying on a business for profit as an incident to the main purpose of the corporation is continued in Section 1005.

Analysis

The staff recommends that New York's classification system for nonprofit corporations not be adopted for this code. The following is an explanation of the New York system: Section 201 of New York's Not-for-Profit Corporation Law classifies nonprofit corporations into four types, designated simply Types A, B, C, and D. Type A corporations are "the usual membership type organization[s] where the support of the organization is derived from a limited class called 'members' and where the non-pecuniary benefits flow primarily to such limited class."¹ Type B corporations are the traditional nonprofit charitable corporations formed for nonbusiness purposes including educational, religious, scientific, and other charitable purposes. Type C is a new form of nonprofit corporation, one formed to provide funds for a public or quasi-public objective such as assisting ghetto businesses. This type of corporation permits the recruitment

1. Revisers' Comment § 201, N.Y. Joint Legis. Comm. to Study Revision of Corporation Laws, 14th Interim Report. Legis. Doc. No. 11 (1970).

of capital from a broad base of the community. Type D corporations are intended to permit the creation of special statutes for more particular types of nonprofit corporations. Such a statute would automatically incorporate all the provisions of the Not-for-Profit Corporation Law and would need to include only those provisions peculiar to those corporations. A corporation formed under the special statute would be deemed a Type D corporation under the Not-for-Profit Corporation Law.

The New York classification system is designed to require special consent and approval procedures for certain kinds of nonprofit corporations, those which more directly affect the public interest, and also to give additional supervision to these organizations. Basically, Type B and Type C corporations are singled out for the special treatment as these charitable or public corporations manage trust property and perform other tasks which are closely related to the public interest. Before a Type B or Type C corporation may be formed, it must be approved by the court and, in addition, certain of these corporations, depending upon their specific purposes, may also require the consent or approval of the regulatory body charged with administering that kind of activity (e.g., the commissioner of education for corporations chartered by the regents of the university). Moreover, before Type B or Type C corporations may make fundamental changes in their purposes or structure, such as selling all or substantially all of the corporate assets, merging, consolidating, or dissolving, they must gain the consent or approval of the court or, in some cases, the regulatory body which had originally to consent to their formation. Most Type A and Type D corporations are not required to gain such approval or consent either upon formation or fundamental change. An exception is made in the case of trade associations which are Type A corporations but which, nevertheless, must be approved by the court before they may incorporate under the Not-for-Profit Corporation Law.

The consent and approval approach of the Not-for-Profit Corporation Law was derived in large part from Section 10 of New York's Membership Corporations Law.² That provision has been strongly criticized, for it

2. N.Y. Memb. Corps. Law § 10 (McKinney 1941) (repealed 1970).

gave the court no standards to aid in administering its consent duties. The result was, concluded one commentator, that a New York judge was given "virtually free rein to indulge his own views as to what the proper purposes for such corporations are."³ Free speech and other rights were often infringed and much needless litigation was required.⁴ The consent and approval requirements of the Not-for-Profit Corporation Law, which are the basis for its classification system, suffer from the same criticisms. The lack of standards invites administrative arbitrariness and the inevitable resulting litigation. Moreover, the consent and approval approach is time consuming and costly to administer.

A better approach seems to be the one employed in New York for most Type A corporations--permit incorporation without the necessity of gaining prior approval. When a corporation abuses its nonprofit status or acts irresponsibly with regard to the law, then corrective measures should be taken in an involuntary dissolution proceeding brought by the Attorney General, a director, or 10 percent of the members.⁵ This approach reduces the cost of administration as every incorporation will not require litigation whereas, under the New York Not-for-Profit Corporation Law, every incorporation of a Type B or Type C corporation requires the expenditure of court resources for the consent decision. Moreover, it offers the advantage of an adversary procedure with the consequent better opportunity for delineation of the issues and creation of fair standards. Prior approval does reduce the possibility that the public will be exposed to fraudulent or improper nonprofit corporations, but the danger to the public, given a liberal involuntary dissolution procedure,

3. Dwight, Objections to Judicial Approval of Charters of Non-Profit Corporations, 12 Bus. Law 454, 457 (1957).

4. See Note 60, New York's Not-for-Profit Corporation Law, 47 N.Y.U.L. Rev. 761, 773 (1972).

5. See Draft Statute Sections 1601, 1602, 1603 and Comments.

does not seem sufficiently great to warrant the added expense and problem of a preliminary system of approvals.⁶

Similar objections may be leveled at the requirement of consent for fundamental changes in the purposes or structure of a Type B or Type C corporation. Such a procedure is also subject to being arbitrary and is expensive and wasteful of time. A better approach seems to be the creation of special statutory causes of action permitting the proper parties to enjoin fraudulent or very unfair fundamental changes in the corporation and, in addition, granting the courts freedom to define in the adversary process the appropriate rules and standards for fraud or fairness.⁷

ISSUES TO BE RESOLVED:

1. Should a classification system such as New York's be adopted? (Recommendation--No.)
2. Should the permissible purposes for nonprofit corporations be specifically listed (see Analysis to Section 155)? (Recommendation--No.)
3. Should the definition of nonprofit corporation be established separately and incorporated by reference? (Recommendation--Yes.)

§ 302. Unincorporated association may incorporate

302. An unincorporated association or organization may be incorporated under this division if the requirements of Section 301 are met.

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6. It should be noted that certain specified nonprofit corporations under present law are given special supervision by a governmental body (e.g., regulation by the state Division of Housing of certain nonprofit corporations engaged in operating recreational trailer parks, Health & Saf. Code § 18304(c)-(d)); see California Nonprofit Corporations, Gold, Relations with Governmental Agencies § 5.26 (Cal. Cont. Ed. Bar 1969) for a list of specially regulated nonprofit corporations. The general approach taken by this division does not preclude specialized regulation where necessary.
 7. Draft Statute Sections 561, 1312, 1405, 1517 and Comments.

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Comment. Section 302 continues the provisions of former Section 9202 of the Corporations Code (General Nonprofit Corporation Law) except that Section 301 omits as unnecessary the listing of specific unincorporated associations. The section is necessary to satisfy the requirement of Security First Nat'l Bank v. Cooper, 62 Cal. App.2d 653, 145 P.2d 722 (1944), that an unincorporated association must have unanimous consent of its members to incorporate unless a provision for incorporation exists in its governing regulations or in the statute under which it desires to incorporate. Consent is implied in the second situation. Accordingly, Section 302 avoids the necessity for unanimous consent if the association or organization is incorporating as a not-for-profit corporation under this division. It should be noted that the provisions of former Section 9203 of the Corporations Code regarding the incorporation of a subordinate body of a larger association are continued in Part 1 of Division 3.

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§ 303. Powers of the corporation

303. Subject to any limitation provided by statute or in its articles of incorporation, a corporation has perpetual duration and, in furtherance of its corporate purposes, may:

(a) Sue and be sued in all courts and participate in actions and proceedings, whether judicial, administrative, arbitratve, or otherwise as natural persons in like cases.

(b) Adopt, use, and at will alter a corporate seal, but failure to affix a seal does not affect the validity of any instrument.

(c) Make bylaws regulating its affairs.

(d) Appoint such subordinate officers or agents as its activities may require and allow them suitable compensation.

(e) Qualify to conduct its affairs in any other state, territory, dependency, or foreign country and conduct its affairs within and without the state.

(f) Receive property by devise or bequest, subject to the laws regulating the transfer of property by will, and otherwise acquire and hold all property real or personal, including shares of stock, bonds, and securities of other corporations.

(g) Act as trustee under any trust incidental to the principal objects of the corporation and receive, hold, administer, and expend funds and property subject to any trust.

(h) Convey, exchange, lease, mortgage, encumber, transfer upon trust, or otherwise dispose of all property real or personal.

(i) Borrow money, contract debts, and issue bonds, notes, and debentures, and secure the payment or performance of its obligations.

(j) Accept subventions from other persons or any unit of government and make capital contributions or subventions to other corporations.

(k) In time of war or other national emergency in aid thereof, make donations, irrespective of corporate benefit, for the public welfare or for community fund, hospital, charitable, educational, scientific, civil, or similar purposes.

(l) Do all other acts necessary or expedient for the administration of the affairs and attainment of the purposes of the corporation.

Comment. Section 303 empowers a nonprofit corporation to engage in a wide range of activities in furtherance of its corporate purposes. These powers are analogous to those granted by Sections 801 and 802 of the Corporations Code to profit oriented corporations. This section does

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not substantially alter the prior law for nonprofit corporations established pursuant to former Section 9501 of the Corporations Code (General Nonprofit Corporation Law); however, for clarity, many powers which would naturally be included within the general grant of authority of former Section 9501(g) are expressly listed in this provision. It should be noted that the power to donate corporate resources in time of emergency set forth in subdivision (k) is new. Moreover, Section 303 abolishes the need to list corporate powers in the articles as a corporation automatically possesses the powers listed in Section 303 as a statutory right subject only to any limitation in the articles or in the statutes of this state. This feature is derived from Section 202 of New York's Not-for-Profit Corporation Law and is designed to remove the danger of an inadvertent omission from the articles of a necessary corporate power. But see Corp. Code §§ 801, 802, and 803.

ISSUES TO BE RESOLVED:

1. Should a nonprofit corporation be required to specifically list its powers or should it automatically possess special and general powers by statutory right subject only to limitations in the articles or other statutes governing particular types of corporations? (Recommendation--Yes.)

2. Are there additional powers which should be listed which are not clearly covered by the general power set forth in subdivision (1)? (Recommendation--No.)

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§ 304. Effect of articles on authority of officers and directors; ultra vires acts

304. (a) The statement in the articles of the objects, purposes, and authorized affairs of the corporation constitutes, as between the corporation and its directors, officers, or members, an authorization to the directors and a limitation upon the actual authority of the representatives of the corporation. Such limitation may be asserted:

(1) In a proceeding by a member or the Attorney General to enjoin the doing or continuation of unauthorized activity by the corporation or its officers, or both.

(2) In a proceeding to dissolve the corporation, as provided in Article 2 of Chapter 8 (commencing with Section 1601).

(3) In a proceeding by or in the right of the corporation to procure a judgment in its favor against an incumbent or former officer or director or the corporation for loss or damage resulting from his unauthorized act.

(b) If the unauthorized act or transfer sought to be enjoined pursuant to paragraph (1) of subdivision (a) is being, or is to be, performed or made under any contract to which the corporation is a party, the court may set aside and enjoin the performance of such contract if all of the parties to the contract are parties to the action and the court determines such remedy to be equitable. If the court sets aside and enjoins performance of the contract, the court may allow to the corporation or to the other parties to the contract, as the case may be, such compensation as may be equitable for the loss or damage sustained by any of them from the action of the court in setting aside and enjoining the performance of such contract, but anticipated profits to be derived from the performance of the contract shall not be awarded by the court as a loss or damage sustained.

(c) Except as provided in subdivision (b), no limitation upon objects, purposes, powers, or authorized affairs of the corporation or upon the powers of the members, officers, or directors, or the manner of exercise of such powers, contained in or implied by the articles or by Chapter 8

(commencing with Section 1501) shall be asserted as between the corporation or any member and any third person.

(d) Any contract or conveyance made in the name of a corporation which is authorized or ratified by the directors, or is done within the scope of authority, actual or apparent, given by the directors, except as their authority is limited by law other than by Chapter 8 (commencing with Section 1501), binds the corporation, and the corporation acquires rights thereunder, whether the contract is executed or wholly or in part executory.

(e) This section applies to contracts and conveyances made by foreign corporations in this state and to all conveyances by foreign corporations of real property situated in this state.

Comment. Section 304 is derived in large part from Section 803 of the Corporations Code. Subdivision (a) provides that the statement of objects, purposes, and authorized activities is binding upon the officers and directors of the corporation and acts as a limitation upon the actual authority of the representatives of the corporation. It should be noted that the articles need not list the powers of the corporation since authorization of corporate powers is accomplished through statutory provisions subject only to limitations in the articles or in the statutes of this state. Section 303 and Comment thereto.

Furthermore, paragraph (1) of subdivision (a) states that any limitation in the articles may be asserted in a proceeding by the Attorney General or a member to enjoin unauthorized activity. Unlike Section 803 of the Corporations Code, this provision does not limit the court's power to enjoin unauthorized activity to situations where the rights of third parties are not involved. Subdivision (b) of Section 304 provides that a court may enjoin such activity after the conditions set forth in subdivision (b) are satisfied even when the rights of third parties are

involved. It should be noted that, when a court sets aside a contract affecting third parties, it is empowered by subdivision (b) to award equitable compensation to damaged parties, but in no case may the court award anticipated profits. This new power to enjoin contracts affecting third parties and to award compensation to injured parties is derived from Section 203 of New York's Not-for-Profit Corporation Law and is designed to balance adequate protection for third parties with the special importance in the nonprofit situation of forcing the corporation to conform to its established purposes.

Paragraphs (2) and (3) of subdivision (a) are substantially the same as the last part of subdivision (a) of Section 803 of the Corporations Code. Paragraph (2) establishes that limitations in the articles may be asserted in an action for dissolution of the corporation. Paragraph (3) permits such limitations to be asserted by the corporation or in the right of the corporation in a proceeding against officers or directors.

Subdivision (c) is substantially the same as subdivision (b) of Section 803 of the Corporations Code. It makes clear that limitations in the articles may not be asserted between the corporation or members and third persons except as provided in subdivision (b).

Subdivision (d) is the same as subdivision (c) of Section 803 of the Corporations Code. It establishes the validity of contracts or conveyances made in the name of the corporation which are authorized or ratified by the board.

Subdivision (e) is the same as subdivision (d) of Section 803 of the Corporations Code. It makes clear that this section applies to contracts or conveyances made by a foreign corporation in this state and to all conveyances by foreign corporations of real property located in this state.

ISSUES TO BE RESOLVED:

1. Should the statement of purposes in the articles act as a limitation on the corporation? (Recommendation--Yes.)
2. Should the approach taken for corporate powers in Section 303 be adopted for purposes as well? (Recommendation--No.)
3. Should a limitation in the corporate powers ever be asserted to enjoin a contract or action when third-party rights are involved? (Recommendation--Yes.)

Article 3. Corporate Name

§ 401. Corporate name

401. (a) The corporate name of a domestic corporation shall not contain any word or phrase which is likely to mislead the public or which is the same as, or resembles so closely as to be deceptive, any of the following:

(1) The name of a domestic profit or nonprofit corporation or established association.

(2) The name of a foreign profit or nonprofit corporation which is qualified to transact intrastate business or to conduct intrastate activities in this state.

(3) A name which is under reservation for another corporation pursuant to Section 402.

(b) The Attorney General or any interested party may bring an action to enjoin use of a name in violation of this section.

(c) The Secretary of State shall not file articles of incorporation or amendments thereto which contain a corporate name in violation of this section.

Comment. Section 401 adopts the substance of Section 310 of the Corporations Code (General Corporation Law) except that Section 401 explicitly creates a corporate duty not to use a prohibited name whereas the prior law merely commanded the Secretary of State not to file the articles of incorporation of a corporation with a prohibited name. This new approach makes unnecessary the language in Section 310 making a violation of its provisions enjoined notwithstanding the filing of articles by the Secretary of State, and it also makes unnecessary for this code the deceptive name provisions of Section 3700 of the Corporations Code (corporate name of an expired corporation).

The requirement established in subdivision (a)(1) that a corporation may not take the name of an existing association codifies the common law. Law v. Crist, 41 Cal. App.2d 862, 107 P.2d 953 (1941).

Subdivision (b) makes clear that the Attorney General has the right to bring an action to enjoin use of a name in violation of subdivision (a). This is designed to insure that the public will be protected from deceptively named corporations.

Analysis

The choice of a corporate name involves important elements of the public interest. The name must not mislead prospective donors, members, or customers, and it should not be a device for trading on the established good will and reputation of existing groups or corporations. See Kahoe, Non-Profit Corporation Names, 21 Cleveland State L. Rev. 114 (1972).

Section 401 is designed to protect the public interest and established groups and is modeled after Section 310 of the Corporations Code (General Corporation Law). Words or phrases "likely to mislead the public" are prohibited, and the Secretary of State is charged with enforcing this requirement as an adjunct to his filing duties for articles of incorporation. Other states have elaborate name restrictions; for example, New York's Not-for-Profit Corporation Law proscribes the use of a long list of specific words in the corporate name. N.Y. Not-for-Profit Corporation Law § 301(a)(5). However, the simpler approach found in the General Corporation Law is sufficient to protect the public interest and should be adopted by this code for uniformity.

ISSUES TO BE RESOLVED:

1. Should the Attorney General be permitted to enjoin an improper corporate name? (Recommendation--Yes.)
2. Should a corporate name which resembles closely an established association be prohibited by statute? (Recommendation--Yes.)
3. Would the New York list of specific words be a desirable alternative? (Recommendation--No.)

§ 402. Reservation of a corporate name

402. Any applicant may, upon the payment of the fee prescribed therefor in Section 12199 of the Government Code, obtain from the Secretary of State a certificate of reservation of any name not prohibited by Section 401 and, upon the issuance of the certificate, the name stated therein shall be reserved for a period of 60 days. The Secretary of State shall not, however, issue certificates reserving the same name for two or more consecutive 60-day periods to the same applicant or for the use or benefit of the same person, partnership, firm, or corporation; nor shall consecutive reservations be made by or for the use or benefit of the same person, partnership, firm, or corporation of names so similar as to fall within the prohibitions of this section.

Comment. Section 402 adopts for nonprofit corporations under this act the reservation power granted in Section 310 of the Corporations Code (General Corporation Law).

Analysis

Most of the important statutes provide the power to reserve the name of a potential corporation. See N.Y. Not-for-Profit Corporation Law § 303; ABA-ALI Model Non-Profit Corporation Act § 7A (optional section); Pa. Corporation Not-for-profit Code § 7315.

Article 4. Articles of Incorporation

§ 501. Required provisions

501. The articles of incorporation shall set forth:

(a) The name of the corporation.

(b) The specific and primary purposes for which it is formed. This requirement does not preclude a statement of general purposes or powers or restrict the right of the corporation to engage in any other lawful activity consistent with its stated purposes.

(c) That the corporation is organized pursuant to the Not-for-Profit Corporation Law.

(d) The county in this state where the principal office for the transaction of the affairs of the corporation is located.

(e) The names and addresses of the persons who are to act in the capacity of directors until the selection of their successors. These persons are subject to all the laws of this state relating to directors except as otherwise provided in this division.

(f) If an existing unincorporated association is being incorporated, the name of the unincorporated association.

Comment. Section 501 is substantially the same as a portion of former Section 9300 of the Corporations Code (General Nonprofit Corporation Law). However, subdivision (b) makes it clear that a corporation may not engage in lawful activity inconsistent with its stated purposes. Prior law did not contain the phrase "consistent with its stated purposes" found at the end of subdivision (b). For the effect of ultra vires activity, see Section 304 (effect of articles on authority of officers and directors).

The provisions of former Section 9300 regulating the number of directors and the provision permitting the corporation to designate its first directors by any title have been removed from this section for organizational purposes. See Section 801 (title of directors) and Section 802 (number of directors). See also Sections 401 (corporate name), 301 (corporate purposes), and 303 (corporate powers).

ISSUE TO BE RESOLVED:

1. Should the language "consistent with its stated purposes" be added at the end of subdivision (b)? (Recommendation--Yes.)

§ 502. Permissible provisions

502. The articles of incorporation may set forth any provision not inconsistent with this code or any other statute of this state for the regulation of the corporation's internal affairs including any restriction authorized by Article 5 (commencing with Section 551) upon the power to amend the articles of incorporation.

Comment. Section 502 is substantially the same as former Section 9303 of the Corporations Code (General Nonprofit Corporation Law). Derived from Section 402(c) of New York's Not-for-Profit Corporation Law, Section 502 makes clear that the corporation may set forth in its articles any provision for regulating the internal affairs of the corporation which is not inconsistent with this code or any other statute of this state.

Former Section 9301 of the Corporations Code (General Nonprofit Corporation Law) required that certain rules regulating the corporation's affairs be set forth in either the articles or the bylaws (e.g., the "rights and privileges" of members). These matters are handled in a different manner by this code. Section 601 requires that a rule governing each of these matters be incorporated in the bylaws unless that subject has been expressly provided for in the articles. In this way, the same result is achieved by a clearer approach. Moreover, the detailed rules concerning dues and assessments formerly found in Section 9301 may be found in Section 708 (members' dues and assessments).

ISSUE TO BE RESOLVED:

1. Is a specific listing of permissible provisions advisable?
(Recommendation--No.)

§ 503. Execution of articles

503. (a) Except as provided in subdivision (b), each person named in the articles to act in the capacity of a first director shall, and any other person desiring to associate with those persons in the formation of the corporation may, personally sign the articles of incorporation. All signatures thereto shall be personally acknowledged before an officer designated by the laws of this state as one before whom an acknowledgment may be made. Any certificate of acknowledgment taken without the state shall be authenticated by the certificate of an officer having the requisite official knowledge of the qualification of the officer before whom the acknowledgment was made when taken before any officer other than a notary public or a judge or clerk of a court of record having an official seal.

(b) In the case of the incorporation of an unincorporated association, the articles of incorporation shall be subscribed and execution thereof personally acknowledged before an officer authorized to take acknowledgments by the presiding officer or acting presiding officer and the secretary or clerk or similar officer of the association or by at least a majority of its governing board or body, and there shall be attached thereto the affidavit of the subscribing officers, board, or body that the association has authorized its incorporation and has authorized such officers, board, or body to execute the articles of incorporation.

Comment. Section 503 is the same in substance as former Section 9304 of the Corporations Code (General Nonprofit Corporation Law). Subdivision (a) requires all persons named in the articles as first directors to sign the articles and acknowledge their signatures as provided. Other persons

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may sign the articles. Subdivision (b) sets forth the affidavit requirements for incorporating an unincorporated association.

ISSUE TO BE RESOLVED:

1. Should first directors be required to sign the articles and thereby automatically become incorporators? (Recommendation--Yes.)

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§ 504. Filing of articles; effect of filing; dissenting member of unincorporated association

504. (a) If the articles conform to law, the Secretary of State shall file them in his office and shall endorse upon them the date of filing. The corporate existence begins upon the filing of the articles and continues perpetually unless otherwise provided in the articles or the laws of this state.

(b) When the articles incorporating an unincorporated association are filed:

(1) The members of the association shall be members of the created corporation except that a member of the association who files his dissent in writing with the secretary or clerk or similar officer of the association shall not become a member of the corporation.

(2) All property owned by or held for the association shall belong to and vest in the corporation subject to all existing encumbrances and claims as if incorporation has not taken place.

Comment. Subdivision (a) of Section 504 is the same in substance as the first paragraph of former Section 9304.5 of the Corporations Code (General Nonprofit Corporation Law). However, this new provision clearly

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permits a corporation to regulate the length of its existence by an appropriate provision in the articles. Present law does not expressly provide such a power.

Subdivision (b) is derived from Section 403 of New York's Not-for-Profit Corporation Law. Paragraph (1), which contains the substance of the first part of former Section 9604 of the Corporations Code (General Corporation Law), permits a dissenting member of an association undergoing incorporation to file a dissent in writing with the secretary or comparable officer of the association and thereby avoid becoming a member of the new corporation. Paragraph (2) codifies the holding in Security First Nat'l Bank v. Cooper, 62 Cal. App.2d 653, 145 P.2d 722 (1944) (after incorporation, property held by the unincorporated association vests in the corporation and the debts of the association become the debts of the corporation).

ISSUES TO BE RESOLVED:

1. Should this section give express recognition to the fact that a corporation may have a limited term of existence? (Recommendation--Yes.)
2. Should a dissenting member of an association undergoing incorporation be permitted to avoid becoming a member of the new corporation? (Recommendation--Yes.)

404-972

§ 505. Filing copy of articles with county clerk

505. The corporation shall file a copy of the articles, certified by the Secretary of State and bearing the endorsement of the date of filing in his office, in the office of the county clerk of the county in which the corporation is to have its principal office and in the office of the county clerk in each county in which the corporation acquires ownership of any real property.

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Comment. Section 505 is the same in substance as the second paragraph of former Section 9304.5 of the Corporations Code (General Nonprofit Corporation Law).

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Article 5. Amendment of Articles

§ 551. Right to amend the articles

551. By complying with the provisions of this article, a corporation may amend its articles of incorporation so long as the amendment contains only such provisions as might lawfully be contained in an original articles of incorporation which is filed at the time of the filing of the certificate of amendment. A corporation may not amend its articles to alter statements which appear in the original articles of the names and addresses of the first directors or to adopt a new corporate name inconsistent with the requirements of Section 401.

Comment. The language of Section 551 is derived from Section 801(a) of New York's Not-for-Profit Corporation Law which limits permissible provisions of amendments to those provisions which might be lawfully contained in an original articles filed at the time of the filing of the certificate of amendment. Section 551 continues the authority granted by Section 3602(b) of the Corporations Code (General Corporation Law) (which was made expressly applicable to nonprofit corporations by former Section 9305 of the General Nonprofit Corporation Law) to amend the articles in any respect consistent with the law. It also continues the prohibition set forth in Section 3603 of the Corporations Code against amending the original articles to change the name or address of first directors,

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and it continues the requirement set forth in Section 3600 of the Corporations Code that an amendment changing the corporate name is subject to the same restrictions as a corporate name originally filed. See Section 401 (corporate name).

Analysis

As well as a general grant of authority to amend the articles in any respect which is not inconsistent with the law, New York's Not-for-Profit Corporation Law specifically lists permissible subjects which may properly be changed by amendment (e.g., the corporate name).¹ This approach seems unnecessary but may be adopted by the Commission for clarity.

ISSUES TO BE RESOLVED:

1. Should this section follow New York's example and specifically list permissible subjects which may be amended in the articles? (Recommendation--No.)
2. Should the corporation be prohibited from amending the statement of the names and addresses of first directors? (Recommendation--Yes.)
3. Should language be added specifically permitting a corporation to readopt or restore any provision in its articles superseded or changed by a proceeding pursuant to law (see Corp. Code § 3602)? (Recommendation--No.)

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§ 552. Adoption of amendments generally

552. (a) Except as otherwise provided in this article, an amendment of the articles of incorporation shall be adopted by a resolution of the board and by the vote or written consent of the members given (either before or after the adoption of the resolution of the board) by one of the following methods:

1. N.Y. Not-for-Profit Corporation Law § 801(b).

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(1) The written consent or vote of at least a majority of the voting power of the corporation.

(2) The vote of at least two-thirds of a quorum of the members at a meeting of the members.

(3) When an alternative manner of voting is used as provided in Section 758, at least a majority of the votes cast by that procedure unless a greater number is specified in the articles or a bylaw adopted by the members.

(b) If the articles or a bylaw adopted by the members so provide, any member action required for the adoption of amendments to the articles may be taken instead by the vote or written consent of at least two-thirds of the members of a policy-making committee created by the members of the corporation to represent and act for the corporation members in this matter with or without authority to represent and act for the corporation members in other matters. Such a policy-making committee shall consist of at least 10 percent of the members entitled to vote in an election of directors or 30 members, whichever is smaller. Only members of the corporation shall serve on this committee.

(c) The articles of incorporation may require the approval of any amendment to the articles by the vote or written consent of the holders of a greater percentage or fraction of the members or of any class of members, or the vote or written consent of a greater percentage or fraction of the voting power, than would otherwise be required under this article; but in no case may the articles or bylaws prohibit any amendment authorized by this code.

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Comment. Section 552 is modeled in part after Section 802 of New York's Not-for-Profit Corporation Law, but it incorporates many of the basic rules found in Sections 3632-3632.5 of the Corporations Code which previously governed nonprofit corporations pursuant to former Section 9305 of the Corporations Code (General Nonprofit Corporation Law). It sets forth the general rule for corporations which have members: Amendments to the articles must be adopted both by the board of directors and by the membership. This latter requirement may be satisfied in several ways: (1) by vote of two-thirds of a quorum at a meeting of the members provided this is not less than a majority of the votes cast, (2) by the written consent or vote of a majority of the voting power of the corporation, (3) when an alternative manner of voting is used as provided in Section 758, by at least a majority of the votes cast or other greater number as specified in the articles or a bylaw adopted by the members, or (4) pursuant to a provision in the articles or a bylaw adopted by the members, by two-thirds of a policy committee which consists of at least 10 percent of the membership or 30 members, whichever number is smaller. This latter alternative to a vote by the membership is similar to former Section 3632.5; however, subdivision (b) of Section 552 adds additional requirements which must be met by such a committee. It must be at least a certain size as set forth above and, furthermore, the authorization for this committee must be in the articles or a bylaw adopted by the members. Unlike former Section 3632.5, this type of committee action may not be authorized by a bylaw adopted by the board of directors. This change is to insure effective membership participation at some point in the amendment process.

Subdivision (c) is substantially the same as the last half of Section 3632 of the Corporations Code. It permits the articles to specify a higher percentage vote of the members or of any class of the members than is otherwise required to amend the articles or any particular article under this article.

Analysis

Like Section 3632 of the Corporations Code (General Corporation Law), proposed Section 552 requires that amendments to the articles be approved

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by both the board of directors and the membership. This approach differs from Section 802 of New York's Not-for-Profit Corporation Law which requires only membership authorization. Two-step authorization is preferable as it increases the probability that any proposed amendment will receive careful consideration prior to adoption. The articles of incorporation are the basis for the corporation, and any change deserves careful scrutiny, particularly since a change will often damage the interests of members who have justifiably relied upon the original provision.

Since, for some nonprofit corporations, membership approval may be extremely burdensome (as, for example, in the case of a corporation which lists all donors as members), Section 552--like former Section 3632.5--provides an alternative procedure for gaining this authorization. Pursuant to an appropriate provision in the articles or a bylaw adopted by the members, membership authorization for amendments to the articles may be gained by a two-thirds vote of a policy committee of the members. However, to protect this procedure from the abuse of being entirely a rubber stamp for the board, Section 552--unlike former Section 3632.5--does not permit such a committee to function pursuant to a bylaw adopted by the board. It does not seem unreasonably burdensome to require the corporation to at least gain actual membership approval for the formation of such a committee. Moreover, Section 552 provides that the policy committee must be at least a certain minimum size, 10 percent of the membership or 30 members, whichever is smaller. This rule also protects the independence of the policy committee from the board of directors.

ISSUES TO BE RESOLVED:

1. Should proposed amendments be adopted by board resolution as well as by the membership? (Recommendation--Yes.)
2. Should amendments to the articles be adopted by members only at a meeting of the members? (Recommendation--No.)
3. Should the policy committee of the members procedure be adopted? (Recommendation--Yes.)
4. Should the corporation be permitted to provide for the policy committee alternative in a bylaw adopted by the board? (Recommendation--No.)
5. Should the size of the policy committee be regulated by statute? (Recommendation--Yes.)

999-547

§ 553. Adoption by incorporators

553. Before any members of a corporation other than the incorporators have been admitted, any amendment of the articles may be adopted by a writing signed by two-thirds of the incorporators of the corporation.

Comment. Section 553 is the same as that part of Section 3630 of the Corporations Code which previously applied to nonprofit corporations. It provides a procedure for adoption of amendments by the incorporators during the period before other members are admitted.

ISSUE TO BE RESOLVED:

1. Should the requirement that two-thirds of the incorporators must consent to an amendment be relaxed? (Recommendation--No.)

999-548

§ 554. Minor amendments

554. The following amendments to the articles may be adopted by the board without membership approval:

(a) To specify or change the location of the principal office of the corporation.

(b) To specify a change in the post office address of the principal office of the corporation.

Comment. Section 554 is derived from Section 802(c) of New York's Not-for-Profit Corporation Law and establishes a simplified procedure for certain specified minor amendments to the articles. Cf. Corp. Code § 3600(c).

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ISSUES TO BE RESOLVED:

1. Should the board be permitted to adopt minor amendments without membership approval? (Recommendation--Yes.)

2. Should a change in address of the corporation's principal office be considered a minor amendment? (Recommendation--Yes.)

999-549

§ 555. Form of amendment; construction

555. (a) The resolution of the board of directors and the vote or written consent of the members approving any amendment, or the writing signed by the incorporators, shall establish the wording of the amendment or amended articles by one or more of the following means:

(1) By providing that the articles shall be amended to read as therein set forth in full.

(2) By providing that any provision of the articles, which shall be identified by the numerical or other designation given it in the articles or by stating the wording thereof, shall be stricken from the articles or shall be amended to read as set forth in full in the resolution or consent or writing.

(b) The wording of any provision proposed to be amended or stricken from the articles or readopted and restored shall be deemed to be that which is contained in the original articles unless such wording has been changed pursuant to a statute which expressly authorized the amendment of articles, in which event such wording shall be deemed to be that which is provided for in the document or documents filed for the purpose of making such amendment effective. No change which has become effective pursuant

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to any statute which did not expressly provide for the amendment of articles shall be deemed to have the effect of impliedly amending the affected provision of the articles so as to read in conformity with such change.

Comment. Section 555 sets forth the proper form and construction of amendments to the articles. It is the same as that portion of Section 3631 of the Corporations Code which applied to nonprofit corporations.

ISSUE TO BE RESOLVED:

1. Should a simpler provision such as Section 7902(b) of Pennsylvania's Corporation Not-for-profit Code be adopted establishing the form of an amendment? (Recommendation--No.)

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§ 556. Certificate of amendment

556. (a) Upon the adoption of any amendment, a certificate of amendment that satisfies the requirements of this section shall be filed with the Secretary of State.

(b) The certificate shall be signed and verified by a signed affidavit stating that the matters set forth in the certificate are true of his own knowledge by any of the following:

- (1) The chief officer of the corporation or any two subordinate officers.
- (2) Two-thirds of the board of directors.
- (3) Before any members have been accepted except incorporators, by two-thirds of the incorporators.

(c) The certificate shall set forth:

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(1) The name of the corporation and, if it has been changed, the name under which it was formed.

(2) The date its articles of incorporation were filed by the Secretary of State.

(3) A copy of the resolution of the board adopting the amendment and a statement that the wording of the article or articles set forth in the members' resolution or written consent is the same as set forth in the directors' resolution or, if the amendment is adopted by the incorporators pursuant to paragraph (3) of subdivision (b), a copy of the writing adopting the amendment signed by the incorporators as provided in Section 553.

(4) A statement of the manner in which the amendment was adopted, which shall consist of a specific reference to the statutory provision or the provision of the articles or bylaws, or both, authorizing use of the procedure used for the amendment of the articles, the number of votes entitled to be cast, and the consenting votes.

(5) If adoption is by the incorporators, a statement that the corporation has admitted no members other than incorporators.

(d) Any number of amendments may be included in one certificate under this section.

Comment. The form of Section 556 is derived in part from Section 803 of New York's Not-for-Profit Corporation Law.

The verification and signature requirements are very similar to those found in Sections 3671 and 3672 of the Corporations Code (General Corporation Law) which applied to nonprofit corporations pursuant to former Section 9305 of the Corporations Code (General Nonprofit Corporation Law).

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In order to aid those filing the amended articles, paragraphs (1) and (2) of subdivision (c) require the certificate to set forth the original name of the corporation and the date of its incorporation. Paragraph (3) requires the text of the resolution of the board adopting the amendment to be set forth in the certificate of amendment; this provision is similar to a part of Section 3671 of the Corporations Code (General Corporation Law). Paragraph (4) requires the manner of adoption to be set forth in the certificate. This provision is intended to operate exactly like the detailed rules found in Sections 3671 and 3672 of the Corporations Code; those rules have merely been simplified for clarity. Paragraph (4) is designed to make the manner of adoption of amendments or changes appear proper on the face of the certificate.

Subdivision (d) makes it clear that several changes in the articles may be included in one certificate.

ISSUES TO BE RESOLVED:

1. Should the provisions in Corporations Code Sections 3671 and 3672--requiring the manner of adoption be set forth in the certificate--be simplified? (Recommendation--Yes.)

2. Is there additional information which should be contained in the certificate? (Recommendation--No.)

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§ 557. Filing of certificate

557. (a) The certificate of amendment shall be submitted to the Secretary of State. If the Secretary of State finds that it complies with the provisions of law, he shall file it and shall endorse upon it the date of filing. Upon filing, the articles of incorporation shall be deemed amended in accordance with the certificate, and a copy of the certificate, certified by the Secretary of State, is prima facie evidence

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of the performance of the conditions necessary to the adoption of the amendment.

(b) The corporation shall file a copy of the certificate, certified by the Secretary of State and bearing the endorsement of the date of filing in his office, in the office of the county clerk of the county in which the principal office of the corporation is located and in the office of the county clerk of every county in which the corporation holds real property.

Comment. Section 557 continues the filing requirements for amendments to the articles found in Sections 3673 and 3674 of the Corporations Code (General Corporation Law) which applied to nonprofit corporations pursuant to former Section 9305 of the Corporations Code (General Non-profit Corporation Law). Subdivision (b) is comparable to Section 505 (filing original articles).

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§ 558. Restatement of articles

558. (a) A corporation may restate in a single certificate the entire text of its articles of incorporation as amended by filing with the Secretary of State a certificate entitled "Restated Articles of Incorporation of (insert name of corporation)" which shall set forth the articles as amended to the date of the certificate, but the certificate shall not itself alter or amend the articles in any respect except that the signatures and acknowledgments of the incorporators may be omitted.

(b) The certificate shall be signed by the chief officer or any two subordinate officers of the corporation and shall be verified by their

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signed affidavits that they have been authorized to execute the certificate by resolution of the board of directors adopted on the date stated and that the certificate correctly sets forth the text of the articles of incorporation as amended to the date of the certificate.

Comment. Section 558 provides a procedure for restatement in a single certificate of the entire text of its articles as amended. This provision is substantially the same as Section 3800 of the Corporations Code. The designation of the persons signing the certificate has been changed to conform to nonprofit terminology and to similar provisions in this code requiring certificates. E.g., Section 556 (certificate of amendment).

ISSUE TO BE RESOLVED:

1. Is there need for a provision permitting restated articles?
(Recommendation--Yes.)

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§ 559. Filing certificate of restatement

559. Whenever a corporation is required to file in any office in this state, a certified copy of its articles pursuant to any provision of law, in lieu of filing a certified copy of the original articles and certified copies of all certificates amendatory of or supplementary to the original articles, it may file a certified copy of the most recent certificate restating its articles as amended, filed pursuant to Section 559, together with certified copies of all certificates of amendment filed subsequent to the restated articles and certified copies of all certificates supplementary to the original articles.

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Comment. Section 559 is the same in substance as Section 3802 of the Corporations Code. It gives effect to Section 558 (restated articles).

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§ 560. Effect of article

560. This article does not alter the vote required under any other section for the adoption of an amendment referred to therein, nor does it alter the authority of the board to adopt amendments under any other section.

Comment. Section 560 makes clear that this article does not affect the requirements established by any other section for specific amendments to the articles. It is derived from Section 802(d) of New York's Not-for-Profit Corporation Law. See Article 2 of Chapter 7 (commencing with Section 1301)(merger and consolidation).

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§ 561. Action by Attorney General, member, officer, or director

561. The Attorney General, or any member, officer, or director may bring an action to enjoin the operation of any amendment to the articles of incorporation which serves as a device to defraud members or the public at large.

Comment. Section 561 creates for the Attorney General, any member, officer, or director a statutory right to enjoin the operation of any

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amendment to the articles of incorporation which serves as a device to defraud members or the public at large. It is intended that the concept of fraud should be interpreted in a very broad fashion so as to embrace anything which is intended to deceive and which results in the injury of one who has justifiably relied upon the previous provision in the articles. See Arch v. Finkelstein, 264 Cal. App.2d 667, 70 Cal. Rptr. 472 (1968).

Analysis

The right to enjoin fraudulent amendments is proposed as an alternative to the approval and consent procedure of Section 804 of New York's Not-for-Profit Corporation Law. That section requires that, before charitable or public interest corporations may amend their articles, they must receive the approval of that body or government official who, under the New York Not-for-Profit Corporation Law, must consent to the original formation of that type of corporation.¹ This proposed code rejects the required consent approach as lacking appropriate standards and inviting administrative arbitrariness. That approach is also time consuming and expensive. See the Comment and Analysis to Section 301 (powers and purposes).

However, some check is needed to insure that a corporation does not radically amend its purposes or do some other dramatic act by amendment which defrauds those who have justifiably relied upon the previous provision in the articles. It should be noted that property given to the corporation, if it is a charitable corporation (defined by Section 125), will be held in trust pursuant to Section 1101 and, therefore, protected from the abuses suggested above. Given this fact, the problem posed does not present too great a danger to the public interest. Nevertheless, there should be some protection against a corporation engaging in the following type of abuse: selling its products with the understanding derived from its stated purposes that the profits would be used to advance a specific cause--charitable or otherwise--and then by design changing its purpose to provide some form of social benefit to its members and using the previously

1. See N.Y. Not-for-Profit Corporation Law § 404 (approvals and consents).

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acquired funds to finance these benefits. Section 561 represents a possible approach to this problem, but perhaps a more definitive standard than fraud can be developed.

ISSUES TO BE RESOLVED:

1. Should a nonprofit corporation be required to gain the consent of some governmental body prior to amending its articles? (Recommendation--No.)

2. Is there a need for a statutory procedure to protect members and the public from certain types of amendments (e.g., fraudulent or unfair)? (Recommendation--Yes.)

3. Should another standard besides fraud be adopted? (Recommendation--No.)

999-314

Article 6. Bylaws

§ 601. Required provisions

601. Except to the extent the articles of incorporation expressly provide for the following, the bylaws shall set forth:

(a) The authorized number and qualifications of members of the corporation and, if any, the different classes of membership.

(b) The property, voting, and other rights and privileges of members.

(c) The liability of members for dues or assessments.

(d) If the voting, property, or other rights or interest, or any of them, be unequal, the rule or rules by which the respective voting, property, or other rights or interests of each member of class of members are fixed and determined.

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Comment. Section 601 is the same in substance as a part of former Section 9301 of the Corporations Code. That section provided that the above matters had to be set forth in either the articles or the bylaws. The phraseology has been changed so that now the above matters must be dealt with in the bylaws if they have not been previously covered in the articles. This alteration works no substantive change. It merely increases the likelihood that the practicing attorney will find the relevant section when he attempts to discover the mandatory requirements for the bylaws.

ISSUE TO BE RESOLVED:

1. Should certain matters be required to be set forth in the articles or bylaws? (Recommendation--Yes.)

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§ 602. Permissible provisions

602. The bylaws may contain any provision relating to the activities of the corporation, the conduct of its affairs, its rights or powers or the rights or powers of its members, directors, or officers, not inconsistent with this code or any other statute of this state or the articles of incorporation.

Comment. Section 602 is modeled after Section 602(f) of New York's Not-for-Profit Corporation Law. It makes clear the general power to regulate all corporate affairs by appropriate bylaws unless doing so violates express provisions in the law or the articles. This approach differs from former Sections 9401, 9402, and 9403 which listed a number of specific areas that might permissibly be regulated by a bylaw. Those sections left unclear whether or not a general power existed to regulate other areas not specifically listed. It should be noted that the specific areas listed in Sections 9401, 9402, and 9403 are now governed by other provisions of this code. E.g., Section 704 (termination of membership).

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Analysis

The modern trend in corporate bylaw provisions is to empower the corporation to regulate any aspect of its affairs in a manner not inconsistent with the law or the articles through appropriate bylaws.¹ This approach is also consistent with Section 501 of the General Corporation Law which contains such a provision. The present statutory treatment in the General Nonprofit Corporation creates the possibility that a court may read the specific listing of permissible areas of bylaw regulation as creating a negative pregnant precluding the use of a bylaw provision for a subject not listed. In any case, the general power approach is neater and eliminates the need for any litigation on this matter.

ISSUES TO BE RESOLVED:

1. Should there be a specific listing of permissible subjects for the bylaws? (Recommendation--No.)

2. Should this revision take the basic statutory approach of specifying a rule for each major area of corporate activity (e.g., what constitutes proper notice for a meeting of the members) while, at the same time, permitting the corporation in some cases to vary from the statutory rule by an appropriate provision in its articles or bylaws? (Recommendation--Yes.)

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§ 603. Adoption; amendment; repeal

603. (a) Subject to subdivision (b), bylaws may be adopted, amended, or repealed by any of the following:

(1) The written consent of members entitled to exercise a majority of the voting power of the corporation.

1. See N.Y. Not-for-Profit Corporation Law § 602(f); Pa. Corporation Not-for-profit Code § 7504.

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(2) The vote of a majority of the votes cast at a meeting of the members, called for that purpose according to the articles or the bylaws, at which a quorum is present.

(3) The vote of a majority of the votes cast according to an alternative voting procedure as provided in Section 758 of this code.

(4) The board of directors, subject to the power of members to change or repeal bylaws and to any limitations imposed by this code.

(b) The articles or bylaws may require the vote or written consent of members entitled to exercise a greater fraction or percentage of the voting power for the amendment or repeal of bylaws generally, or of particular bylaws, or for the adoption of new bylaws, than would otherwise be required under this section. Whenever a bylaw is adopted pursuant to this section requiring a larger percentage of membership vote or consent, it shall not be amended or repealed by a lesser percentage. The articles or a bylaw adopted by the members may limit or restrict the power of the directors to adopt, amend, or repeal bylaws or may deprive them of the power.

Comment. Section 603 is derived from former Section 9400 of the Corporations Code (General Nonprofit Corporation Law). It establishes the procedures for the adoption, amendment, or repeal of bylaws. Bylaws may generally be adopted by the board or by a majority vote of the membership. It should be noted that paragraph (3) provides for a corporation adopting an alternative voting procedure other than by vote at a meeting of the members as provided in Section 758. Paragraph (4) of subdivision (a) recognizes that some bylaws may not be adopted, amended, or repealed by the board.

Subdivision (b) is derived from the last part of former Section 9400, and it expressly provides that the articles or bylaws may require the vote of a greater percentage of the members to adopt or repeal bylaws or a particular bylaw than would otherwise be required by this section.

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ISSUES TO BE RESOLVED:

1. Should there be limitations on the board's authority to adopt certain bylaws (e.g., changing the number of directors)? (Recommendation--Yes.)
2. Should the articles or bylaws be permitted to specify a greater percentage vote for the adoption of bylaws generally or of specific bylaws? (Recommendation--Yes.)
3. Should bylaws be adopted by the members only at a meeting of the members? (Recommendation--No.)

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§ 604. Record book

604. All bylaws shall be recorded in a book which shall be kept in the principal office of the corporation.

Comment. Section 604 is the same as former Section 9404 of the General Nonprofit Corporation Law. It supplements the requirements of Section 901 (books and records). See also Section 902 (member's right to inspect corporate books and records).

CHAPTER 3. MEMBERS

Article 1. Members Generally§ 701. Members

701. (a) Corporations, whether formed for profit or not, joint-stock associations, unincorporated associations, and partnerships, as well as any person without limitation, may be members of a nonprofit corporation. No member may hold more than one membership.

(b) If neither the articles nor bylaws provide for members and there are in fact no members other than the persons constituting the board of directors, the persons constituting the board are the members of the corporation, and they shall have all the obligations and exercise all of the rights and powers of members.

(c) If there are no members and no directors, those signing the articles of incorporation shall be deemed to be the members of the corporation and shall have all the obligations and exercise all of the rights and powers of members.

Comment. Subdivision (a) of Section 701 is derived from Section 601(a) of New York's Not-for-Profit Corporation Law. This provision makes clear that a corporation, joint-stock association, unincorporated association, or partnership may be a member of a nonprofit corporation. The former law left this matter unclear by not expressly establishing a rule as to who or what might be a member of a nonprofit corporation incorporated under that law. Subdivision (a) also continues the rule found in former Section 9602 of the Corporations Code (General Nonprofit Corporation Law) which prohibited a member from holding more than one membership.

Subdivision (b) is the same in substance as former Section 9603 of the Corporations Code (General Nonprofit Corporation Law). It provides that, if there are no members, the persons serving on the governing board

shall be deemed members possessing all of the obligations, rights, and privileges of members.

Subdivision (c) codifies the rule established in Coon v. Freeman, 1 Cal.3d 542, 463 P.2d 441, 83 Cal. Rptr. 217 (1970). If there are no members and no persons on the governing board, the persons signing the articles of incorporation are deemed to be the members and possess all of the obligations, rights, and privileges of members.

ISSUES TO BE RESOLVED:

1. Should there be any limitation on who or what may be a member of a nonprofit corporation? (Recommendation--No.)

2. Should the law specify who is to be deemed a member in the absence of members in fact? (Recommendation--Yes.)

§ 702. Classes of members

702. A nonprofit corporation may have one or more classes of members. Any provision for classes of members shall be set forth in the articles or the bylaws. If there is no such provision, the corporation has only one class of members.

Comment. Section 702 is the same in substance as the first part of former Section 9602 of the Corporations Code (General Nonprofit Corporation Law). It complements Section 601 which provides that, in the absence of a controlling provision in the articles, the bylaws shall set forth the classification of members if any classification exists.

ISSUE TO BE RESOLVED:

1. Should corporations be permitted to provide for different classes of members with different rights and powers? (Recommendation--Yes.)

§ 703. Membership certificates

703. (a) Membership in a nonprofit corporation may be evidenced by a membership certificate or by any reasonable method as prescribed by the articles or the bylaws.

(b) If membership is evidenced by a membership certificate, a statement that the corporation is not for profit shall be printed in clear type upon the face of each such certificate.

(c) Membership certificates and other forms of evidence of membership are not transferable, and this fact shall be noted in clear type upon the face of the certificate or other form of evidence of membership. If the articles or bylaws permit transfer of membership, upon each transfer the certificate or card issued to a former member shall be surrendered and a new certificate or card issued to the new member.

Comment. The first part of subdivision (a) of Section 703 is the same as part of former Section 9607 of the Corporations Code (General Nonprofit Corporation Law), and the latter part is similar to Section 601(c)(4) of New York's Not-for-Profit Corporation Law. Subdivision (a) permits membership to be evidenced by any reasonable method as prescribed by the articles or bylaws such as, for example, signature on the certificate of incorporation, membership card, or designation in the bylaws.

Subdivision (b) is included to insure that the membership certificate will not be confused with stock in a profit oriented corporation. Cf. Section 1000 (stock prohibited). The subdivision continues the last portion of former Section 9607 and adds the requirement that the certificate indicates on its face that it is nontransferable. This requirement is taken from Section 501 of New York's Not-for-Profit Corporation Law.

Subdivision (c) is adapted from Section 601(d) of New York's Not-for-Profit Corporation Law. It is designed to facilitate an accurate record of the membership as required by Section 901. Moreover, like

subdivision (b) and Section 701(a) (one membership per person), it helps reduce the possibility that membership certificates will be freely traded in a fashion similar to securities. This danger exists especially if considerable appreciated assets are available for distribution upon voluntary dissolution of the corporation as permitted under Section 1512.

Analysis

Section 703 is designed to provide a flexible rule for the evidencing of membership while at the same time protecting against the danger that these certificates or other permitted forms of evidence of membership might be traded as securities. It continues existing California Law (Section 9607) regarding the power of corporations to use certificates to evidence membership, but this power is expanded to include other reasonable means of accomplishing this function, an approach consistent with other modern nonprofit codes. See § 601 of N.Y. Not-for-Profit Corporation Law. This increased flexibility provides formal sanction for methods currently used to evidence membership. The prohibition against transfer of certificates is taken from Section 601(d) of New York's Not-for-Profit Corporation Law. An explanation of the need for this provision can be found in the Comment to this section.

ISSUES TO BE RESOLVED:

1. Should evidence of membership be limited to membership certificates? (Recommendation--No.)
2. Should membership certificates and other forms of evidence of membership be transferable? (Recommendation--No.)
3. Should membership certificates be labeled "nontransferable" and "not-for-profit"? (Recommendation--Yes.)

§ 704. Termination of membership

704. (a) Membership may be terminated in the manner provided in the articles or bylaws. Unless the articles, the bylaws, or the laws under which the corporation was formed provide otherwise, all the rights of a member in the corporation or in its property cease on death, resignation, expulsion, or expiration of a term of membership. Except as provided in Section 1001, the articles, or the bylaws, any termination of membership is without prejudice to the member's rights, if any, as a holder of a capital or subvention certificate.

(b) Unless the articles provide otherwise, no member may be expelled except for cause and with a proper hearing before the board of directors. This provision does not apply to the sale or forfeiture of membership upon notice pursuant to Section 708 for failure to pay dues or assessments.

(c) The articles or bylaws may provide a reasonable procedure for resignation of membership. In the absence of such a provision, a member may resign upon 30 days' written notice to the corporation. Such resignation terminates all future rights, powers, and obligations of membership, but it does not end the member's liability for debts owed to the corporation.

Comment. Section 704 is designed to establish clear rules governing the termination, resignation, and expulsion of members. Subdivision (a) is substantially the same as former Section 9608 of the Corporations Code (General Nonprofit Corporation Law) except that "other termination" as used in that section is defined in Section 704 to mean resignation, expulsion, or expiration of a term of membership. The last sentence of this subdivision makes clear that, except as provided in Section 1001, any termination shall be without prejudice to a member's rights, if any, as a holder of capital or subvention certificates.

Subdivision (b) reverses the holding in Erickson v. Gospel Foundation, 43 Cal.2d 581, 275 P.2d 474 (1954) (except where property right involved, court will not review expulsion of member by proper tribunal of the association). Subdivision (b) provides that, unless the articles specifically provide otherwise, a member may not be expelled from a nonprofit corporation except upon cause and with a proper hearing. These rights are enforceable in court. It is not intended that the term "proper hearing" should be interpreted by the courts to mean a hearing which will satisfy all the requirements of "due process." This hearing requirement is satisfied if the member charged with violating a rule of the organization is given an opportunity to rebut these charges before the governing body. A similar provision requiring cause and a hearing for expulsion is found in Section 7767 of Pennsylvania's Corporation Not-for-profit Code.

The first sentence of subdivision (c) codifies the holding in Haynes v. Annandale Golf Club, 4 Cal.2d 28, 47 P.2d 470 (1935) (a nonprofit organization may impose only reasonable restrictions on a member's right to resign). The second sentence is entirely new. It provides a method of resignation if none is provided in the articles or bylaws.

Analysis

Subdivision (b) of Section 704 establishes an important new right for members of all nonprofit corporations. A member may be expelled from a nonprofit corporation only upon cause and with a proper hearing before the governing body. The old rule--found in Erickson v. Gospel Foundation, 43 Cal.2d 581, 275 P.2d 474 (1954)--that courts will not inquire into the expulsion of members unless a property right is involved is unnecessarily narrow. It was motivated in large part by the court's desire to stay clear of the internal affairs of organizations, particularly where ecclesiastical matters are involved. However, in fact, the new protection given members does not force a court to become excessively involved in internal matters of organizations. Section 704(b) merely insures procedural fairness which entails no inquiry into the substance of organizational rules. The "cause" requirement is satisfied by proof of a violation of any valid rule of the organization which means any properly adopted rule.

The new rule is mandated by the obvious importance to individuals of membership in organizations.

"When we turn aside from the authorities and consider the actual human interests which suffer from an expulsion, it becomes apparent that in many cases they are chiefly interests of personality. The expelled club member finds his social reputation blasted, and is likely to be black-balled by other desirable clubs. The former trade unionist is ostracized by union members. A student like Shelley who has been excluded from college is branded for years to come, and deprived of intimate associations with places and companions. Excommunication from a church means loss of the opportunity to worship God in familiar surroundings with a cherished ritual, and inflicts upon the devout believer loneliness of spirit In comparison with such emotional deprivations, mere losses of property often appear trivial. . . ." [43 Cal.2d at 590-591, 275 P.2d at 480 (Carter, J., in dissent).]

The requirement of a hearing is not excessively burdensome on corporations, particularly since "proper" hearing should not be interpreted to mean a hearing sufficient to satisfy all of the requirements of "due process." It should be satisfied if the member charged with violating a rule of the organization is given an opportunity to rebut the charges before the governing body.

There is an exception to Section 704(b). The articles may provide for expulsion upon lesser grounds and with lesser procedural protection. This exception permits flexibility in corporate organization while, at the same time, protecting the valid interests of members. A member has no grounds to complain if he joins an organization with "notice" that he may be expelled without cause or hearing or, in the case of an amendment to the articles, it does not seem unfair to compel a member to abide by the decision of his fellow members to reduce the rights of the membership.

Subdivision (c) of Section 704 also provides a new protection for members. If there is no valid procedure in the articles or bylaws concerning resignation, a member may resign by giving the corporation 30 days' written notice. This is consistent with the principal, announced in Haynes v. Annandale Golf Club, 4 Cal.2d 28, 47 P.2d 470 (1935), that a member should not be forced to remain indefinitely committed against his will to the obligations of membership in a nonprofit corporation. The 30-day period gives the corporation time to adjust its records and solicit a new member.

ISSUES TO BE RESOLVED:

1. Should all members' rights terminate upon death, resignation, expulsion, or expiration of the term of membership if a contrary position is not taken in the articles or bylaws? (Recommendation--Yes.)
2. Should members generally be subject to expulsion without cause and a hearing before the governing board? (Recommendation--No.)
3. Should the requirements of a "proper hearing" be set forth in more detail? (Recommendation--No.)
4. Should the corporation be permitted to expel a member without a hearing and without cause if this power is granted by the articles? (Recommendation--Yes.)
5. Should this code specify a procedure for resignation of membership? (Recommendation--Yes.)

999-325

§ 705. Transfer of membership

705. No member may transfer his membership or any right arising therefrom unless the articles or bylaws so provide.

Comment. Section 705 is the same as former Section 9609 of the Corporations Code (General Nonprofit Corporation Law) and is the same in substance as subdivision (d) of Section 7767 of Pennsylvania's Corporation Not-for-profit Code. It prohibits the transfer of membership rights except as provided in the articles or bylaws.

ISSUE TO BE RESOLVED:

1. Should membership rights be freely transferable? (Recommendation--No.)

§ 706. Property and other rights of members

706. Unless the articles or bylaws set forth the rule or rules fixing voting, property, and other rights and interests of each member or class of members, the rights and interests of members are equal as to any right or interest not so fixed.

Comment. Section 706, which is the same in substance as the last sentence of former Section 9602 of the Corporations Code (General Nonprofit Corporation Law), makes clear that, in the absence of a provision in the articles or bylaws expressly providing for unequal membership rights or interests, the rights and interests are equal. Section 706 complements Section 601 which provides that, in the absence of a controlling provision in the articles, the bylaws shall set forth the voting, property, and other rights and interests of each member if they are unequal.

ISSUE TO BE RESOLVED:

1. Should the articles or bylaws be permitted to specify unequal membership rights? (Recommendation--Yes.)

999-327

§ 707. Liability of members

707. Members of a nonprofit corporation are not personally liable for the debts, liabilities, or obligations of the corporation.

Comment. Section 707 is the same as former Section 9610 of the Corporations Code (General Nonprofit Corporation Law). It is the same in substance as Section 517(a) of New York's Not-for-Profit Corporation Law and part of Section 11 of the ABA-ALI Model Non-Profit Corporation Act.

ISSUE TO BE RESOLVED:

1. Should members be liable under any circumstances for the corporate debts? (Recommendation--No.)

999-330

§ 708. Dues; assessments

708. (a) A nonprofit corporation may levy dues or assessments or both upon its members pursuant to any provision of its articles or bylaws authorizing the levy of dues or assessments.

(b) The articles or bylaws may authorize dues or assessments, or both, to be levied upon all members or classes of membership alike or in different amounts or proportions or upon a different basis upon different members or classes of membership and may exempt some members or classes of membership from either dues or assessments, or both.

(c) The articles or bylaws may fix the amount and method of collection of dues or assessments, or both, or may authorize the board of directors to fix the amount thereof from time to time and make them payable at such times or intervals, and upon such notice, and by such methods as the directors may prescribe. Dues or assessments, or both, may be made enforceable by action or by the sale or forfeiture of membership, or both, upon reasonable notice.

Comment. Subdivision (a) of Section 708 is the same in substance as former Section 9611 of the Corporations Code (General Nonprofit Corporation Law). Subdivisions (b) and (c) are the same as the last two paragraphs in former Section 9301 of the Corporations Code (General Nonprofit Corporation Law). It should be noted that Section 708 complements Section 601 which requires that any rule establishing the liability of members for dues or

assessments be enacted as a bylaw unless such a provision is found in the articles of incorporation.

ISSUES TO BE RESOLVED:

1. Should dues or assessments be leviable upon individual members or classes of members in different amounts? (Recommendation--Yes.)

2. Should dues or assessments be enforceable by sale or forfeiture of membership upon notice without a hearing? (Recommendation--Yes.)

999-550

§ 709. Reduction of members below stated number

709. Unless the articles otherwise provide, if the members of a nonprofit corporation having a stated number of members are reduced below that number by death, withdrawal, or otherwise, the corporation shall not be dissolved for that reason, and the surviving or continuing members may fill vacancies and continue the corporate existence.

Comment. Section 709 is substantially the same as former Section 9605 of the Corporations Code (General Nonprofit Corporation Law). A corporation may elect to dissolve when its membership falls below a stated number by providing in its articles for expiration of its term of existence upon that condition. See Sections 303 (power of corporation to provide for limited duration in its articles) and 1503(c)(dissolution upon expiration of the term of existence).

Article 2. Meetings of Members; Voting

§ 751. Regular and annual meetings

751. (a) The articles or bylaws may provide for the number, time, and place of meetings of members or dispense entirely with regular or annual meetings; but, unless otherwise provided for in the articles or a bylaw adopted by the members, a meeting shall be held at least once each calendar year for the election of directors at such time and place as is provided in or fixed pursuant to authority granted by the articles or bylaws.

(b) Failure to hold the annual or other regular meeting at the designated time does not work a dissolution of the corporation; but, if the annual or other regular meeting is not called and held within six months after the designated time, any member may call the meeting at any time thereafter after giving notice as provided in Section 754.

Comment. Section 751 is modeled after subdivision (a) of Section 7755 of Pennsylvania's Corporation Not-for-profit Code. Subdivision (a) states the general rule that an annual meeting of the members must be held to elect directors unless the articles or a bylaw adopted by the members either dispenses with regular or annual meetings or provides other times for a meeting of the members. Cf. Section 758 (articles or a bylaw adopted by the members may provide for a manner of voting other than at a meeting of the members). Subdivision (b) provides that failure to call a required meeting will not work a dissolution of the corporation but, rather, will entitle any member after the meeting is six months overdue to call a meeting of the members.

Analysis

Many corporation codes, including New York's Not-for-Profit Corporation Law, provide for a mandatory annual meeting of the members. See N.Y. Not-for-Profit Corporation Law § 603 and ABA-ALI Model Non-Profit Corporation

Act § 13; see also Cal. Corp. Code § 2200 (General Corporation Law). However, a mandatory meeting of the members would be an expensive and futile rule for many nonprofit corporations. Without the profit incentive to spur member interest, it is questionable whether many such organizations could engage in a meaningful business at a meeting of the members even with liberal quorum and proxy rules to support the effort.

A better approach is to permit corporations to adjust the timing of regular meetings to fit their individual needs or, if necessary, to dispense with regular meetings entirely. However, to protect against oversight and to force corporations to directly confront this issue and make a decision which is recorded for all to see, an annual meeting should be required in the absence of affirmative corporate action in the articles or in a bylaw adopted by the members. The above approach is incorporated into Section 751.

Present California law for nonprofit corporations probably does not require a meeting of the members regardless of whether or not there is a provision on this matter in the articles or the bylaws.¹ Section 9600 of the Corporations Code (General Nonprofit Corporation Law) provides who may call a meeting of the members, but nothing in the statute

1. It is possible that the courts might construe the mandatory annual meeting requirement of Section 2200 of the Corporations Code (General Corporation Law) to apply to nonprofit corporations according to the following reasoning process: Section 9002 of the Corporations Code (General Nonprofit Corporation Law) makes the General Corporation Law applicable in all areas not "specifically" governed by the General Nonprofit Corporation Law, and there is no provision in the General Nonprofit Corporation Law explicitly covering the timing of meetings of the members. Section 2200 requires an annual meeting of the "shareholders," but Section 103 of the Corporations Code defines this to include members of a "nonstock corporation," which itself is defined by Section 107 of the Corporations Code to include all corporations which are not stock corporations. However, it is doubtful that the Legislature intended Section 2200 to apply to nonprofit corporations. The drafters probably believed that Sections 9401 and 9600 dealt in sufficient specificity with timing of meetings of the members to preclude application of any of the General Corporation Law rules on this matter. In general, the courts should not read "specifically otherwise provided" too narrowly. When an area has been dealt with generally in the General Nonprofit Corporation Law, it should be sufficient to preclude application of the General Corporation Law.

itself requires that a meeting ever be called. Section 751 rejects this approach as explained above.

ISSUES TO BE RESOLVED:

1. Should an annual meeting of the members be required for every nonprofit corporation? (Recommendation--No.)

2. Should a corporation be permitted to dispense entirely with regular or annual meetings pursuant to an appropriate provision in its articles or bylaws? (Recommendation--Yes.)

3. Should an annual meeting be required if there is no contrary provision in the articles or a bylaw adopted by the members? (Recommendation--Yes.)

999-332

§ 752. Special meetings

752. Special meetings of the members where any business of the corporation which is a proper subject for action by the members may be transacted (including the election of directors) may be called by the board, by such person or persons as may be authorized by the articles or bylaws, and by members holding not less than 10 percent of the total number of votes entitled to be cast at such meeting. The right of members to call a special meeting pursuant to this section may not be abolished by any provision in the articles or the bylaws.

Comment. Section 752 is similar to Section 603(c) of New York's Not-for-Profit Corporation Law. Like former Section 9600 of the Corporations Code (General Nonprofit Corporation Law), it provides that meetings of the members may be called by members holding not less than 10 percent of the total number of votes entitled to be cast at such meetings. This provision also makes clear that all business which may be transacted in

regular meetings of the members may be transacted at special meetings. Moreover, the member's right to call a special meeting may not be abolished by a contrary rule in the articles or the bylaws.

These rules insure that, even if a corporation has abolished regular meetings of the members, a meeting may still be called by the board or by 10 percent of the members. A meeting of the members is potentially a powerful check on the effectiveness of officers and directors, and the threat of such a meeting should never be completely removed.

ISSUES TO BE RESOLVED:

1. Should a corporation be permitted to abolish special meetings in its articles or bylaws? (Recommendation--No.)
2. Should less than 10% of the members entitled to vote be permitted to call a special meeting? (Recommendation--No.)
3. Should directors be electable at a special meeting? (Recommendation--Yes.)

999-333

§ 753. Adjournments

753. Any regular or special meeting may be adjourned, but any meeting at which directors are to be elected may be adjourned only from day to day, or for longer periods not exceeding 15 days each, as the members present entitled to cast at least a majority of the votes which all members present and voting are entitled to cast shall direct until directors have been elected.

Comment. Section 753 is the same in substance as Section 7755(c) of Pennsylvania's Corporation Not-for-profit Code. It permits the adjournment of regular or special meetings subject to special rules for meetings at which directors are to be elected.

ISSUE TO BE RESOLVED:

1. Are special rules necessary for the adjournment of meetings at which directors are to be elected? (Recommendation--Yes.)

999-334

§ 754. Notice to members of meetings

754. (a) Subject to subdivisions (d), (e), and (f), notice of any regular or special meeting of members shall be sent to each member entitled thereto not less than seven days before the meeting. The notice shall specify the place, the day, and the hour of the meeting, and, in the case of a special meeting, the purpose for which the meeting is called.

(b) The notice may be given to the member, either personally or by mail or other means of written communication, charges prepaid, addressed to the member at his address appearing on the books of the corporation or given by him to the corporation for the purpose of notice. If a member gives no address, notice may be given him by mail or other means of written communication addressed to the place where the principal office of the corporation is situated or may be published at least once in some newspaper of general circulation in the county in which the office is located.

(c) Whenever notice is mailed, the notice shall be deemed to be given when deposited in the United States mail, with postage prepaid, addressed to the member in compliance with subdivision (b). An affidavit of the person giving the notice that the notice required by this section has been given is prima facie evidence of the facts therein stated.

(d) If the corporation has more than 500 members, notice of any meeting of the members may be given by publication, in lieu of mailing,

in a newspaper of general circulation in the county in which the principal office of the corporation is located, once a week for two successive weeks next preceding the date of the meeting.

(e) Notice of meetings need not be given to any member who submits a signed waiver of notice, in person or by proxy, whether before or after the meeting. The attendance of any member at a meeting, in person or by proxy, without protesting prior to the conclusion of the meeting the lack of notice of such meeting, constitutes a waiver of notice by him.

(f) If the articles or bylaws so provide, a corporation may dispense with notice of all regular meetings of members held at a regular place and time as prescribed in the articles or bylaws.

Comment. Section 754 is designed to establish firm rules for giving notice of a meeting of the members. Subdivisions (a) and (b), which state the general rule requiring seven days' written notice to be delivered either by mail or personally, are the same in substance as Sections 2205 and 2206 of the Corporations Code (General Corporation Law). But see former Section 9401 of the Corporations Code (General Nonprofit Corporation Law) (bylaws may provide manner of giving notice of meetings of the members).

Subdivision (c) is derived from a portion of Section 605(a) of New York's Not-for-Profit Corporation Law.

Subdivision (d) provides an alternative to the notice required in subdivision (b) for corporations with over 500 members. In that case, notice may be given by publication in a local newspaper. The publication requirement is based on a portion of Section 605(a) of New York's Not-for-Profit Corporation Law.

Subdivision (e) is the same in substance as Section 606 of New York's Not-for-Profit Corporation Law and is similar to Section 2209 of the Corporations Code (General Corporation Law).

Subdivision (f) is completely new in form; however, it has the same practical effect as part of former Section 9401(a) of the Corporations

Code (General Nonprofit Corporation Law) which gave corporations the power to dispense with notice in the bylaws. This subdivision clearly establishes that corporations may continue to structure their bylaws so as to dispense with notice for regular meetings. See California Nonprofit Corporations, Rath, Formation § 2.52 (meetings)(Cal. Cont. Ed. Bar 1969).

Analysis

This section follows fairly closely the existing law on notice of shareholder's meetings found in Sections 2205 and 2206 of the Corporations Code (General Corporation Law). These rules presently govern a nonprofit corporation only if it fails to provide for other notice in its bylaws pursuant to Corporations Code Section 9401(b). See Corp. Code § 9002. To discourage abuse, a better statutory approach is to provide clear but flexible notice rules. A corporation should not be permitted to establish its own notice rules without any limitation.

Subdivision (d) provides an alternative method for giving notice when a corporation has more than 500 members. When that condition is met, publication in a local paper is sufficient. This alternative reduces the potential expense of notice without excessively reducing the opportunity for members to learn of the meeting. A balance must be struck between the certainty of notice and the expense involved. Personal notice, because it is not certain, is always preferable; however, if the expense is too great, a corporation should be permitted to abandon this form of notice. The size of the mailing which depends upon the number of members is obviously the best index by which to measure expense. The 500-member rule follows Section 605 of New York's Not-for-Profit Corporation Law and strikes the balance at that point. The expense of notice is a particularly important factor when a meeting is called by an individual member pursuant to Section 751(b)(regular meeting six months overdue) or when a special meeting is called by 10 percent of the members pursuant to Section 752. If the expense of notice is too great, the effectiveness of those sections will be undermined.

Subdivision (f) makes clear that the new provision does not affect the established practice of providing in the bylaws that there shall

be no notice for regular meetings held at the regular time and place as set forth in the articles or bylaws. This practice is expressly approved.

ISSUES TO BE RESOLVED:

1. Should notice of a regular or annual meeting specify the business to be transacted? (Recommendation--No.)

2. Should corporations with more than 500 members be permitted by statutory right to substitute published notice for personal notice? (Recommendation--Yes.)

3. Should a corporation be permitted to dispense with notice of regular meetings which are held as prescribed in the articles or bylaws? (Recommendation--Yes.)

999-337

§ 755. Quorum

755. (a) Unless the articles or the bylaws provide a different number:

(1) The presence in person or by proxy of the persons entitled to vote a majority of the voting power at any meeting constitutes a quorum for the transaction of business.

(2) When a specified item of business is required to be voted on by a class of members, voting as a class, members entitled to cast a majority of the total number of votes entitled to be cast by such class constitute a quorum for the transaction of such specified item of business.

(b) Memberships shall not be counted to make up a quorum for a meeting if voting them at the meeting has been enjoined or for any reason they cannot be lawfully voted at the meeting.

(c) The members by a majority vote of those present may adjourn the meeting despite the absence of a quorum.

(d) The members present at a duly called or held meeting at which a quorum is present may continue to do business until adjournment notwithstanding the withdrawal of enough members to leave less than a quorum.

Comment. Subdivision (a) of Section 755 is the same in substance as the first part of Section 2211 of the Corporations Code (General Corporation Law) except that more detail is added concerning what constitutes a quorum for a class vote when a specified item of business is required to be decided by a particular class of members. This section retains the power granted by former Section 9401(b) of the Corporations Code (General Nonprofit Corporation Law) to alter the "majority of members entitled to vote equals a quorum" rule by an appropriate bylaw and also provides that a change in the general quorum requirement may be made by the articles.

Subdivision (b) is exactly the same as the second paragraph of Section 2211 of the Corporations Code (General Corporation Law). It provides a rule on how to calculate a quorum when members ineligible to vote are present.

Subdivision (c) is the same in substance as Section 2213 of the Corporations Code (General Corporation Law), but the language is taken from Section 608(c) of New York's Not-for-Profit Corporation Law. It provides that lack of a quorum does not preclude adjournment by a majority of votes present.

Subdivision (d) is the same in substance as Section 2212 of the Corporations Code (General Corporation Law).

Analysis

Section 755 does not modify existing law found in Corporations Code Sections 2211, 2212, 2213, and 9401(b) in any major respect. The language of those sections has been altered for increased clarity and more detail has been added concerning a quorum for class votes. No other changes are required as present law is very flexible and conforms to that found in other modern codes. See, e.g., Section 608 of New York's Not-for-Profit Corporation Law.

ISSUE TO BE RESOLVED:

1. Should a corporation be permitted to specify that some number which is less than a majority of the voting power of the corporation constitutes a quorum for the transaction of business? (Recommendation--Yes.)

999-338

§ 756. Record date for determining members

756. Unless the articles or bylaws otherwise provide, the board may fix a time in the future as a record date for the determination of the members entitled to notice of and to vote at any meeting or other vote of the members. The record date so fixed shall not be more than 50 days prior to the date of the meeting or vote for the purposes of which it is fixed. When a record date is so fixed, only members of record on that date are entitled to notice of and to vote at the meeting or other vote or to exercise the rights of membership, as the case may be, notwithstanding any transfer of membership pursuant to the articles or bylaws on the books of the corporation after the record date.

Comment. Section 756 is the same in substance as Section 2214 of the Corporations Code (General Corporation Law). The language has merely been changed to conform to nonprofit corporation terminology. The section establishes the record date for members entitled to exercise the privileges of membership at a meeting or vote of the members. The board is given discretion to set the date, but it must not be over 50 days from the meeting or other vote.

ISSUE TO BE RESOLVED:

1. Should a corporation be permitted to specify a record date which is more than 50 days from the date of the members' vote for which it is fixed? (Recommendation--No.)

§ 757. List of members eligible to vote

757. A list or record of members entitled to vote, certified by the corporate officers or others responsible for its preparation or by a transfer agent, shall be produced at any meeting of members upon the request of any member who has given written notice to the corporation that such request will be made at least 10 days prior to the meeting. If the right to vote at any meeting is challenged, the inspectors of election or the person presiding shall require the list or record of members to be produced as evidence of the right of the persons challenged to vote at the meeting, and all persons appearing on the list or record as members entitled to vote may vote at the meeting.

Comment. Section 757 is new and is substantially the same as Section 607 of New York's Not-for-Profit Corporation Law. It establishes the right of a member to require the corporation to produce a list of members entitled to vote at a particular meeting of the members. Such a list helps reduce the danger of confusion and controversy surrounding who may vote at a particular meeting.

ISSUE TO BE RESOLVED:

1. Should a member be permitted to require the corporation to produce at the meeting a list of members entitled to vote at that meeting? (Recommendation--Yes.)

§ 758. Voting rights; voting by class; manner of voting

758. (a) Unless the articles or bylaws provide otherwise, every member of a nonprofit corporation is entitled to one vote and may act or vote by proxy as provided in Section 760.

(b) The articles or the bylaws may contain provisions specifying that any class or classes of members shall vote as a class in connection with the transaction of any business or any specified item of business at a meeting of the members or otherwise as permitted by subdivision (c), including amendments to the articles. If such a provision exists, any percentage vote or written consent required by this code to authorize a particular corporate action is satisfied by the percentage vote or written consent of each class of members entitled to vote in the election.

(c) The articles or a bylaw adopted by the members may specify a manner of voting on corporate affairs other than at a meeting of the members. Such means may be by mail, ballot, or any other reasonable means, or a combination of means.

(d) The manner of voting at a meeting of the members may be by ballot or any other reasonable means as provided in the articles or bylaws.

Comment. Subdivision (a) of Section 758 is the same as the first sentence of former Section 9601 of the Corporations Code (General Nonprofit Corporation Law). It states the general rule for nonprofit corporations that each member is entitled to only one vote, but it also provides that this formula may be altered by an appropriate provision in the articles or the bylaws.

Subdivision (b) is the same in substance as part of Section 616 of New York's Not-for-Profit Corporation Law. It provides the same general grant of authority to regulate class voting in the bylaws formerly found in Section 9402 of the Corporations Code (General Nonprofit Corporation Law). More detail is added to this provision for clarity and, furthermore, it provides that class voting requirements may also be written into the articles. It should be noted that the general numerical vote requirements

for class voting are found in Section 761, and Section 601 requires that any unequal class voting rights must be set forth in the bylaws if the articles have no provision on this matter.

Subdivision (c) is derived from the second sentence of former Section 9601. It permits nonprofit corporations a great amount of flexibility in the manner of voting. A vote of the members is expressly not limited to voting at a meeting of the members but may be by mail, ballot, or other reasonable means if an article or a bylaw adopted by the members so provides. This approach may be contrasted with Section 2239 of the Corporations Code (General Corporation Law) which permits action without a meeting only by unanimous consent of those entitled to vote. It should be noted that "reasonable means" should be interpreted to require "reasonable notice" of votes to be taken pursuant to a procedure adopted pursuant to this subdivision.

Subdivision (d) continues the substance of a part of former Section 9601. It may be contrasted with Section 2234 of the Corporations Code which permits any shareholder to request a vote by ballot when directors are being elected.

Analysis

The established norm for nonprofit corporations is the rule of one-member, one-vote.¹ Subdivision (a) expressly adopts this norm unless there is a contrary provision in the articles or the bylaws. This flexibility is also consistent with most modern nonprofit codes.²

Subdivision (b) complements the power to create differing classes of members set forth in Section 702. It provides that these classes may vote as a class if the articles or bylaws so provide. The right to vote by class in order to protect class interests is the most important reason for the creation of membership classes permitted under Section 702.

1. See *Green Gables Home Owner's Ass'n v. Sunlite Homes*, 202 P.2d 143 (1949).

2. See N.Y. Not-for-Profit Corporation Law § 611(e); ABA-ALI Model Non-Profit Corporation Act § 15.

The provision in subdivision (c) for alternative means of voting besides the traditional meeting of the members is an important aspect of this code. Section 751 dispenses with the mandatory annual meeting requirement of the General Corporation Law and, therefore, the corporation must be permitted to use other means to poll the membership on such issues as the election of directors. See the Comment and Analysis to Section 751 for an explanation of why increased flexibility in voting procedures is advisable for nonprofit corporations.

ISSUES TO BE RESOLVED:

1. Should any member be permitted to have more than one vote? (Recommendation--Yes.)
2. Should this code permit class voting? (Recommendation--Yes.)
3. Should a corporation be permitted to establish a reasonable manner of voting other than at a meeting of the members? (Recommendation--Yes.)
4. Should detailed notice rules be established for such a voting procedure? (Recommendation--No.)
5. Should this code require votes at a meeting of the members to be by ballot? (Recommendation--No.)

999-345

§ 759. Cumulative voting

759. Unless otherwise prohibited by this code, the articles or bylaws may provide that, in all elections of directors of the corporation, each member shall be entitled to as many votes as shall equal the number of votes which, except for the provisions as to cumulative voting, he would be entitled to cast for the election of directors multiplied by the number of directors to be elected, and he may cast all of such votes for a single director or may distribute them among the number to be voted for, or for

any two or more of them, as he may see fit, which right, when exercised, shall be termed cumulative voting. Unless the articles or the bylaws provide otherwise, a corporation shall not employ cumulative voting.

Comment. Section 759 is the same in substance as the last sentence of former Corporations Code Section 9601 except that this new provision defines cumulative voting as it is defined in Section 617 of New York's Not-for-Profit Corporation Law. The former section left this term undefined. Cumulative voting is prohibited unless expressly provided for in the articles or the bylaws.

By an appropriate provision in the articles or the bylaws, a nonprofit corporation may provide for cumulative voting as a means to protect minority interests by insuring minority representation on the board of directors.

ISSUES TO BE RESOLVED:

1. Should cumulative voting be required? (Recommendation--No.)
2. Should cumulative voting be permitted? (Recommendation--Yes.)

999-346

§ 760. Proxies

760. (a) Except as otherwise provided in this code, the articles, or the bylaws, every person entitled to vote or execute consents may do so either in person or by one or more agents authorized by a written proxy executed by the person or his duly authorized agent and filed with the secretary of the corporation or other officer charged with filing proxy authorizations. A fiduciary may give a proxy.

(b) A proxy is not valid after the expiration of 11 months from the date of its execution unless the person executing it specifies therein

the length of time for which it is to continue in force, which in no case shall exceed three years from the date of execution. A proxy is not revoked, and continues in full force and effect, until an instrument revoking it, or a proxy bearing a later date, is filed with the secretary of the corporation or other officer charged with filing proxy authorizations.

(c) Except as provided in subdivision (e), notwithstanding that a valid proxy is outstanding, the powers of the proxy holder are suspended if the person executing the proxy is present at a meeting and elects to vote in person.

(d) A proxy is not revoked by the death or incapacity of the maker unless, before the vote is counted or the authority is exercised, written notice of death or incapacity is given to the corporation.

(e) A proxy is revokable at the pleasure of the member executing it, but a proxy which is entitled "irrevocable proxy" and which states that it is irrevocable is irrevocable subject to the provisions of Section 765 regarding voting agreements among members when it is coupled with an interest.

Comment. Section 760 follows in large part the substance of the proxy rules of Corporations Code Sections 2225-2228. However, there are some important differences. A nonprofit corporation may outlaw proxies by an appropriate provision in the articles or bylaws. Former Section 9601 of the Corporations Code (General Nonprofit Corporation Law) also contained such a provision. A proxy may not continue in force for a period to exceed three years--a provision which is derived from Section 7759 of Pennsylvania's Corporation Not-for-profit Code. The old rule set forth in Corporations Code Section 2226 was seven years. Subdivision (e) requires irrevocable proxies to be clearly labeled irrevocable. This requirement follows Section 609(a)(6) of New York's Not-for-Profit

Corporation Law and is designed to facilitate the determination of valid proxies at a meeting.

ISSUES TO BE RESOLVED:

1. Should members be permitted to vote by proxy? (Recommendation--Yes.)
2. Should proxies be valid for a period greater than three years? (Recommendation--No.)
3. Should proxies be irrevocable under certain limited conditions? (Recommendation--Yes.)
4. Should management be permitted to solicit proxies at the corporation's expense without statutory restriction? (Recommendation--Yes.)

999-347

§ 761. Vote sufficient for particular actions

761. (a) Except as otherwise required by this code or by the articles or the bylaws, directors shall be elected by a plurality of the votes cast by the members or class of members entitled to vote in the election.

(b) Whenever any corporate action, other than the election of directors, is to be taken under this code by vote of the members or class of members, it shall, except as otherwise required by this code or by the articles or the bylaws, be authorized by a majority of the votes cast by the members entitled to vote thereon.

Comment. Subdivision (a) establishes the basic rule that a plurality of votes is sufficient to elect directors for a nonprofit corporation. This rule is the same as Section 613(a) of New York's Not-for-Profit Corporation Law. Prior law contained no rule on this matter.

Subdivision (b) is the same in substance as Section 613(b) of New York's Not-for-Profit Corporation Law.

Analysis

Even though majority rule has long been the tradition for authorizing action by the membership, it is wise to expressly state this rule in order to eliminate any possibility of litigation on this issue. It should be noted that Section 761 only requires the approval of a majority of the votes cast to authorize corporate action. This is to insure that a corporation will not be immobilized by a large number of disinterested members, a real possibility for nonprofit corporations.

The New York plurality rule for the election of directors has been chosen so that expensive and time-delaying run-off elections will not be necessary. Such a rule is particularly necessary given the fact that, pursuant to Section 758, corporations may elect directors by mail or similar convenient but expensive means.

ISSUES TO BE RESOLVED:

1. Is a general provision for voting requirements necessary?
(Recommendation--Yes.)

2. Should directors be elected by a plurality of the votes cast?
(Recommendation--Yes.)

999-348

§ 762. Inspectors

762. (a) If the bylaws require inspectors at any meeting of members, the requirement is waived unless compliance is requested by a member present in person or by proxy and entitled to vote at such meeting. Unless otherwise provided in the bylaws, in advance of any meeting of members, the board of directors may appoint inspectors of election to act at the meeting or any adjournment. If inspectors are not so appointed, the chairman of any meeting of members may or, on the request of any member or his proxy, shall appoint inspectors of election at the meeting.

(b) The number of inspectors shall be either one or three. If appointed at a meeting on the request of one or more members or proxies, the majority of members present shall determine whether one or three inspectors are to be appointed.

(c) In case any person appointed as inspector fails to appear or fails or refuses to act, the vacancy may be filled by appointment made by the board of directors in advance of the convening of the meeting or at the meeting by the person acting as chairman.

Comment. The first sentence of subdivision (a) of Section 762 is taken from Section 610 of New York's Not-for-Profit Corporation Law. It provides that, even if inspectors are required by the bylaws, this requirement is waived if no member at the meeting requests its implementation. This provision is designed to excuse the fulfillment of a needless requirement where an election involves no controversy. The remaining sentences in subdivision (a) are the same in substance as Section 2232 of the Corporations Code (General Corporation Law). They establish the general rule that inspectors must be appointed upon the request of any member who is present at the meeting either in person or by proxy and entitled to vote.

Subdivisions (b) and (c) are the same as the second and third paragraphs of Section 2232 of the Corporations Code (General Corporation Law). These subdivisions establish basic rules concerning the number of inspectors and the filling of vacancies.

Analysis

This code adopts the general rules for the selection of inspectors found in Section 2232 of the Corporations Code (General Corporation Law). Most modern codes have very similar rules. See Section 610 of New York's Not-for-Profit Corporation Law; Section 7762 of Pennsylvania's Corporation Not-for-profit Code of 1972.

ISSUE TO BE RESOLVED:

1. Should this code require the appointment of inspectors upon the request of any member who is present at the meeting either in person or by proxy? (Recommendation--Yes.)

§ 763. Duties of inspectors

763. (a) The inspectors of election shall determine the number of memberships outstanding and the voting power of each, the memberships represented at the meeting, the existence of a quorum, the validity and effect of proxies, and shall receive votes, ballots, or consents, hear and determine all challenges and questions arising in connection with the right to vote, count and tabulate all votes, ballots, or consents, determine the result, and do such acts as are proper to conduct the election or vote with fairness to all members.

(b) On request of the person presiding at the meeting or any members entitled to vote, the inspectors shall make a report in writing of any challenge, question, or matter determined by them and execute a certificate of any fact found by them. Any report or certificate made by them is prima facie evidence of the facts stated therein.

Comment. Section 763 is the same in substance as Section 2233 of the Corporations Code (General Corporation Law).

999-350

§ 764. Consent to action without a meeting

764. Any action which may be taken at a meeting of the members, except adjournment of a special meeting called by 10 percent of the members pursuant to Section 752, may be taken without a meeting if consent in writing, setting forth the action, is signed by a majority of the members or of each class of members (or other percentage as provided in this

code for certain items of business) who would be entitled to vote at a meeting for such purpose and filed with the secretary of the corporation or other appropriate officer.

Comment. Section 764 is similar to Section 2239 of the Corporations Code (General Corporation Law); however, that section requires the unanimous consent of those entitled to vote before action may be taken without a meeting. Generally, Section 764 requires only the consent of a majority of the members or of each class of members entitled to vote. However, when this code requires a different percentage of members to authorize a specific type of action by the corporation, Section 764 requires the written consent of that percentage before such action may be taken without a meeting.

The rule in Section 764 is consistent with the philosophy of Section 751 which permits a corporation to dispense with annual or regular meetings of the members by an appropriate bylaw adopted by the members (bylaws may be adopted pursuant to Section 603 by a majority vote of the members entitled to vote) and also Section 758(c) which permits the corporation to prescribe in a bylaw adopted by the members an alternative manner of voting besides at a meeting of the members.

An exception is made in Section 764 for adjournments of special meetings to insure that the right of 10 percent of the members to call a special meeting--granted in Section 752--will not be circumvented by improper application of this section.

Analysis

Section 764 is consistent with the flexible voting procedures recommended in Sections 752 and 758(c). See the Comment and Analysis of those sections for an explanation of why this flexible approach is desirable.

Given those two sections, Section 764 is necessary as it permits a corporation to act on specific matters using the written consent method without having to alter in general its regular or annual meeting of the members' requirements through an appropriate amendment to the bylaws. Not to allow this approach would be unjustifiable given Sections 752 and 758(c).

ISSUES TO BE RESOLVED:

1. Should the membership action by written consent requirements of Corporations Code Section 2239 be liberalized? (Recommendation--Yes.)

2. Should a corporation be permitted to specify in its articles or bylaws a greater percentage for membership action by written consent? (Recommendation--No.)

999-351

§ 765. Agreements as to voting

765. A written agreement between two or more members, signed by the parties, may provide that, in exercising their voting rights as members, they shall vote as provided or as they may agree or as determined in accordance with a procedure agreed upon by them. If there is no contrary provision in the agreement, it may be terminated at any time by the holders of a majority of the memberships bound by the agreement. No voting agreement shall be made irrevocable for a period of more than three years.

Comment. Section 765, permitting voting agreements, is modeled on Section 619 of New York's Not-for-Profit Corporation Law. It replaces the voting trust concept permitted under Section 2230 of the Corporations Code (General Corporation Law). This new device is simpler in operation and more appropriate for nonprofit corporations as there is no economic incentive or other good reason for members of such corporations to transfer their voting rights to a trustee.

The second sentence of Section 765 provides rules concerning the termination and revocability of voting agreements. These rules are similar to those for voting trusts found in Section 2231 of the Corporations Code (General Corporation Law).

ISSUES TO BE RESOLVED:

1. Should members be permitted to make binding voting agreements? (Recommendation--Yes.)
2. Should the voting trust concept be employed for nonprofit corporations? (Recommendation--No.)
3. Should voting agreements be revocable by other than majority vote? (Recommendation--No.)

999-355

§ 766. Judicial relief

766. Upon the filing of an action therefor by any member, the superior court shall try and determine the validity of any election or appointment of any director of any domestic corporation or for any foreign corporation if the election was held or the appointment made in this state. The provisions of Sections 2236, 2237, and 2238 of the Corporations Code apply to any action brought under this provision.

Comment. Section 766 is the same as the first part of Section 2236 of the Corporations Code which previously governed nonprofit corporations pursuant to former Section 9002 of the Corporations Code (General Nonprofit Corporation Law). This provision incorporates by reference the provisions set forth in Sections 2236, 2237, and 2238 of the Corporations Code. Those sections provide rules governing such actions. It should be noted that Section 2238 provides an equitable remedy and the scope of the inquiry into the contested election is not limited to technical and procedural questions but rather encompasses all factors bearing on the validity of the questioned elections. Baude & Ruddnick v. Havenner, Civil No. 33512 (1st App. Dist., filed April 1, 1974).

Analysis

Sections 2236-2238 of the Corporations Code (General Corporation Law), which provide for judicial hearing and relief in a contested election or appointment of directors, have generally received praise, particularly the "speedy" hearing provision. See Gitelson & Gitelson, Intra-Corporate Squabbles: Advantages of Corporations Code Sections 2236-2238, 43 L.A. Bar Bull. 405 (1968). Section 766 adopts these rules for nonprofit corporations.

ISSUE TO BE RESOLVED:

1. Should the Corporations Code provisions on judicial relief for contested elections be incorporated by reference? (Recommendation--Yes.)

999-356

Article 3. Members' Derivative Action

Analysis to Article 3

The member's derivative suit is a necessary device for enforcing the fiduciary duties of officers and directors, but it also can be used as a means to harass management or to promote other improper ends. Any statute which creates the power to bring a derivative action must be carefully structured. Meritorious claims must be encouraged while improper suits which can cripple the effective operation of a corporation by tying up the time of officers and directors in defense of their legitimate conduct must be discouraged.

Present law facilitates the member's derivation action by permitting the successful plaintiff to recover the costs of prosecuting the action including attorney's fees and, in general, California courts have not placed many limitations on this right.¹ In this respect, Article 3 follows the California common law philosophy. However, Section 778 provides the court with guidelines to aid in determining the amount of the award. The

1. Fletcher v. A.J. Industries, Inc., 266 Cal. App.2d 313, 72 Cal. Rptr. 146 (1968).

effort involved in successfully prosecuting the action is weighed against the result obtained, but recovery is not limited to situations where the corporation receives a future pecuniary benefit from the action.² Under this provision, expenses should be fully recoverable unless the claim concerns a purely trivial matter where the result does not justify the expense.

To reduce the danger of a derivative action being used as a "strike suit" to harass, present law provides for the mandatory posting of a security bond upon the defendant's motion if the court determines at a hearing that: (1) there is no reasonable probability that the prosecution of the cause of action will benefit the corporation or its members or (2) the moving party did not participate in the transaction in any capacity. If the plaintiff fails to post this security when required, the suit is dismissed.³ The present California security requirement with its hearing provision is certainly not as burdensome upon plaintiffs as the absolute rule of some jurisdictions.⁴ However, it is not the best approach to the problem of "strike" suits or improper causes of action for the hearing to determine whether or not to require the posting of security wastes the court's resources by requiring an inquiry into the substantive issues which will have to be duplicated later when the substantive issues themselves are addressed. Furthermore, it is easier and fairer for the court to assess the merits of the plaintiff's case at a later stage of the proceedings when the plaintiff has had an opportunity to engage in full discovery. The present statute is also potentially harmful to the interests of the defendant. If his motion for the posting of security is denied, the order denying his motion is not appealable,⁵ and it is not clear whether he may still recover

2. Similar rules are suggested by Comment, Attorney's Fees in Shareholder Derivative Suits: The Substantial Benefit Rule Reexamined, 60 Cal. L. Rev. 164 (1972).

3. Corp. Code § 834 (General Corporations Law).

4. See Hetherington, Fact and Legal Theory: Shareholders, Managers, and Corporate Social Responsibility, 21 Stan. L. Rev. 248, 260 n.50 (1969).

5. Efron v. Kalmanovitz, 185 Cal. App.2d 149, 8 Cal. Rptr. 107 (1960).

costs if he is successful because Section 834 of the Corporations Code seems to provide only for the recovery of costs from the fund placed as security. Of course, in the case posed, there is no such fund.

The proposed statute addresses the danger of improper suits in three ways. Before a derivative action may be brought, 50 or more members or at least 10 percent of the membership, whichever number is smaller, must join in the action. This requirement makes it less likely that the claim will be motivated by improper objectives. Moreover, Section 779 provides that the court shall award successful defendants their reasonable expenses including attorney's fees if the court, upon termination of the action, makes a factual finding which is similar to the one required for posting security under Corporations Code Section 834. Concerning the interrelationship between these two provisions of Article 3, it should be noted that the "50 members or 10-percent" rule makes it unlikely that a defendant will be unable to recover most of his awarded costs. A significant number of plaintiffs each liable for a proportionate share of the costs are not going to be judgment proof. Finally, Section 777 provides that the derivative action shall not be compromised or settled without the court's permission. The prospect of a secret settlement is an incentive for improper suits brought not to aid the corporation but rather for personal enrichment. Section 777 eliminates this incentive.

999-358

§ 775. Right to bring a derivative action

775. Fifty or more members or at least 10 percent of the membership, whichever number is smaller, of a domestic or foreign corporation may bring an action pursuant to this article in the right of the corporation to procure a judgment in its favor.

Comment. Section 775 alters the prior law on members' derivative actions for nonprofit corporations found in Section 834 of the Corporations Code (General Corporation Law) by requiring the consent of 50 or more members or at least 10 percent of the membership, whichever number is smaller, before an action may be brought in the name of the corporation whereas Section 834 of the Corporations Code (General Corporation Law) (as clarified by Section 103 of the Corporations Code regarding the definition of "holder of shares") permits any member to bring a derivative action if the other conditions of that section are met.

The "50 members or 10-percent" rule is comparable to Section 623 of New York's Not-for-Profit Corporation Law and is adopted as an alternative to the security for expenses requirement of Section 834(b) of the Corporations Code (General Corporation Law). Like a security requirement, this provision is designed to reduce the possibility of "strike" suits or harassment by members with an unjustified cause of action, for it is unlikely that a substantial number of the members will join in such an action particularly since Section 779 creates a potential liability for the defendant's expenses when an action is improperly brought.

The new "50 members or 10-percent" rule makes unnecessary the old contemporaneous ownership requirement, which was designed to insure against the purchase of a membership for the purpose of bringing suit, as no group is likely to purchase that many memberships in order to bring suit under this section. See Section 776. It should be noted that Section 701(a) prohibits any member from owning more than one membership.

ISSUES TO BE RESOLVED:

1. Should a smaller number of members be permitted to bring a derivative action? (Recommendation--No.)

2. Should foreign corporations be subject to California derivative actions? (Recommendation--Yes.)

§ 776. Allegations of complaint

776. In an action brought pursuant to Section 775, the complaint shall allege all of the following:

(a) Each plaintiff is a member of the corporation at the time the action is commenced.

(b) The effort, with particularity, to secure the action desired from the board or the reason for the plaintiffs not making an effort to gain this action.

(c) The corporation or the board has been informed in writing of the factual basis for each cause of action against each defendant. This requirement is satisfied by an allegation that a copy of the complaint to be filed has been delivered to the corporation or the board.

Comment. Section 776 is derived in large part from Section 834 of the Corporations Code (General Corporation Law). However, subdivision (a) abandons the rule set forth in that law which requires the plaintiff to be a member at the point of the disputed transaction. The new rule adopted in Section 775 requiring 50 or more members or 10 percent of the membership, whichever number is smaller, to join in the derivative action makes unnecessary the contemporaneous ownership requirement of the Corporations Code. See the Comment to Section 775.

Subdivisions (b) and (c) continue the substance of the notice and demand requirements found in Section 834(a)(2) of the Corporations Code. The complaint must allege that the corporation or its board of directors have been informed of the basic facts supporting the cause of action and either that a demand for affirmative action has been made and refused or that there are good reasons for not making such a demand. The corporation is thereby given the opportunity to act itself along normal channels before a suit may be brought in its name by complaining members.

ISSUES TO BE RESOLVED:

1. Should each plaintiff be required to be a member of the corporation at the point of the disputed transaction? (Recommendation--No.)
2. Prior to bringing an action, should the plaintiffs be required to make a specific demand upon the corporation for the desired action? (Recommendation--Yes.)

999-360

§ 777. Court approval required to discontinue or settle

777. An action brought pursuant to this article shall not be discontinued, compromised, or settled without the approval of the court.

Comment. Section 777 is the same as the first part of Section 623 of New York's Not-for-Profit Corporation Law. By requiring court approval before a derivative suit may be compromised or settled, it adds additional protection against suits brought for improper purposes such as the personal enrichment of the plaintiffs or their attorneys. The prospect of a secret settlement is an incentive for such improper suits.

ISSUE TO BE RESOLVED:

1. Should parties be permitted to settle without court approval? (Recommendation--No.)

999-361

§ 778. Prevailing plaintiffs' expenses

778. If the action on behalf of the corporation was successful in whole or in part, or if anything was received by the plaintiffs as a result of the judgment, compromise, or settlement of an action or claim,

the court may award such amount as is just under the circumstances for plaintiffs' expenses in bringing and prosecuting the action including attorney's fees. The court shall adjust the amount of the award to what is reasonable considering the magnitude of the effort and the result obtained, but the recovery of costs is not to be limited to situations where the corporation receives a substantial, future pecuniary benefit from the action. The plaintiffs shall account to the corporation for any recovery in excess of expenses awarded pursuant to this section.

Comment. Section 778 grants the court express authority to award expenses including attorney's fees to the plaintiffs if the action terminates favorably. The common law right to these expenses is clear after Fletcher v. A.J. Industries, Inc., 226 Cal. App.2d 313, 72 Cal. Rptr. 146 (1968). However, this section provides guidelines to aid the court in determining the amount of the award. In making this decision, the magnitude of the effort involved in successfully prosecuting the action and the result obtained are to be weighed; however, consistent with the holding in Fletcher, reimbursement for expenses is not to be limited to circumstances where the corporation receives substantial, future pecuniary benefit from the action. Any time the suit enforces a fiduciary duty of officers or directors, reasonable expenses should be recoverable.

ISSUES TO BE RESOLVED:

1. Should there be a statutory provision for awarding reasonable expenses to successful plaintiffs? (Recommendation--Yes.)
2. Should plaintiffs receive expenses only when the corporation receives a financial benefit from the action? (Recommendation--No.)

§ 779. Prevailing defendants' expenses

779. If the derivative action is dismissed or a favorable judgment is rendered for any or all defendants, the court shall award to those defendants reasonable expenses including attorney's fees assessed proportionately against all plaintiffs and their attorneys if the court determines that either of the following existed at the time the action was commenced:

(a) No reasonable probability that the prosecution of the action by the plaintiffs would benefit the corporation or its members.

(b) No probable cause to believe that the defendant or defendants participated in the transaction complained of in any capacity.

Comment. Section 779 grants the court authority to award reasonable expenses to the defendant or defendants if an action is favorably terminated and the court determines that the action was brought without a reasonable probability for success or that there existed at the time of the action no probable cause that the defendant or defendants participated in the illegal transaction.

This provision is necessary as a final deterrent against improper actions brought to harass, and it also protects vindicated defendants or the corporation from having to bear these costs. Prior law provided pursuant to Section 834(b) of the Corporations Code (General Corporation Law) that, upon the motion of the defendants, plaintiffs could be required to post security for expenses if the court determined after a hearing that: (1) there was no reasonable probability that the prosecution of the cause of action would benefit the corporation or its members or (2) the moving party did not participate in the transaction in any capacity.

Section 779 rejects this approach for several reasons. The hearing to determine whether or not to require the posting of security requires a preliminary finding on the substantive issues which wastes valuable court resources. Moreover, it is easier for the court to assess the

merits of the plaintiffs' case at a later stage when the plaintiffs have had an opportunity to engage in full discovery. Section 779 makes clear, however, that the plaintiffs act at their peril if their intention is merely to engage in a fishing expedition.

When the court makes a determination pursuant to this section that the action was improper, it shall assess defendant's expenses proportionately against each plaintiff and all of plaintiff's attorneys. This rule of proportionate liability has been adopted to reduce the potential liability for each plaintiff so as not to unreasonably deter the bringing of these actions. It should be noted that, with so many required plaintiffs, there is little danger that a significant number will be judgment proof such that a defendant awarded costs will be unable to recover most of the award. See Section 775 (50 or more members or 10 percent of the membership must join in the derivative action). The danger of a judgment-proof plaintiff was another justification for the prior rule requiring a pretrial posting of security for defendant's expenses.

Prior to judgment, defendants' litigation expenses may be advanced by the corporation. See Section 855.

ISSUES TO BE RESOLVED:

1. Should plaintiffs be required to post security for defendants' expenses? (Recommendation--No.)
2. Should prevailing defendants be entitled in some circumstances to reasonable expenses? (Recommendation--Yes.)
3. Should plaintiffs be jointly and severally liable for defendants' expenses? (Recommendation--No.)
4. Should the attorneys for the losing plaintiffs be liable for a pro rata share of the defendant's litigation expenses? (Recommendation--Yes.)

CHAPTER 4. MANAGEMENT

Article 1. Directors and Officers Generally§ 801. Board of directors; title of the board and member of board

801. (a) A nonprofit corporation shall have a board of directors and, except as otherwise provided in the articles, bylaws, or this code, the power of a nonprofit corporation shall be exercised, its property controlled, and its affairs conducted by the board of directors.

(b) The board of directors may be designated by such name as is deemed appropriate. Members of the board may be given such titles as are deemed appropriate.

Comment. Subdivision (a) of Section 801 is substantially the same as part of former Section 9500 of the Corporations Code (General Nonprofit Corporation Law). It provides that, except as otherwise provided in the articles, bylaws, or this code, the board of directors is charged with management of the corporation. This language clearly permits limitations in the articles, bylaws, or this code concerning specific actions which must be authorized or approved by the members. Moreover, it allows delegation of the board's authority to an executive committee or committees. See Section 821.

Subdivision (b) expressly permits the corporation to designate its governing board or any member of that board by any title deemed appropriate. For a similar provision in the prior law, see former Section 9300 of the Corporations Code (General Nonprofit Corporation Law).

Analysis

Most modern statutes also permit a nonprofit corporation to vary somewhat from the traditional model of complete director autonomy in

governing the affairs of the corporation.¹ Nonprofit corporations exist in many forms, and each should be permitted to tailor the organization and powers of its governing board to its own individual needs.² However, director management generally facilitates efficient and proper management, and it is expected that most nonprofit organizations will conform fairly closely to the traditional model.

ISSUES TO BE RESOLVED:

1. Should a nonprofit corporation be permitted to operate without a governing board? (Recommendation--No.)

2. Should the corporation be permitted to limit the authority of its governing board in the articles or bylaws? (Recommendation--Yes.)

405-190

§ 802. Number of directors

802. (a) The number of directors constituting the entire board shall be not less than three except in the following cases:

(1) Before members other than the incorporator are accepted, the minimum number of directors is one.

(2) If there are only two members or incorporators, the minimum number of directors is two.

(3) A corporation organized for charitable purposes which is incorporated after the operative date of this code shall have not less than nine nor more than 25 directors.

1. N.Y. Not-for-Profit Corporation Law § 701; Pa. Corporation Not-for-profit Code § 7721.

2. For a discussion of innovative alternative models for governing nonprofit corporations, see Leshner, Non-Profit Corporation: A Neglected Stepchild Comes of Age, 22 Bus. Law 951 (1967).

(4) Notwithstanding paragraph (3), in the case of a corporation formed under this division by the bishop, chief priest, presiding elder, or other presiding officer of any religious denomination, society, or church, for the purpose of administering and managing the affairs, property, and temporalities thereof, the minimum number of directors is one.

(b) Subject to the limitation in subdivision (a):

(1) The number of directors may be fixed by the articles or, unless otherwise provided in the articles, by a bylaw adopted by the members or as provided in subdivision (c).

(2) If not otherwise fixed under paragraph (1), the number of persons listed in the articles pursuant to subdivision (e) of Section 501 shall be the number of directors.

(c) In the case of a corporation not organized for charitable purposes, the articles or, unless the articles provide otherwise, a bylaw adopted by the members may state that the number of directors shall be not less than a stated minimum (which in no case shall be less than five) nor more than a stated maximum (which in no case shall exceed such stated minimum by more than three). If the articles or bylaws permit such an indefinite number of directors, the exact number of directors shall be fixed, within the limits specified in the articles or bylaws, by a bylaw or an amendment of the bylaws adopted by the members or by the board of directors.

Comment. Subdivision (a) of Section 802 continues the general requirement of former Section 9500 of the Corporations Code (General Nonprofit Corporation Law) that a nonprofit corporation be governed by a board of not less than three directors. However, subdivision (a) provides exceptions to

this general rule: A corporation which has not accepted members other than the incorporator is required to have only one director and, similarly, a corporation with only two members or incorporators is required to have only two directors. These departures from former Section 9500 are consistent with both the increased flexibility of this code and with Section 301 of the Corporations Code (General Corporation Law). See also Section 201 (incorporators). Paragraph (3) continues the provisions of former Section 10201 of the Corporations Code which required that the governing board of corporations formed under Section 10200 of the Corporations Code (Corporations for Charitable or Eleemosynary Purposes) consist of not less than nine nor more than 25 directors. See Section 170(b). Paragraph (3) expands this requirement to include all charitable corporations incorporated after the operative date of this code. Paragraph (4) provides a special rule for corporations sole--former Corporations Code Section 10000 et seq.--thereby making practical the incorporation of these corporations under this division.

Subdivision (b) establishes the manner for fixing the number of directors within the limits set forth in subdivision (a). Paragraph (1) continues former Section 9401 of the Corporations Code (General Nonprofit Corporation Law) as qualified by former Section 9400(c) of that code. Paragraph (2) is similar to subdivision (e) of former Section 9300 of the Corporations Code (General Nonprofit Corporation Law).

Subdivision (c) continues the "indefinite number of directors" provision of former Section 9300 of the Corporations Code.

ISSUES TO BE RESOLVED:

1. Should the "nine to 25" rule be continued for charitable corporations? (Recommendation--Yes.)
2. Should there be statutory rules regulating the number of directors? (Recommendation--Yes.)
3. Should the provisions for an indefinite number of directors be continued? (Recommendation--Yes.)

§ 803. Changing number of directors

803. (a) The number of directors may be increased or decreased by an amendment to the articles.

(b) Unless the articles provide otherwise, the number of directors may be increased or decreased by a bylaw adopted by the members or by the board under the specific provisions of a bylaw adopted by the members. If the board is authorized by the bylaws to change the number of directors, such change requires the vote of a majority of the entire board.

(c) No change in the number of directors may shorten the term of an incumbent director.

(d) If the number of directors is fixed pursuant to subdivision (c) of Section 802, unless the articles provide otherwise, such indefinite number may be changed, or a definite number fixed without provision for an indefinite number, by a bylaw duly adopted by the members.

Comment. Section 803 provides for changing the number of directors. Subdivisions (a)-(c) are derived from Section 702 of New York's Not-for-Profit Corporation Law and alter prior law as set forth in former Sections 9300 and 9400 of the Corporations Code (General Nonprofit Corporation Law) in only two respects: (1) The board may change the number of directors pursuant to the specific provisions of a bylaw adopted by the members provided that such amendment is adopted by a majority of the board and (2) any change in the number of directors under Section 803 shall not reduce the term of an incumbent director. This latter modification of existing law makes impossible the use of the provisions of this section to effect the indirect removal of an unpopular director. Procedures for the removal of directors are set forth in Section 808.

Subdivision (d) is the same in substance as the last sentence of former Section 9300 of the Corporations Code (General Nonprofit Corporation Law). When a corporation elects to adopt a procedure for an indefinite

number of directors as provided in Section 802(c), subdivision (d) states the manner of changing the number fixed pursuant to that section or for changing the parameters of indefiniteness.

Analysis

An important policy issue in this provision concerns the limitation on the power of the board of directors to alter the number of directors except pursuant to a specific plan set forth in a bylaw adopted by the members.¹ As a general rule, it seems unwise to permit a majority of the board to rid itself of fellow board members who are disliked by the device of adopting a bylaw decreasing the number of directors and thereby making it less likely that the disliked or dissenting member or members will be elected for another term. It is important to preserve dissent on the board so that all policy questions will be fully discussed and also to protect the membership's alternative source of inside information.

ISSUES TO BE RESOLVED:

1. Should the board be permitted to change the number of directors other than pursuant to the specific provisions of a bylaw adopted by the members? (Recommendation--No.)

2. Should this section permit the term of an incumbent director to be shortened by a change in the number of directors? (Recommendation--No.)

405-193

§ 804. Qualifications for directors

804. Except as otherwise provided in this code, every director shall be a member of the corporation. Unless the articles or bylaws

1. Present California law follows this general approach and does not permit the board of either a business or a nonprofit corporation to alter the number of directors by amending the bylaws. Corp. Code §§ 501, 9400.

provide otherwise, a director need not be a resident of this state.

The articles or bylaws may prescribe other qualifications for directors.

Comment. To insure a close interest in the affairs of the corporation, Section 804 requires that each director be a member of the corporation. This is a new provision for nonprofit corporations. Section 804 of the Corporations Code (General Corporation Law), which previously applied to nonprofit corporations pursuant to Section 9002 of the Corporations Code (General Nonprofit Corporation Law) and Section 103 of the Corporations Code (definition of "shareholder"), does not require the first or succeeding directors to be members. It should be noted that, under this code, a director appointed pursuant to Section 807 (vacancies on the board) need not be a member and a director appointed pursuant to Section 815.5 (provisional director) shall not be a member.

The second sentence of Section 804, which provides that a director need not be a resident of this state unless there is an express provision in the articles or bylaws to the contrary, is modeled after Section 7722 of Pennsylvania's Corporation Not-for-profit Code.

The last sentence continues the grant of authority to establish additional qualifications for directors formerly found in Section 9401(c) of the Corporations Code (General Nonprofit Corporation Law).

Analysis

Directors of nonprofit corporations are often not very closely involved in the corporation's affairs. Many times they are chosen for the prestige of their name or for honorary purposes. Consequently, many boards of directors of nonprofit corporations fail to adequately function as a check on the officers' management.¹ To remedy this situation somewhat, Section 804 requires that directors must be members of the corporation. The assumption underlying this provision is that member directors possessing a greater personal interest in the corporation are more likely to become involved in the corporation's affairs.

1. See Antony, Can a Non-Profit Organization Be Well Managed, 37 Vital Speeches 44-45 (1971).

ISSUES TO BE RESOLVED:

1. Should directors be required to be members of the corporation?
(Recommendation--Yes.)

2. Should this code specify other qualifications for directors?
(Recommendation--No.)

405-194

§ 805. Term of directors

805. (a) Except as provided in this code or unless the articles or a bylaw adopted by the members provides otherwise, all directors, other than those named in the articles, shall serve a term of one year running from the date of election or appointment.

(b) Each director shall hold office until the expiration of the term for which he was selected and until his successor has been elected or appointed and qualified or until his death, resignation, or removal.

Comment. Subdivision (a) of Section 805 adopts the same basic one-year term required by Section 805 of the Corporations Code (General Corporation Law); however, subdivision (a) permits the articles or a bylaw adopted by the members to specify a different term, including a longer term, for directors. It should be noted that those persons named in the articles as first directors serve as directors only until the selection of their successors. See Section 501. Moreover, in the absence of a contrary provision in the articles or bylaws, directors filling a vacancy in the board serve the balance of the unexpired term of the director that they replace. See Section 807 (vacancies in the board).

Subdivision (b), which is similar to part of Section 7724 of Pennsylvania's Corporation Not-for-profit Code, specifically lists the events which terminate a director's term of office.

ISSUE TO BE RESOLVED:

1. Should directors be permitted to serve other than a one-year term as provided in the corporation's articles or bylaws? (Recommendation--Yes.)

405-195

§ 806. Election of directors

806. (a) Except as otherwise provided in this code, the articles, or a bylaw adopted by the members, all directors shall be elected at a meeting of the members.

(b) Unless otherwise provided in the articles or bylaws, any director or any 10 members may, by written petition delivered to the corporation 30 days prior to an election of directors, place a name in nomination for election as director according to the procedures established by this code, the articles, or bylaws for the election of directors.

(c) Nothing in this section precludes a corporation from providing, in the articles or a bylaw adopted by the members, a procedure for the selection of directors other than an election by the members or by the members as a whole.

Comment. Subdivision (a) of Section 806 makes the director's election requirements consistent with Section 751 which requires an annual meeting of the members for the election of directors unless the articles or a bylaw adopted by the members provide otherwise.

Subdivision (b) is entirely new. It provides a nonexclusive procedure for the nomination of directors; any director, or 10 members, may place a name in nomination for election as director. The corporation may adopt any other means for the nomination of directors in addition to this

procedure or, if pursuant to an appropriate provision in the articles or bylaws, exclusive of the procedure. Subdivision (b) is designed to facilitate a more open nomination process and discourage an ingrown board of directors.

Subdivision (c) expressly permits charitable or other corporations to use an alternative means for the selection of the governing board if that alternative is set forth in the articles or a bylaw adopted by the members. For example, subdivision (c) permits directors to be elected by special districts or membership sections or other means besides by the members as a whole if that procedure is set forth in the articles or a bylaw adopted by the members. Subdivision (c) is based on former Section 10202 of the Corporations Code (Corporations for Charitable or Eleemosynary Purposes).

ISSUES TO BE RESOLVED:

1. Should a corporation pursuant to its articles or bylaws be permitted to elect directors other than at a meeting of the members? (Recommendation--Yes.)

2. Should this code specify a statutory procedure for the nomination of directors? (Recommendation--Yes.)

3. Should a nonprofit corporation be permitted to select directors by a procedure other than an election by the members? (Recommendation--Yes.)

405-196

§ 807. Vacancies

807. (a) Unless otherwise provided in the articles or bylaws, any vacancy in the board of directors caused by death, resignation, removal, or disability shall be filled by a majority of the remaining members of the board though less than a quorum and each person so selected shall be a director to serve for the balance of the unexpired term of his

predecessor in office unless otherwise restricted in the articles or bylaws.

(b) If a corporation has no members other than directors and all the directors resign, die, or become incompetent, upon a petition of a creditor of the corporation or the personal representative of a deceased director or of the guardian or conservator of an incompetent director, the superior court of the county in which the principal office of the corporation is or was located may appoint directors of the corporation. A director so appointed need not be a member of the corporation.

Comment. The first part of subdivision (a) of Section 807 is substantially the same as former Section 9502 of the Corporations Code (General Nonprofit Corporation Law). The remainder of subdivision (a) is derived from Section 7725 of Pennsylvania's Corporation Not-for-profit Code. See also Section 805(b) (director whose term has expired holds office until his successor has been elected or appointed and qualified).

Subdivision (b) is the same as part of Section 809.5 of the Corporations Code (General Corporation Law). It provides for appointment of directors by the court upon petition of those persons listed if there are no members or living competent directors. This provision operates notwithstanding the requirement of Section 804 that all directors must be members.

ISSUE TO BE RESOLVED:

1. Should a majority of the board be permitted to fill vacancies on the board? (Recommendation--Yes.)

§ 808. Removal of directors

808. (a) The entire board of directors or any individual member may be removed from office by the vote of a majority of the members entitled to vote in an election of directors. If the entire board or any individual director is removed, new directors may be elected at the same meeting. If members are entitled to vote cumulatively for the board, the entire board may be removed by majority vote, but no individual director shall be removed if there are sufficient votes cast against the resolution for his removal which, if cumulatively voted at a regular election of directors, would be sufficient to elect one or more directors.

(b) The Attorney General, 50 or more members or at least 10 percent of the membership, whichever number is smaller, or any director may bring an action in the superior court of the county where the principal office is located to remove a director from office for a fraudulent or dishonest act or gross abuse of his authority or discretion with reference to his duties to the corporation and to bar from reelection any director so removed by a period prescribed by the court. The corporation shall be made a party to the action.

(c) A director may be suspended by a majority vote of the board of directors pending the outcome of an action to remove him brought pursuant to subdivision (b).

Comment. Subdivision (a) of Section 808 is substantially the same as Section 810 of the Corporations Code (General Corporation Law). When coupled with the power of 10 percent of the members to call a special meeting pursuant to Section 752, subdivision (a) provides a mechanism for effective control of the board of directors by the membership.

Subdivision (b) is derived in part from Section 811 of the Corporations Code (General Corporation Law) except that the power to sue for removal of a director for cause is broadened to permit the suit to be brought by any director or by the Attorney General. Fifty or more members or at least 10 percent of the membership, whichever number is smaller, may also bring such an action; this is the same number of members as are required to join in a derivative action under Section 775.

Subdivision (c) is new. It protects the integrity of the board by allowing the board to suspend any director by majority vote pending the outcome of a suit for his removal.

Analysis

Subdivisions (a) and (b) of Section 808 incorporate into the Not-for-Profit Corporation Law standard corporate rules for the removal of directors.¹ This section contains only three important changes from the Corporations Code treatment of this subject. The lesser of 50 members or 10 percent of the membership may bring an action to remove a director for cause under subdivision (b). This change from the flat 10-percent rule set forth in the Corporations Code recognizes the fact that, for a nonprofit corporation with a large membership, it is prohibitively difficult to get 10 percent of the members to join such an action. Furthermore, consistent with the expanded power of supervision given the Attorney General by this code, subdivision (b) also permits him to bring an action for removal of a director. In addition, subdivision (b) permits any director to bring such an action for removal of a fellow director. This provision is an alternative to the power given the board under some nonprofit codes to itself remove a director for cause by majority vote.² That approach is rejected and the alternative taken here because the burden should be on the board to prove in court that there exists sufficient cause to warrant removal and not upon the challenged director to go to court to gain reinstatement for wrongful removal. However, to protect the integrity

1. Cal. Corp. Code §§ 810, 811 (General Corporation Law); Pa. Corporation Not-for-profit Code § 7726.

2. N.Y. Not-for-Profit Corporation Law § 706.

of the board during this litigation, subdivision (c) permits the board to suspend the challenged director pending the outcome of the court's decision.

ISSUES TO BE RESOLVED:

1. When cumulative voting is not employed, should directors be removable without cause by the vote of a majority of the members entitled to vote? (Recommendation-Yes.)

2. Should the board be permitted to remove a director for cause? (Recommendation--No.)

3. Should any director or the Attorney General be permitted to bring an action to remove a director for cause? (Recommendation--Yes.)

4. After commencement of an action to remove a director for cause, should the board be permitted to suspend the challenged director pending the outcome of the action? (Recommendation--Yes.)

405-199

§ 809. Meetings of board; call

809. Unless the articles or bylaws provide otherwise, all meetings of the board of directors of a corporation shall be called by the highest officer of the corporation or by any two or more directors.

Comment. Section 809 is comparable to the rule set forth in Section 812 of the Corporations Code (General Corporation Law). The articles or bylaws may specify a different procedure for calling meetings of the board. The power to provide such a procedure in the bylaws is continued from former Section 9401(a) of the Corporations Code (General Nonprofit Corporation Law).

ISSUE TO BE RESOLVED:

1. Should the articles or bylaws be permitted to specify other persons who may call a meeting of the board? (Recommendation--Yes.)

§ 810. Notice of meeting; adjourned meeting

810. Except in the case of regular meetings, notice of which having been dispensed with by the articles or bylaws, written notice of the time and place of the meetings of the board of directors shall be delivered personally to each director or sent to each director by mail or by other form of written communication at least seven days before the meeting unless the articles or bylaws provide otherwise. If the address of a director is not shown on the records and is not readily ascertainable, notice shall be addressed to him at the city or place at which the meetings of directors are regularly held. Notice of the time and place for holding an adjourned meeting of a meeting need not be given to absent directors if the time and place are fixed at the meeting adjourned.

Comment. Section 810 is the same in substance as Section 813 of the Corporations Code (General Corporation Law). It establishes a general rule for notice of meetings of the board. This rule may be altered by an appropriate provision in the articles or bylaws. The power to provide for other notice in the bylaws and to abolish by appropriate provisions in the bylaws all notice for regular meetings is continued from former Section 9401(a) of the Corporations Code (General Nonprofit Corporation Law).

ISSUE TO BE RESOLVED:

1. Should the corporation be permitted to alter the manner of notice by a provision in the articles or bylaws? (Recommendation--Yes.)

§ 811. Validation of meeting defectively called or noticed

811. The transactions of any meeting of the board of directors, however called and noticed or wherever held, are as valid as though transacted at a meeting duly held after regular call and notice if a quorum is present and if, either before or after the meeting, each of the directors not present signs a written waiver of notice, a consent to holding the meeting, or an approval of the minutes thereof. All such waivers, consents, or approvals shall be filed with the corporate records or made a part of the minutes of the meeting.

Comment. Section 811 is the same in substance as Section 814 of the Corporations Code (General Corporation Law) which previously applied to nonprofit corporations pursuant to former Section 9002 of the Corporations Code (General Nonprofit Corporation Law).

§ 812. Place of meeting

812. (a) Regular meetings of the board of directors shall be held at any place within or without this state which has been designated by the bylaws or from time to time by resolution of the board or by written consent of all members of the board. In the absence of such designation, regular meetings shall be held at the principal office of the corporation. Special meetings of the board may be held either at a place so designated or at the principal office. Any regular or special meeting is valid wherever held, if held upon written consent of all members of the board

given either before or after the meeting and filed with the secretary or similar officer of the corporation.

(b) Meetings held by conference telephone or similar communications equipment as provided in subdivision (b) of Section 814 are deemed held at the principal office of the corporation.

Comment. Section 812 is the same in substance as Section 815 of the Corporations Code (General Corporation Law). The authority to establish in the bylaws the place for meetings of the board and the power to hold such meetings outside this state is continued from former Section 9401 of the Corporations Code (General Nonprofit Corporation Law). Subdivision (b) recognizes that meetings of the board may be held by conference telephone or similar communications equipment. This is a new provision. See Section 814.

405-203

§ 813. Quorum of board

813. A majority of the authorized number of directors constitutes a quorum of the board for the transaction of the corporation's affairs unless:

(a) The articles or bylaws provide that a different number, which in no case shall be less than one-third the authorized number of directors, nor less than two, constitutes a quorum.

(b) The authorized number of directors is one, in which case one director constitutes a quorum.

Comment. Section 813 establishes the statutory rule for a quorum of the board of directors. It is substantially the same as Section 816

of the Corporations Code (General Corporation Law). Within the specified limits, a corporation may provide that a different number constitutes a quorum. See Section 802 (authorized number of directors). Cf. former Section 9401(b) of the Corporations Code (General Nonprofit Corporation Law) which provided that the requirements of a quorum may be established in the bylaws and that the number established may be greater or less than a majority.

ISSUE TO BE RESOLVED:

1. Should there be any statutory limitation on the number of directors which constitutes a quorum? (Recommendation--Yes.)

405-204

§ 814. Effect of majority vote of quorum at board meeting; conference telephone

814. (a) Every act or decision done or made by a majority of the directors present at a meeting duly held at which a quorum is present is the act of the board of directors unless the law, the articles, or the bylaws require a greater number.

(b) Participation in a meeting by means of a conference telephone or similar communications equipment by which all persons participating can hear each other constitutes presence in person at such meeting.

Comment. Subdivision (a) of Section 814 is the same as Section 817 of the Corporations Code (General Corporation Law) which previously governed nonprofit corporations pursuant to former Section 9002 of the Corporations Code (General Nonprofit Corporation Law). Directors may act without a meeting by unanimous consent. See Section 816.

Subdivision (b) is new. This provision is derived from Section 7709 of Pennsylvania's Corporation Not-for-profit Code.

ISSUE TO BE RESOLVED:

1. Should the board be permitted to act via a conference telephone or similar communications equipment? (Recommendation--Yes.)

405-205

§ 815. Adjournment of meeting for lack of quorum

815. In the absence of a quorum, a majority of the directors present may adjourn from time to time until the time fixed for the next regular meeting of the board.

Comment. Section 815 is the same as Section 818 of the Corporations Code (General Corporation Law) which previously governed non-profit corporations pursuant to former Section 9002 of the Corporations Code (General Nonprofit Corporation Law).

405-791

§ 815.5. Provisional director

815.5. (a) Any director or 10 percent of the membership of a corporation may bring an action to appoint a provisional director.

(b) In such an action, notwithstanding any provision in the articles or bylaws of the corporation or the fact that an action for involuntary dissolution is or is not pending, the superior court of the county where the corporation's principal office is located may appoint a provisional director if it finds the following facts to be true:

(1) The corporation has an even number of directors who are equally divided and cannot agree on the management of the corporation's affairs.

(2) There is a danger that the corporate property will be impaired or lost or the corporate affairs can no longer be conducted successfully.

(c) The provisional director shall be an impartial person who is neither a member nor a creditor of the corporation nor related by consanguinity or affinity within the third degree to any of the other directors of the corporation or to any judge of the court by which he is appointed. The provisional director has all the rights and powers of a director and is entitled to notice of the meetings of the board and to vote at such meetings until the deadlock in the board of directors is broken or until he is removed by order of the court or by vote or written consent of a majority of the members entitled to vote. He is entitled to receive such compensation as may be agreed upon between him and the corporation and, in the absence of such an agreement, compensation shall be fixed by the court.

Comment. Section 815.5 provides an important remedy for a "deadlocked" corporation and is derived from Section 819 of the Corporations Code. This remedy is not dependent upon the plaintiff's bringing an action for dissolution of the corporation, but it may be ordered in such an action. See Section 1609 (court's power to appoint a provisional director in involuntary dissolution proceedings).

It should be noted that Section 815.5 permits 10 percent of the members to bring an action for appointment of a provisional director whereas Corporations Code Section 819 requires 33-1/3 percent of the outstanding shares to join in this action. The 10-percent rule is consistent with other provisions of this code regarding court action by the membership. See, e.g., Section 1601 (10 percent of the membership may bring an action for involuntary dissolution).

ISSUES TO BE RESOLVED:

1. Should the statutory action to appoint a provisional director be continued? (Recommendation--Yes.)
2. Should one-third of the membership be required to join in such an action? (Recommendation--No.)

405-356

§ 816. Action by board without meeting

816. If the articles or bylaws so provide, any action required or permitted to be taken by the board of directors under any provision of this division may be taken without a meeting if all members of the board individually or collectively consent in writing to such action. The written consent or consents shall be filed with the minutes of the proceedings of the board. Such action by written consent has the same force and effect as a unanimous vote of such directors. Any certificate or other document filed under any provision of this division which relates to action so taken shall state that the action was taken by unanimous written consent of the board of directors without a meeting and that the articles of incorporation or bylaws, as the case may be, authorize the directors to so act, and such statement is prima facie evidence of such authority.

Comment. Section 816 is the same in substance as former Section 9503.1 of the Corporations Code (General Nonprofit Corporation Law). Normally, the board takes action only by a majority of the directors present at a meeting duly held at which a quorum is present. See Section 814.

ISSUE TO BE RESOLVED:

1. Should directors be permitted to act without a meeting by less than unanimous consent? (Recommendation--No.)

§ 817. Duty to act in good faith with ordinary skill

817. (a) Directors and officers shall discharge the duties of their respective positions in good faith, with a view to the interests of the corporation, and with a degree of diligence, care, and skill which ordinary prudent men would exercise under similar circumstances in like positions.

(b) A director or officer does not violate the standard set out in subdivision (a) if he relies in good faith upon a financial statement of the corporation represented to be correct by the chief officer of the corporation, or the officer of the corporation having charge of its books of accounts, or stated in a certified written report by an independent public or certified public accountant or firm of such accountants chosen with reasonable care to be correct and according to the books of the corporation.

Comment. Subdivision (a) of Section 817 establishes the fiduciary duty owed by officers and directors to the corporation. It is not meant to affect in any way the prohibition against self-dealing set forth in Bancroft-Whitney Corp. v. Glen, 64 Cal.2d 327, 411 P.2d 912, 49 Cal. Rptr. 825 (1966). However, due to the wide variation in types of nonprofit corporations, this section establishes a flexible standard of care regarding the duty of the director or officer to affirmatively advance the corporation's interests and to protect the corporation from mismanagement. The standard of care is what a reasonable, prudent man would do under the circumstances which may vary according to the kind of corporation and the particular circumstances in which the director or officer is called upon to act. This flexible standard is the same as Section 717(a) of New York's Not-for-Profit Corporation Law. It is intended to incorporate the more restrictive duties in the management of trust property set forth in Article 2, Chapter 2, Title 8, Part 4 of the Civil Code. See Section 1103. It does not

alter the liability of a corporate officer for injury to the corporation's employees as set forth in Ulwelling v. Crown Coach Corp., 206 Cal. App.2d 96, 23 Cal. Rptr. 631 (1962)(no liability for nonfeasance).

Subdivision (b) is very similar to Section 717(b) of New York's Not-for-Profit Corporation Law and to Section 829 of the Corporations Code (General Corporation Law). It is designed to establish the effect of reliance upon corporate financial statements.

Analysis

It is a fact of life that many nonprofit corporations are inefficiently managed.¹ One might take this fact as necessitating the creation of a stricter standard of care for officers and directors to encourage more concerned and responsible action. However, it is also true that many directors and officers serve in a more or less honorary capacity with little remuneration. A strict standard of care places an unfair burden on such individuals. Given these two factors pulling in opposite directions, the best approach seems to be to create a flexible standard which takes into consideration the type of corporation and the individual circumstances. Subdivision (a) accomplishes this by requiring that an officer or director exercise only the degree of skill which a reasonable, prudent man would exercise under similar circumstances in a like position. This approach is also taken in Section 717 of New York's Not-for-Profit Corporation Law.

ISSUES TO BE RESOLVED:

1. Should a standard of care for directors and officers be specified by statute? (Recommendation--Yes.)

2. Should the standard of care be stricter than that proposed in this draft (e.g., prudent man managing his own affairs)? (Recommendation--No.)

1. See Antony, Can a Non-Profit Organization Be Well Managed, 37 Vital Speeches 44 (1971).

§ 818. Interested directors and officers; quorum

818. (a) No contract or other transaction between a corporation and one or more of its directors or officers, or between a corporation and any other corporation, firm, association, or other entity in which one or more of its directors or officers are directors or officers, or have a substantial financial interest, is either void or voidable for this reason alone or by reason alone that such director or directors or officer or officers are present at the meeting of the board, or of a committee thereof, which authorizes such contract or transaction, or that his or their votes are counted for such purpose, if either of the following circumstances exist:

(1) The material facts of the common directorship or substantial financial interest are disclosed or known to the board of directors or committee and noted in the minutes, and the board or committee authorizes, approves, or ratifies the contract or transaction in good faith by a vote sufficient for the purpose without counting the vote or votes of such director or directors.

(2) The material facts of the common directorship or substantial financial interest are disclosed or known to the members, and they approve or ratify the contract or transaction in good faith by a majority vote or written consent of members entitled to vote.

(b) If there was no disclosure or knowledge of the material facts of the common directorship or substantial financial interest, or if the vote of the interested director was necessary for the authorization of the contract or transaction at a meeting of the board or committee at which it was authorized, the party or parties to the contract or transaction

must establish affirmatively that it was fair and reasonable as to the corporation at the time it was authorized by the board, a committee, or the members, or the transaction or contract may be voided by the corporation.

(c) Common or interested directors may be counted in determining the presence of a quorum at a meeting of the board or a committee thereof which authorizes, approves, or ratifies a contract or transaction.

Comment. Section 818 contains substantially the same rules for interested directors and officers found in Section 820 of the Corporations Code (General Corporation Law). It provides that, if the common directorship or substantial financial interest is disclosed to and ratified by the board or membership according to the procedure of paragraph (1) or (2) of subdivision (a), then the transaction or contract is not void or voidable.

Even if there is no disclosure or if the vote of the interested director is essential for approval of the action, the transaction or contract is not voidable if the parties can demonstrate affirmatively that the action was reasonable or fair to the corporation at the time it was authorized. However, subdivision (b) makes clear that the burden is upon the party wishing to uphold the contract or transaction to prove reasonableness. This provision establishing the burden of proof is new and is designed to encourage full disclosure of all financial ties and interests. Section 715 of New York's Not-for-Profit Corporation Law contains a similar rule.

Subdivision (c) makes clear that common or interested directors may be counted in determining the presence of a quorum. This provision is the same as the last paragraph of Section 820 of the Corporations Code.

ISSUES TO BE RESOLVED:

1. If there is no disclosure of the common directorship or substantial financial interest, or if the vote of the interested director was necessary for authorization of the transaction, should the burden be on the parties wishing to uphold the transaction to prove its "reasonableness"? (Recommendation--Yes.)

2. Should a contract authorized by an interested director or otherwise approved without disclosure of his common directorship or substantial financial interest be automatically void? (Recommendation--No.)

§ 819. Officers

819. (a) A corporation may have such officers as may be provided for in the articles or bylaws. Officers may be designated by any title as may be provided in the articles or the bylaws and shall be chosen in a manner and hold their offices for a term as prescribed in the articles or bylaws. If the corporation has no officers, the board shall select one of its members to act as chief officer of the corporation for the purpose of the duties imposed by this code upon the chief officer of the corporation.

(b) An officer has the authority and shall perform the duties in the management of the corporation as provided in the articles or bylaws or, to the extent not so provided, by the board. The board may require any officer to give security for the faithful performance of his duties.

Comment. Subdivision (a) of Section 819 provides complete flexibility to nonprofit corporations to structure their management to meet their individual needs. Most corporation codes require that there be at least a president, secretary, and treasurer (see Pa. Corporation Not-for-profit Code § 7732); however, this requirement is unduly restrictive for many organizations and serves no important function where the profit motive is not present. The last sentence of subdivision (a) requires the board to select one of its members to fulfill the duties imposed by this code upon the chief officer of the corporation. E.g., Section 558 (duty to sign certificate of restated articles).

Subdivision (b) is modeled after Section 713(e) of New York's Not-for-Profit Corporation Law and establishes the corporation's power to delegate to the officers the authority to manage the corporation in the manner it deems desirable. This provision is similar to the last paragraph of Section 821 of the Corporations Code (General Corporation Law).

Analysis

Section 819 is designed to permit a corporation to structure its management organization in any fashion that best suits its own interests. There are no good reasons for imposing an arbitrary system of organization upon nonprofit corporations which have varying needs and purposes.

ISSUES TO BE RESOLVED:

1. Should a nonprofit corporation be required to have certain specified officers? (Recommendation--No.)
2. Should officers be required to have certain designated titles? (Recommendation--No.)

405-362

§ 820. Removal of officers

820. (a) Unless otherwise provided in the articles or bylaws, any officer or agent may be removed by majority vote of the board of directors without cause whenever in its judgment removal serves the best interests of the corporation, but such removal does not affect the contract rights of any person so removed.

(b) An action to procure a judgment removing an officer for cause may be brought by the Attorney General, by 50 or more members, by not less than 10 percent of the membership, or by any director. The court may bar from reelection or reappointment any officer so removed for a period fixed by the court.

Comment. Subdivision (a) of Section 820 is derived from Section 7733 of Pennsylvania's Corporation Not-for-profit Code. It provides for the removal of any officer without cause by a majority vote of the board and is designed to facilitate board control over the management

of the corporation. However, removal without cause does not affect the officer's or agent's contract rights with the corporation.

Subdivision (b) is derived from subdivision (c) of Section 714 of New York's Not-for-Profit Corporation Law. An action may be brought by the persons listed to remove an officer for cause. For a similar provision for removal of directors, see Section 808.

ISSUES TO BE RESOLVED:

1. Should a majority of the board be permitted to remove an officer without cause in the absence of a contrary provision in the articles or bylaws? (Recommendation--Yes.)
2. Should there be a statutory action for removal of an officer for cause? (Recommendation--Yes.)

405-363

§ 821. Executive committees

821. (a) If the articles or bylaws so provide, the board, by resolution adopted by a majority of the entire board, may designate from among its members an executive committee and other standing committees, each consisting of three or more directors, and each of which, to the extent provided in the resolution or in the articles or bylaws, shall have all the authority of the board except that no such committee has authority as to any of the following matters:

- (1) The filling of vacancies in the board of directors or in any committee.
- (2) The fixing of compensation of the directors for serving on the board or on any committee.
- (3) The amendment or repeal of the bylaws or the adoption of new bylaws.

(4) The amendment or repeal of any resolution of the board which by its terms is not so amendable or repealable.

(b) The board may designate one or more directors as alternate members of any standing committee, who may serve in place of any absent member or members at any meeting of such committee.

(c) The bylaws may provide for special committees of the board or may authorize the board to create such special committees as may be deemed desirable. Unless otherwise provided in the bylaws, the members of such committees shall be appointed by the chairman of the board or, if there is no chairman of the board, by the chief officer of the corporation with the consent of the board. A special committee has only the powers specifically delegated to it by the board and in no case does it have any power not authorized for a standing committee under this section.

(d) Each committee of the board serves at the pleasure of the board. The designation of any such committee and the delegation thereto of authority does not itself relieve any director of his duty to the corporation under Section 817.

(e) Committees, other than standing or special committees of the board, whether created by the board or by the members, shall be committees of the corporation. Such committees may be elected or appointed in the same manner as officers of the corporation. Provisions of this article applicable to officers generally shall apply to members of such committees.

Comment. Section 821 is substantially the same as Section 712 of New York's Not-for-Profit Corporation Law. It continues the power as modified herein to create executive committees pursuant to an appropriate authorization in the articles or bylaws. See former Section 9401 of the

Corporations Code (General Nonprofit Corporation Law). However, Section 821 expressly limits the functions that may be performed by such committees. Very important corporate matters such as the adoption, amendment, or repeal of bylaws deserve the consideration of the entire board. This same approach is taken by the Corporations Code. Corp. Code § 822 (General Corporation Law).

Subdivision (d) makes clear that the creation of executive committees and the delegation of authority thereto does not itself relieve any director from his duty to the corporation.

Subdivision (e) provides for the creation and status of committees other than standing or special committees of the board.

ISSUES TO BE RESOLVED:

1. Should there be some restrictions placed upon the size and authority of executive committees? (Recommendation--Yes.)
2. Should the delegation of authority to executive committees release the board from its duty of care concerning the matters delegated? (Recommendation--No.)
3. Should committees, other than standing or special committees of the board, be permitted? (Recommendation--Yes.)

405-365

§ 822. Loans to officers and directors

822. No loans, other than through the purchase of bonds, debentures, or similar obligations of the type customarily sold in public offerings, or through ordinary deposit of funds in a bank, or for litigation expenses pursuant to Section 855, shall be made by a corporation to its directors or officers, or to any other corporation, firm, association, or other entity in which one or more of its directors or officers are directors or officers or hold a substantial financial interest. A loan made in violation of this section is a violation of the duty to the corporation of the

directors or officers authorizing the loan or participating in it, but the obligation of the borrower with respect to the loan is not affected by such violation.

Comment. Section 822, prohibiting loans to officers or directors, is taken from Section 716 of New York's Not-for-Profit Corporation Law. It alters the prior law for nonprofit corporations which permitted loans if two-thirds of the members consented to this transaction. See Corp. Code § 823 (General Corporation Law).

Analysis

The modern trend is to prohibit all loans to officers and directors of nonprofit corporations by the corporation.¹ This seems to be a wise policy as there is no good reason why a corporation must make such loans. They are inherently suspicious.

ISSUE TO BE RESOLVED:

1. Should loans to officers and directors be strictly prohibited? (Recommendation--Yes.)

405-366

§ 823. Action against directors and officers for misconduct

823. An action may be brought by the corporation, any director, officer, receiver, trustee in bankruptcy, unsatisfied judgment creditor, 50 members or more or at least 10 percent of the membership pursuant to a member's derivative action under Section 775, to compel any director or officer to account to the corporation for his official conduct if

1. ABA-ALI Model Non-Profit Corporation Act § 27; N.Y. Not-for-Profit Corporation Law § 716.

it is in violation of the duties imposed by Section 817 or to enjoin future violations of those duties.

Comment. Section 823 establishes the persons who may enforce the duties imposed by Section 817. This provision is derived from Section 720 of New York's Not-for-Profit Corporation Law and is designed to encompass all parties who are most directly affected by the improper conduct of directors. It should be noted that the Attorney General may also bring an action to enforce these duties pursuant to Section 1903 (Attorney General's power to enforce the provisions of this code).

ISSUES TO BE RESOLVED:

1. Should there be a special statutory action for directors' or officers' misconduct? (Recommendation--Yes.)

2. Should directors, officers, and unsatisfied judgment creditors be permitted to bring such an action? (Recommendation-Yes.)

405-367

§ 824. Liability of directors

824. (a) The directors who vote for or concur in any of the following corporate actions are jointly and severally liable to the corporation for the benefit of its creditors or members or the ultimate beneficiaries of its activities to the extent of any injury suffered by those persons, respectively, as a result of the action or, if there are no creditors or members or ultimate beneficiaries injured, to the corporation to the extent of any injury suffered by the corporation as a result of the action:

(1) The distribution of the corporation's cash or property to members, directors, or officers other than a distribution permitted under Section 1006.

(2) The redemption of capital certificates, subvention certificates, or bonds to the extent such redemption is contrary to the provisions of Section 1001, 1002, or 1004.

(3) The payment of a fixed or contingent periodic sum to the holders of subvention certificates or of interest to the holders or beneficiaries of bonds to the extent the payment is contrary to the provisions of Section 1002 or 1004.

(4) The distribution of assets after dissolution of the corporation in violation of Section 1512 or without paying or adequately providing for all known liabilities of the corporation excluding any claim not filed by creditors within the time limit set in notice given to the creditors under Section 1510.

(5) The making of any loan contrary to Section 822.

(b) A director is not liable under this section if, in the circumstances, he discharged his duty to the corporation under Section 817 and did not willfully violate the provisions of this code.

(c) A director against whom a claim is successfully asserted under this section is entitled to contribution from the other directors who voted or concurred in the action upon which the claim is asserted.

(d) A director against whom a claim is successfully asserted under this section is entitled to subrogation to the corporation for amounts reimbursed after an improper action to the extent of the amounts paid by him to the corporation because of the claim.

(e) This section does not affect any liability otherwise imposed by law upon any director or officer.

(f) Except as otherwise provided by law, directors are not personally liable for the debts, liabilities, or obligations of the corporation.

Comment. Section 824 establishes clearly the liability of officers or directors who authorize or participate in certain illegal distributions, payments, or loans where such participation is in violation of their duty to the corporation under Section 817 or is willful with regard to the requirements of this code. This liability to the corporation is measured by the harm done to creditors, members, or the ultimate beneficiaries of the corporation's activities. It should be noted that members may bring an action in the right of the corporation pursuant to Article 3 (commencing with Section 775) of Chapter 3.

Section 824 is derived from Section 719 of New York's Not-for-Profit Corporation Law and is similar in approach to Section 823 of the Corporations Code (General Corporation Law)(liability for illegal loans to directors) and Section 825 of the Corporations Code (General Corporation Law)(liability for illegal distributions to shareholders).

Subdivision (c) is the same as subdivision (c) of Section 719 of New York's Not-for-Profit Corporation Law, and it entitles directors who are held liable under this section to seek contribution from other directors who also participated in the action. Cf. Corp. Code § 828. Subdivision (d) gives them a right of subrogation to funds which are later reimbursed to the corporation by the distributees or other illegal recipients. It is derived from subdivision (d) of Section 719 of New York's Not-for-Profit Corporation Law. Subdivision (e) makes it clear that this section is not intended to affect the liability of directors imposed by any other provision of this code or the law. It is the same as subdivision (f) of Section 719 of New York's Not-for-Profit Corporation Law.

Subdivision (f) is substantially the same as former Section 9504 of the Corporations Code (General Nonprofit Corporation Law).

ISSUES TO BE RESOLVED:

1. Should directors be personally liable for certain distributions or other transactions expressly prohibited by this code? (Recommendation--Yes.)

2. Should directors be generally liable for the debts or obligations of the corporation? (Recommendation--No.)

3. Should directors be liable under this section for conduct which does not constitute a willful violation of the provisions of this code or a breach of his duty to the corporation, i.e., "negligent" conduct? (Recommendation--No.)

998-835

§ 825. False report, statement, or entry; civil liability

825. Any officers, directors, employees, or agents of a corporation who do any of the following are liable jointly and severally for all the damage resulting therefrom to the corporation or any person injured thereby who relied thereon, or to both:

(a) Make, issue, deliver, or publish any report, circular, certificate, financial statement, balance sheet, public notice, or document respecting the corporation or its membership list, capital or subvention certificates, assets, liabilities, capital, affairs, earnings, or accounts which is false in any material respect, knowing it to be false, or who knowingly participate therein.

(b) Make or cause to be made in the books, minutes, records, or accounts of a corporation any entry which is false in any material particular, knowing such entry is false.

(c) Remove, erase, alter, or cancel any entry therein with intent to defraud.

Comment. Section 825 is comparable to Section 3018 of the Corporations Code which previously governed nonprofit corporations pursuant to former Section 9002 of the Corporations Code.

ISSUE TO BE RESOLVED:

1. Should the standard for liability be stricter than knowing falsehood? (Recommendation--No.)

405-370

Article 2. Indemnity for Litigation Expenses

§ 851. Right of officer, director, or employee to indemnity

851. (a) When a person is sued, either alone or with others, because he is or was a director, officer, or employee of a corporation, domestic or foreign, in any proceeding arising out of his alleged misfeasance or nonfeasance in the performance of his duties or out of any alleged wrongful act against the corporation or by the corporation, indemnity for his reasonable expenses, including attorney's fees incurred in the defense of the proceeding, may be assessed against the corporation, its receiver, or its trustee, by the court in the same or a separate proceeding, if both of the following conditions exist:

(1) The person sued is successful in whole or in part, or the proceeding against him is settled with the approval of the court.

(2) The court finds that his conduct fairly and equitably merits such indemnity.

(b) The amount of indemnity under this article shall be so much of the expenses, including attorney's fees, incurred in the defense of the proceeding, as the court determines to be reasonable.

Comment. Section 851 is the same in substance as subdivision (a) of Section 830 of the Corporations Code (General Corporation Law) which previously governed nonprofit corporations pursuant to former Section 9002 of the Corporations Code (General Nonprofit Corporation Law). Section 851 empowers the court to order the corporation, its receiver, or trustee to indemnify successful defendants for their litigation expenses in an amount which the court finds to be reasonable. In determining reasonable expenses, the court should set off all amounts received from unsuccessful plaintiffs under Section 779.

Analysis

Under normal circumstances, it would be manifestly unfair to place the burden of the cost of litigation upon an officer, director, or employee who has been successful in proving that his conduct did not constitute a breach of his duty to the corporation. Corporate officers and directors are often required to make business decisions which might subject them to litigation. The cost of this litigation should be considered part of the risk of "doing business" and, therefore, should be borne by the corporation unless these costs are imposed upon the unsuccessful plaintiffs pursuant to Section 779 or unless, of course, the officer or director was found to have breached his duty to the corporation.

ISSUE TO BE RESOLVED:

1. Should directors, officers, and employees of the corporation have a right of indemnity from the corporation for litigation expenses when proceedings arising out of the performance of their duties are favorably terminated? (Recommendation--Yes.)

§ 852. Application for indemnity

852. Application for indemnity under this article may be made either by a person sued or by the attorney or other person rendering services to

him in connection with the defense, and the court may order fees and expenses to be paid directly to the attorney or other person although he is not a party to the proceeding.

Comment. Section 852 is the same in substance as subdivision (b) of Section 830 of the Corporations Code (General Corporation Law) which previously governed nonprofit corporations pursuant to former Section 9002 of the Corporations Code (General Nonprofit Corporation Law).

ISSUE TO BE RESOLVED:

1. Should the attorney or person rendering services be permitted to make application for indemnity? (Recommendation--Yes.)

405-406

§ 853. Service of notice of application

853. (a) Notice of the application for indemnity shall be served upon the corporation, its receiver, or its trustee, and upon the plaintiff and other parties to the proceeding.

(b) The court may order notice to be given also to the members in the manner provided in this division for giving notice of members' meetings, in such form as the court directs.

Comment. Section 853 is the same in substance as subdivision (c) of Section 830 of the Corporations Code (General Corporation Law) which previously governed nonprofit corporations pursuant to former Section 9002 of the Corporations Code (General Nonprofit Corporation Law).

§ 854. Voluntary payment of expenses and judgment by corporation

854. Notwithstanding Section 856, the board of directors may authorize a corporation to pay expenses incurred by, or to satisfy a judgment or fine rendered or levied against, a present or former director, officer, or employee of the corporation in an action brought by a third party against such person (whether or not the corporation is joined as a party defendant) to impose a liability or penalty on such person for an act alleged to have been committed by such person while a director, officer, or employee, or by the corporation, or by both, if the board of directors determines in good faith that such director, officer, or employee was acting in good faith within what he reasonably believed to be the scope of his employment or authority and for a purpose which he reasonably believed to be in the best interests of the corporation or its members. Payments authorized under this section include amounts paid and expenses incurred in settling any such action or threatened action. This section does not apply to any action instituted or maintained in the right of the corporation.

Comment. Section 854 is substantially the same as subdivision (f) of Section 830 of the Corporations Code (General Corporation Law) which previously governed nonprofit corporations pursuant to former Section 9002 of the Corporations Code (General Nonprofit Corporation Law). Section 854 provides for voluntary indemnification by the corporation if the board of directors determines in good faith that the challenged director or officer was acting in good faith within what he reasonably believed to be the scope of his employment or authority and for a purpose which he reasonably believed to be in the best interests of the corporation or its members. The last sentence makes clear that this section does not apply to members' derivative actions brought pursuant to Article 3 (commencing with Sec-

tion 775) of Chapter 3; advancing of litigation expenses in derivative actions is covered by Section 855.

ISSUES TO BE RESOLVED:

1. Should the corporation be permitted to voluntarily indemnify officers, directors, or employees for litigation expenses and judgments and fines? (Recommendation--Yes.)

2. Should this section apply to members' derivative actions or other actions instituted or maintained in the right of the corporation? (Recommendation--No.)

405-408

§ 855. Advancing litigation expenses

855. Expenses incurred in defending an action brought in the right of the corporation may be paid by the corporation in advance of the final disposition of the action if both of the following requirements are satisfied:

(a) The advancement of such expenses is authorized by a majority of the board of directors.

(b) The corporation receives an undertaking from the challenged officer or director that he will repay any amount advanced unless it ultimately is determined pursuant to Section 851 that he is entitled to indemnification by the corporation for the amount advanced.

Comment. Section 855 is modeled after Section 7745 of Pennsylvania's Corporation Not-for-profit Code and is new for California. It permits a corporation to pay in advance the litigation expenses of directors and officers whose actions are challenged in a member's derivative action so long as the challenged party agrees to reimburse the corporation for all expenses paid if it is later determined that he is not entitled to

indemnification by the corporation under Section 851. Also, the corporation is entitled to be reimbursed for any expenses paid by it which are later recovered from unsuccessful plaintiffs pursuant to Section 779.

Analysis

Indemnification for litigation expenses after final judgment is an incomplete protection for directors and officers whose official conduct is challenged in a member's derivative action, for they would still be required to raise the capital demanded by the litigation--no small hardship--prior to the determination of their right to indemnification under Section 851 or their right to be awarded costs under Section 779. Since litigation can be incited by many legitimate business decisions, a method should be available to the corporation to protect its officials until such time as they are proven to have breached their duty to the corporation. Section 855 permits the corporation by a majority vote of the board of directors to provide this protection. The litigation expenses of challenged officials may be paid if they agree to reimburse the corporation for all expenses paid in excess of the amount of indemnification determined under Section 851. The corporation is, of course, entitled to be reimbursed for any expenses which are later recovered from unsuccessful plaintiffs pursuant to Section 779.

ISSUE TO BE RESOLVED:

1. Should the corporation be permitted under limited conditions to advance litigation expenses to officers or directors challenged in a members' derivative action? (Recommendation--Yes.)

405-409

§ 856. Right and remedy exclusive

856. The rights and remedy provided by this article are exclusive. The awarding of indemnity for expenses, including attorney's fees, to parties to such proceedings, whether terminated by trial on the merits

or by settlement or dismissal, shall be made only upon order of court pursuant to Section 851 and is not governed by any provision in the articles or bylaws of the corporation or by resolution or agreement of the corporation, its directors, or its members.

Comment. Section 856 is the same in substance as subdivision (e) of Section 830 of the Corporations Code (General Corporation Law) which previously governed nonprofit corporations pursuant to former Section 9002 of the Corporations Code (General Nonprofit Corporation Law). It provides that the indemnity rights established by this article are exclusive and may not be altered by the corporation pursuant to its articles or bylaws. The corporation, however, may voluntarily pay litigation expenses as authorized by Section 854 or advance litigation expenses as authorized by Section 855.

ISSUE TO BE RESOLVED:

1. Should the rights and remedies of this article be exclusive?
(Recommendation--Yes.)

405-410

§ 857. Application of article

857. (a) This article applies to all proceedings specified in Section 851, whether brought by the corporation, its receiver, its trustee, one or more of its members or creditors, any governmental body, any public official, or any private person or corporation, domestic or foreign.

(b) The provisions of this article apply to the estate, executor, administrator, heirs, legatees, or devisees of a director, officer, or employee, and the term "person" where used in this article includes the

estate, executor, administrator, heirs, legatees, or devisees of such person.

Comment. Subdivision (a) of Section 857 is the same in substance as subdivision (d) of Section 830 of the Corporations Code (General Corporation Law). Subdivision (b) is the same in substance as subdivision (g) of Section 830 of the Corporations Code. Section 830 previously governed nonprofit corporations pursuant to former Section 9002 of the Corporations Code (General Nonprofit Corporation Law).

405-411

§ 858. Indemnity insurance

858. Nothing in this article prohibits a corporation, either domestic or foreign, from paying, in whole or part, the premium or other charge for any type of indemnity insurance in which any officer, director, or employee of the corporation or any of its subsidiary corporations is indemnified or insured against liability or loss arising out of his actual or asserted misfeasance or nonfeasance in the performance of his duties or out of any actual or asserted wrongful act against, or by, any of such corporations including, but not limited to, judgments, fines, settlements, and expenses incurred in the defense of actions and appeals therefrom.

Comment. Section 858 is the same in substance as subdivision (h) of Section 830 of the Corporation Code (General Corporation Law) which previously governed nonprofit corporations pursuant to former Section 9002 of the Corporations Code (General Nonprofit Corporation Law). The last sentence of subdivision (h) of Section 830 has been omitted because it is unnecessary given Section 170.

ISSUE TO BE RESOLVED:

1. Should corporations be permitted to purchase indemnity insurance for officers, directors, or employees? (Recommendation--Yes.)

CHAPTER 5. CORPORATE RECORDS AND REPORTS

Article 1. Books and Records§ 901. Books and records

901. (a) Except as otherwise provided in this section, every corporation shall keep at the office of the corporation:

(1) Correct and complete books and records of account and minutes of the proceedings of its members, board, and executive committee, if any.

(2) A list or record containing the names and addresses of all members, the class or classes of membership or capital certificates, and the number of capital certificates held by each, and the dates when they respectively became the holders of record thereof.

(b) A corporation may keep its books, minutes, and records in an office of the corporation without the state as specified in the articles of incorporation.

(c) Any of the books, minutes, and records may be in written form or in any other form capable of being converted into written form within a reasonable time.

Comment. Section 901 is derived from Section 621(a) of New York's Not-for-Profit Corporation Law and is very similar to the provisions of Sections 3000-3002 of the Corporations Code (General Corporation Law). Section 901 includes the requirement found in former Section 9606 of the Corporations Code (General Nonprofit Corporation Law) that the corporation keep a list of its members. Such a list is designed to facilitate the operation of other provisions of this code permitting membership action. See, e.g., Sections 752 (right of 10 percent of the members entitled to vote to call a special election), 775 (right of 50 members or 10 percent

of the membership to bring a derivative action in the right of the corporation), 808 (right of 50 members or 10 percent of the membership to petition the court for removal of a director for cause), 1603 (right of 10 percent of the membership to petition the court for dissolution of the corporation).

ISSUES TO BE RESOLVED:

1. Should a nonprofit corporation be required to maintain a complete set of books and records? (Recommendation--Yes.)

2. Should such records be required to be kept in this state? (Recommendation--No.)

405-757

§ 902. Right to inspect books and records

902. (a) The list and record of all members, the books of account, and the minutes of proceedings of the members and the board of directors and of executive committees of the directors of every domestic corporation and of foreign corporations keeping any such records in this state shall be open to inspection at any reasonable time upon the written demand, stating the purpose of the inspection, of any member or holder of outstanding subvention certificates for a purpose which is reasonably related to his interests as a member or as a holder of subvention certificates and shall be exhibited at any time at any meeting of the members when required by the demand of 10 percent of the members represented at the meeting.

(b) Inspection by a member or holder of subvention certificates may be made in person or by agent or attorney, and the right of inspection includes the right to make extracts.

(c) The right of the members to inspect the corporate books, minutes, and records as provided in this section may not be limited in the articles or bylaws.

Comment. Section 902 is derived from Section 3003 of the Corporations Code (General Corporation Law). The language has been altered to conform to the terminology of nonprofit corporations. Moreover, it should be noted that Section 902 permits holders of outstanding subvention certificates to inspect the corporate books and records. See Section 1002 (subventions). See also Section 1004 (articles or bylaws may confer inspection rights upon bondholders).

Analysis

Section 621 of New York's Not-for-Profit Corporation Law contains more detail concerning the legitimate grounds for refusal to permit inspection of the membership list (e.g., the applicant previously "sold or offered for sale" the list of members of a corporation), and there is a requirement that an applicant be a member for six months before he has a right to inspect the corporate books and records. However, the added detail is not essential as the California courts have adequately defined "reasonably related to his interests" as member,¹ the standard employed by Section 902 to grant or deny an application for inspection. Moreover, the six-month requirement is not necessary to protect the corporation as the demand for inspection must be for a proper purpose anyway. It is important to preserve uniformity between the Corporations Code and the Not-for-Profit Corporation Law where the reasons for diverse treatment are not compelling.

ISSUES TO BE RESOLVED:

1. Should a member be required to have been a member for a certain period of time prior to his demand to inspect the membership list? (Recommendation--No.)

2. Should more detail be added concerning the meaning of "reasonably related to his interests as a member or holder of subvention certificates"? (Recommendation--No.)

3. Should the right of inspection be extended to holders of subvention certificates? (Recommendation--Yes.)

1. See *Laher Spring & Tire Co. v. Superior Court*, 52 Cal. App.2d 467, 126 P.2d 391 (1942); *Capron v. Pacific Southwest Discount Corp.*, 6 Cal. App.2d 436, 44 P.2d 629 (1935).

§ 903. Inspection of records and properties by directors

903. Every director has the absolute right at any reasonable time to inspect all books, records, documents of every kind, and the physical properties of the corporation, domestic or foreign, of which he is a director, and also of its subsidiary corporations, domestic or foreign. Such inspection by a director may be made in person or by agent or attorney, and the right of inspection includes the right to make extracts. In the case of foreign corporations, this right extends only to such books, records, documents, and properties of such corporation as are kept or located in this state.

Comment. Section 903 is the same in substance as Section 3004 of the Corporations Code. It establishes a statutory right for directors to inspect the records and properties of the corporation. Moreover, Section 903 assures that directors have the right to delegate inspection to agents or attorneys as this is not a common law right. Dandini v. Superior Court, 38 Cal. App.2d 32, 100 P.2d 535 (1940).

ISSUE TO BE RESOLVED:

1. Should directors be permitted to delegate their absolute right of inspection to attorneys or agents? (Recommendation--Yes.)

998-812

§ 904. Enforcement of right to inspect

904. (a) Upon refusal of a lawful demand for inspection, or upon petition of 10 percent of the members, the superior court of the county in which the principal office or in which the records are located may

enforce the right of inspection with just and proper conditions, or may appoint one or more competent inspectors or accountants to audit the books and records kept in this state, and to investigate the property, funds, and affairs of any domestic corporation or any foreign corporation keeping records in this state and of any subsidiary corporation thereof, domestic or foreign, keeping records in this state, and to report thereon in such manner as the court may direct.

(b) All officers and agents of the corporation shall produce to the inspectors and accountants so appointed all books and documents in their custody or power under penalty of punishment for contempt of court.

(c) All expenses of the investigation or audit shall be defrayed by the applicant unless the court orders them to be paid or shared by the corporation.

Comment. Section 904 is the same in substance as Section 3005 of the Corporations Code (General Corporation Law). It establishes the court's authority to enforce the right of inspection set forth in Sections 902 and 903 and, if necessary, to order an independent inspection of the corporate books and records.

ISSUES TO BE RESOLVED:

1. Should the court be permitted to appoint inspectors or auditors to investigate the corporate records upon refusal of a lawful demand for inspection? (Recommendation--Yes.)

2. Should the applicant bear the cost of the independent investigation? (Recommendation--Yes.)

Article 2. Annual Report

Analysis of Article 2

Article 2 requires corporate disclosure through an annual report and is an essential aspect of the proposed revision. There is a substantial danger that organizations may take advantage of the increased freedom and flexibility of this division to swindle their members or the public.¹ Disclosure is the best and least costly method for reducing this danger; for, in the words of Louis Brandeis, "publicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants; electric light the most efficient policeman."² In addition, these corporations are formed for specific "nonprofit" purposes, and adequate disclosure is necessary so that members, donors, and others can check to see if these objectives are indeed being served. Without the "profit" incentive and guideline, the social usefulness of these organizations is totally dependent upon how well they serve the intended purpose, and disclosure is the best constraint against undue deviation from that purpose or purposes.

Presently, the affairs of many nonprofit organizations can be carried out in private. These organizations are often exempt from the disclosure requirements of the federal securities laws as they do not offer securities for sale; moreover, nonprofit corporations need not make annual reports under Section 3006 of the Corporations Code (General Corporation Law) as that provision governs only "stock" companies.³

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1. For a discussion of this problem, see Oleck, Proprietary Mentality and the New Non-Profit Corporations Law, 20 Cleveland State L. Rev. 145 (1971).
 2. L. Brandeis, Other Peoples Money 62 (Hall Home Lib. ed. 1933). Many commentators have argued that there should be more disclosure for all corporations; see Blumberg, The Public's "Right to Know": Disclosure in the Major American Corporations, 28 Bus. Law 1025 (1973); Schoenbaum, The Relationship Between Corporate Disclosure and Corporate Responsibility, 40 Fordham L. Rev. 565 (1972).
 3. Section 9402 of the Corporations Code (General Nonprofit Corporation Law) authorizes nonprofit corporations to provide for an annual report in their bylaws, but this is not a mandatory requirement.

It is true that charitable corporations and those which hold property in trust are required by the Uniform Supervision of Trustees for Charitable Purposes Act (Govt. Code § 12580 et seq.) to file annual and other reports as prescribed by the Attorney General, but the Uniform Act does not provide for dissemination of the disclosed information to members and other interested persons so as to warrant exemption of these corporations from the provisions of this article.⁴ Furthermore, the disclosure requirements of this article are in many respects more detailed than the requirements established by the Attorney General under the Uniform Act.⁵ These provisions are designed to present an accurate picture of the overall effectiveness of the organization in order that members and the public may decide whether continued support is warranted. This goal requires a different emphasis than is ordinarily required for the supervision of trust property.

In general, the proposed annual report combines the financial disclosure requirements of Section 519 of New York's Not-for-Profit Corporation Law (which has been adopted in Pennsylvania as Section 7555 of the Corporation Not-for-profit Code of 1972) with the general activities report requirements of Section 81 of the ABA-ALI Model Non-Profit Corporation Act. Basic facts concerning the corporate activities (e.g., changes in the number of members) and the corporate financial condition (e.g., assets and liabilities) must be disclosed every 12-month period.

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4. Section 12590 of the Government Code provides that, subject to reasonable rules and regulations adopted by the Attorney General, the reports filed pursuant to the Uniform Supervision of Trustees for Charitable Purposes Act shall be open to public inspection. However, that section expressly prohibits the public inspection of any document whose contents are not exclusively for charitable purposes. Moreover, the right of inspection is quite a different matter from the right to a copy pursuant to Section 953.
 5. See the Administrative Rules and Regulations for the Uniform Supervision of Trustees for Charitable Purposes Act (Cal. Admin. Code, Tit. 11, §§ 300-310). In particular, see Section 306 (contents of the report.). The Uniform Act does not require disclosure of such facts as changes in number of members, and it is unclear whether it requires an itemized list of salaries.

In addition to the disclosure requirements of the Model Act and New York's new code, the proposed annual report requires the corporation to specifically relate its present activities to its purposes as set forth in the articles (Section 952(d)). This statement forces the corporation to consciously consider its objectives, and it also provides a helpful factual basis for a proceeding to enjoin ultra vires activities.

Also, a new provision--subdivision (i) of Section 952--permits the courts to define the limits of proper disclosure. The corporation is under a duty to disclose in its annual report all facts which are "reasonably necessary" to make the report accurate and not misleading. This requirement is necessary because adequate disclosure is not susceptible to a general statutory definition but rather is better handled by the courts on a case by case basis.

If the annual report is to be effective, a means must be developed for its preservation as a public record. One approach is to require a verified copy of the report to be delivered to the Secretary of State for filing in a manner analogous to other corporate records (e.g., articles of incorporation). However, this approach places a large burden on the Secretary of State and, given his limited staff, is probably unworkable. As an alternative, this code requires the corporation to preserve its own annual report for a period of 10 years at its principal office or, in the case of a foreign corporation, at the office or residence of its designated agent for service of process. Moreover, any interested person may inspect the annual reports at these locations during any reasonable time. See Section 953. It should also be noted that, since there is no mandatory filing requirement, Section 951 requires the corporation to complete the preparation of its annual report by March 1 unless another date is specified in the articles or bylaws.

Adequate disclosure also demands an effective mechanism for dissemination of the disclosed information to the relevant parties. Many states require the presentation of the annual report at the annual meeting of the members or shareholders (in the case of profit oriented corporations).⁶ However, this division does not require such a meeting for the reasons discussed

6. See N.Y. Not-for-Profit Corporation Law § 519.

in the Analysis to Section 751; therefore, a new procedure is needed for dissemination of the required report. A possible alternative is to require every nonprofit corporation to send a copy to each member,⁷ but this is a costly process and is potentially wasteful of resources as many members, lacking a financial stake in the organization, will probably not read the report which is sent to them. A better approach is to require the corporation to send a copy only to persons who make a written request for the report. See Section 954. This reduces waste while insuring that all interested persons have easy access to the report.

It should be noted that the proposed statute does not limit the right to request a copy of the report to members of the corporation. The public at large needs access to this report as nonprofit corporations receive special advantages from the state and, therefore, require close public scrutiny of their activities. The provision granting any interested person a right to a copy is designed to facilitate that scrutiny. However, it is unlikely that many persons will take advantage of this right so the cost to the corporation should be minimal.

Since the goal of this article is gaining the required information from nonprofit corporations, the best enforcement mechanism is simply a statutory action whereby any aggrieved person may seek to compel the corporation to comply with the annual report requirements or be held in contempt of court. Section 955 permits any person to bring such an action after making a proper demand on the corporation for voluntary compliance. Furthermore, when a court orders compliance, the plaintiff is awarded his reasonable expenses in bringing and prosecuting the action. In this manner, the enforcement action is made practical by reducing the burden on a person seeking to gain his legal rights under this article.

7. See Corp. Code § 3006 (General Corporation Law)(each shareholder must be sent an annual report). Section 954 permits the articles or bylaws to require that a copy of the annual report be sent to each member, but this is a permissive rule.

§ 951. Annual report required; date for preparation

951. (a) Each domestic and each foreign corporation conducting intrastate activities in this state shall prepare an annual report as prescribed by this article. The report shall be completed between the first day of January and the first day of March or by such other date as is specified in the articles or bylaws.

(b) The requirements of this article are in addition to the requirement of Section 12586 of the Government Code.

Comment. Section 951 establishes the scope of the disclosure requirements of this article. All nonprofit corporations conducting affairs in this state must comply with these provisions. The provisions of this article are designed to provide members and the general public with basic information concerning the activities of nonprofit corporations.

For many nonprofit corporations, a mandatory annual report is new. Former Section 9402 of the Corporations Code (General Nonprofit Corporation Law) provided that the bylaws of a nonprofit corporation might make provision for the making of annual reports and financial statements to the members, but this was not a mandatory requirement. Charitable corporations and those which hold property in trust or accept property to be used for a charitable purpose are required by the Uniform Supervision of Trustees for Charitable Purposes Act (Govt. Code § 12580 et seq.) to file annual and other reports as prescribed by the Attorney General.

Subdivision (b) makes clear that the annual report required by this article is in addition to any report required by the Uniform Supervision of Trustees for Charitable Purposes Act (Govt. Code § 12580 et seq.). The disclosure provisions of that act will not serve as a substitute for the requirements of this article because the Uniform Act does not provide for adequate public dissemination of the facts disclosed. See Section 954 (right to a copy). If the disclosure provisions of this article coupled

with those of the Uniform Act result in unnecessary duplication and hardship, the corporation may petition the Attorney General pursuant to Section 12586 of the Government Code for suspension of the reporting requirements of the Uniform Act.

ISSUES TO BE RESOLVED:

1. Should nonprofit corporations be required to prepare and keep an annual report? (Recommendation--Yes.)
2. Should this requirement govern foreign corporations that conduct intrastate activities in this state? (Recommendation--Yes.)
3. Should this annual report be in addition to the reporting requirements for charitable corporations under the Uniform Act? (Recommendation--Yes.)
4. Should the corporation be required to file its annual report with a governmental official? (Recommendation--No.)

998-817

§ 952. Required provisions

952. The annual report shall show in appropriate detail all of the following:

- (a) The name of the corporation and its place of incorporation.
- (b) The name and address of each director and officer and a statement of the place where the name and address of each employee of the corporation may be found.
- (c) The number of members of the corporation as of the date of the report together with a statement of increase or decrease in that number during the year immediately preceding the date of the report and a statement of the place where the name and residence address of each current member may be found.

(d) A brief statement of the character of the affairs of the corporation or, in the case of a foreign corporation, those affairs actually conducted in the state and how these relate to the purposes for which the corporation was formed.

(e) The assets and liabilities, including the trust funds, of the corporation as of the end of a 12-month fiscal period terminating not more than six months prior to the report.

(f) The principal changes in assets and liabilities, including trust funds, during the year immediately preceding the date of the report.

(g) The revenue or receipts of the corporation, both unrestricted and restricted to particular purposes, for the year immediately preceding the date of the report.

(h) The expenses and disbursements of the corporation, for both general and restricted purposes, including the salaries or other remuneration of officers and directors during the year immediately preceding the date of the report.

(i) All other information which is reasonably necessary to present an accurate and not misleading picture of the affairs of the corporation to members, creditors, and the public at large.

Comment. Section 952 is derived in large part from Section 519 of New York's Not-for-Profit Corporation Law and from Section 81 of the ABA-ALI Model Non-Profit Corporation Act. Subdivision (a) follows in substance Section 81(a) of the Model Act, and subdivision (b) follows in substance Section 81(b) of that act. The language of subdivision (c) is taken from Section 519(a)(5) of New York's Not-for-Profit Corporation Law. Subdivision (d) follows Section 81(c) of the Model Act except that

this provision requires a more explicit statement as to how the corporation's affairs relate to its intended purposes as set forth in the articles of incorporation. This requirement is designed to force the corporation to consciously consider its intended purposes and also to facilitate a challenge to ultra vires activities. See Section 304 (ultra vires acts). Subdivisions (e) through (h) are the same as the financial reporting requirements of Section 519(a) of New York's Not-for-Profit Corporation Law except that, in addition, paragraph (h) explicitly requires the listing of all remuneration given to directors and officers. Subdivision (i) is entirely new. It authorizes the courts to define the parameters of proper disclosure and is intended to promote an accurate and not misleading report.

ISSUES TO BE RESOLVED:

1. Should the annual report include a detailed financial statement? (Recommendation--Yes.)
2. Should the annual report include a statement of the affairs of the corporation? (Recommendation--Yes.)
3. Should there be a general provision requiring the corporation to present all information necessary for an accurate and not misleading picture of its activities? (Recommendation--Yes.)

998-818

§ 953. Duty to preserve the annual report

953. (a) Every domestic corporation shall keep a copy of each of its annual reports for a period of 10 years at its principal office.

(b) Every foreign corporation shall keep a copy of each of its annual reports for a period of 10 years at its principal office in this state or at the business office or residence, in this state, of the person or corporation designated as agent for service of process.

(c) Anyone may inspect the corporation's annual reports at a reasonable time.

Comment. Section 953 is new and is designed to permit long-term public scrutiny of the affairs of a nonprofit corporation. Subdivision (c) creates a public right of inspection which is analogous to the member's right of inspection of the corporate books and records set forth in Section 902; however, by permitting public inspection of only the last 10 annual reports, subdivision (c) preserves somewhat the sanctity of the membership list (which need not be included in those reports). See Section 952.

ISSUES TO BE RESOLVED:

1. Should the corporation be required to keep a copy of its annual report more than 10 years? (Recommendation--No.)

2. Should the right of inspection at reasonable times of the corporation's past annual reports be unrestricted? (Recommendation--Yes.)

998-819

§ 954. Providing copies of annual report on request

954. (a) Except as provided in subdivision (b), the corporation shall deliver by mail or other appropriate means one copy of the latest annual report to any person who makes written request for this report. The corporation may charge a person who is not a member of the corporation a fee not to exceed five dollars (\$5) for providing a copy of the annual report.

(b) The articles or bylaws may require a copy of the annual report to be sent to all members or to specified classes or types of members without written or other request.

Comment. Section 954 requires the corporation to send a copy of the annual report to any person upon written request. It guarantees easy access to the annual report by interested persons. Furthermore, by facilitating disclosure, it aids the enforcement provisions of this code. For a comparable provision, see Section 621(e) of New York's Not-for-Profit Corporation Law.

Subdivision (b) recognizes that the corporation may desire to provide in its articles or bylaws that each member shall be sent a copy of the annual report. Cf. former Corp. Code § 9402(e).

ISSUES TO BE RESOLVED:

1. Should the corporation be required to send a copy of the annual report to each member? (Recommendation--No.)
2. Should the corporation be permitted to require in its articles or bylaws that a copy of the annual report be sent to each member or to certain classes of members? (Recommendation-Yes.)
3. Should the right to receive a copy of the report upon written request be restricted to the members? (Recommendation--No.)
4. Should the corporation be permitted to charge a nominal fee for sending a copy of the report to nonmembers? (Recommendation-Yes.)

998-820

§ 955. Action to compel compliance; attorney's fees

955. (a) Any person may bring an action to compel a corporation to comply with the provisions of this article.

(b) Thirty days prior to bringing an action under this section, the plaintiff shall make a written demand upon the corporation stating specifically in what respect there is noncompliance with the provisions of this article.

(c) If a court orders compliance with the provisions of this article, the plaintiff shall be awarded reasonable expenses in bringing and prosecuting the action, including reasonable attorney's fees.

(d) An officer, director, employee, or agent of a corporation shall indemnify the corporation for plaintiff's expenses awarded under subdivision (c) if the corporation's failure to comply with the provisions of this article was caused by a breach of his fiduciary duty to the corporation.

Comment. Section 955 provides a statutory means for compelling a corporation to comply with the provisions of this article. It recognizes that the most important goal in any enforcement provision pertaining to the annual report is simply to gain the required information rather than to punish the corporation for its noncompliance. Consistent with this goal, subdivision (b) requires the plaintiff to make a demand for compliance 30 days prior to initiating an action to compel compliance. This provision permits the corporation to correct unintentional deficiencies and is analogous to the demand requirement of Section 1601 (written demand must be made 30 days prior to bringing an action for involuntary dissolution on certain grounds).

To reduce the burden of litigation expenses upon persons seeking to compel compliance with the annual report requirements, subdivision (c) requires an award of reasonable costs to the plaintiff whenever the corporation is ordered to comply with this article, and subdivision (d) places the final burden of awarded costs upon those most at fault.

ISSUES TO BE RESOLVED:

1. Should there be a special statutory action to compel compliance with the provisions of Article 2? (Recommendation--Yes.)
2. Should there be a civil liability provision for failure to comply with the disclosure requirements? (Recommendation--No.)
3. Should plaintiffs in the action to compel compliance be awarded litigation expenses if the court decides favorably? (Recommendation--Yes.)

4. Should the corporation be given a right of indemnity when litigation expenses are awarded as a consequence of an officer's, director's, or employee's breach of fiduciary duty to the corporation? (Recommendation--Yes.)

998-822

§ 956. Criminal penalty for fraudulent annual report

956. Every director, officer, or agent of any corporation who concurs in the preparation and keeping of an annual report which contains any material statement which is false or which in any other way is fraudulent and meant to deceive is guilty of a felony punishable by a fine not to exceed fifty thousand dollars (\$50,000) or by imprisonment in the state prison or county jail for a period not to exceed one year, or both, if he knows the report is false, fraudulent, or meant to deceive.

Comment. Section 956 is similar to Section 3019 of the Corporations Code (General Corporation Law) (criminal penalty for false records). It provides a criminal penalty for those who participate in the making or filing of a false or fraudulent annual report knowing the report to be false or fraudulent. For civil liability for false reports, see Section 825.

ISSUES TO BE RESOLVED:

1. Should there be criminal penalties for participation in the preparation of a fraudulent annual report? (Recommendation--Yes.)

2. Is the penalty provided appropriate? (Recommendation--Yes.)

Article 3. Statement of Identification of Corporate Offices
and Officers; Designation of Agent for Service

§ 975. Statement of identification of corporate offices and officers
required

975. Every corporation shall file statements of identification of the corporate offices and officers as provided in this article.

Comment. Section 975 establishes the scope of this article which supersedes those provisions of Section 3301 of the Corporations Code which applied to nonprofit corporations.

ISSUE TO BE RESOLVED:

1. Should the statement of identification of the corporate offices and officers be continued? (Recommendation--Yes.)

406-470

§ 976. Required provisions

976. The statement of identification of the corporate offices and officers shall set forth:

(a) The names and complete business or residence addresses of the officers of the corporation if the corporation has officers.

(b) The address of the corporation's principal office.

Comment. Section 976 alters the information requirements of Section 3301 of the Corporations Code (which previously governed nonprofit corporations) so as to conform to the provisions of this code which permit a corporation to have such officers as it deems advisable. See Section 819.

ISSUE TO BE RESOLVED:

1. Are there other subjects which should be included in this statement? (Recommendation--No.)

406-471

§ 977. Designation of an agent for service of process

977. A corporation may designate in the statement of identification of the corporate offices and officers an agent for service of process. If a natural person is designated, the statement shall set forth his complete business or residence address. If a corporate agent, nonprofit or otherwise, is designated, the statement shall set forth the state or place under which such agent was incorporated and the name of the city, town, or village wherein it has the office at which the corporation designating it as such agent may be served as set forth in the certificate filed by such corporate agent pursuant to Sections , , , or of the Code of Civil Procedure.

Comment. Section 977 continues for nonprofit corporations the provisions of Section 3301 of the Corporations Code that permit an agent for service of process to be designated in the statement of identification of corporate offices and officers.

Note. The staff plans to draft a new chapter in the Code of Civil Procedure which will cover designation of an agent for service of process for both business and nonprofit corporations.

§ 978. Filing of first statement

978. A corporation shall file with the Secretary of State a statement of identification of the corporate offices and officers within 90 days after filing its original articles of incorporation.

Comment. Section 978 supersedes a part of Section 3301 of the Corporations Code to the extent that that section previously governed nonprofit corporations.

§ 979. Amended statement

979. (a) A corporation shall forthwith file with the Secretary of State an amended statement of identification of the corporate offices and officers containing the information required by Section 976 each time there is a change in the location or address of its principal office or the stated address of a natural person whom it has designated as an agent for service of process or the city, town, or village wherein it may be served by delivery of a copy of any process to a designated corporate agent.

(b) A corporation may at any time file with the Secretary of State an amended statement containing the information required by Section 976 wherein a new agent for service of process is designated or a prior designation of agent is expressly revoked without designating a new agent, and such filing shall be deemed to revoke any prior designation of agent.

Comment. Section 979 continues in substance part of Section 3301 of the Corporations Code (which is superseded for nonprofit corporations by this article).

ISSUES TO BE RESOLVED:

1. Should a nonprofit corporation be required to file an amended statement when there is a change in officers? (Recommendation--No.)
2. Should an amended statement be required each time there is a change in the name or address of a corporate officer? (Recommendation--No.)

406-474

§ 980. Supplemental statements

980. During the period commencing on April 1st and ending June 30th of the fifth calendar year following the filing of its last statement of identification of corporate offices and officers (whether such statement was its first statement, an amended statement, or a supplemental statement), a corporation shall file a supplemental statement satisfying the requirements of Section 976.

Comment. Section 980 continues much of the substance of the supplemental statement previously required of nonprofit corporations pursuant to Section 3301 of the Corporations Code. It should be noted that corporations which filed a statement in compliance with that provision must comply with Section 980. See Section 986. Besides updating the record of corporate officers, this provision provides a means for determining whether or not a corporation is still functioning.

ISSUE TO BE RESOLVED:

1. Should the supplemental statement be filed sooner than five years after the filing of the last statement? (Recommendation--No.)

§ 981. Public's right to information

981. The information filed by a corporation pursuant to this article shall be made available to the public upon request.

Comment. Section 981 is the same as a part of Section 3301 of the Corporations Code (which is superseded for nonprofit corporations by this article).

ISSUE TO BE RESOLVED:

1. Should this information be a public record? (Recommendation-- Yes.)

406-476

§ 982. Effect of article as constituting notice

982. This article shall not be construed to place any person dealing with a corporation on notice of, or impose on any such person a duty or obligation to inquire about the existence or content of, any statement filed pursuant to this article.

Comment. Section 982 is the same in substance as a part of former Section 3301 of the Corporations Code which established the effect of the statement previously required of nonprofit corporations by that section.

406-477

§ 983. Disposal of superseded statements

983. The Secretary of State may destroy or otherwise dispose of any statement filed pursuant to this article after it has been on file for

10 years or has been superseded by the filing of a new statement, whichever is the earlier time.

Comment. Section 983 is derived from Section 3301.3 of the Corporations Code.

ISSUE TO BE RESOLVED:

1. Is 10 years too long to require the Secretary of State to maintain statements which have not been superseded? (Recommendation--No.)

404-331

§ 984. Default; suspension for failure to file; notice

984. (a) Any corporation which fails to file the statements required by this article shall be deemed in default and, except for the purpose of amending the articles of incorporation to set forth a new name, the corporate powers, rights, and privileges of such corporation shall, as soon as practicable, be suspended by the Secretary of State.

(b) Upon suspension of the corporation as provided in subdivision (a), the Secretary of State shall notify the corporation and the Franchise Tax Board of such suspension. If the only address disclosed by the records of the Secretary of State for the corporation's principal office is the county in which the office is located, then such notice of the suspension of the corporation's powers shall be sent to the county seat addressed to the corporation in care of the county clerk. In such case, the county clerk shall promptly send the notice to the corporation at its address in the county, if known to him, or, if unknown, shall cause the notice to be posted at the courthouse of the county for 30 days.

(c) The suspension of the corporate powers, rights, and privileges is effective upon the transmittal to the Franchise Tax Board of notification of the suspension and has the same effect as a suspension for nonpayment of franchise taxes pursuant to Section 23301 of the Revenue and Taxation Code.

Comment. Section 984 is derived from Section 3301.1 of the Corporations Code which previously governed nonprofit corporations that defaulted in filing the statements of identification of the corporate offices and officers required by Section 3301 of the Corporations Code.

ISSUE TO BE RESOLVED:

1. Should the penalty for failure to file the statements required by this article be suspension of the corporate existence? (Recommendation--Yes.)

404-332

§ 985. Relief from default and suspension

985. (a) Subject to subdivision (b), a corporation which has suffered the suspension provided for in Section 984 and whose corporate powers are not also otherwise suspended may be relieved therefrom upon making an application therefor to the Secretary of State on a form prescribed by him, making the filing which was the basis for the suspension, and paying the required filing fee. Application for such relief may be made by any member or creditor of the corporation or by a majority of the surviving directors of the corporation.

(b) If the name of the corporation which has suffered such suspension is one which is likely to mislead the public or is the same as, or resembles

so closely as to tend to deceive, the name of a foreign or domestic profit or nonprofit corporation which is qualified to transact business or conduct intrastate activities in this state or a name which is under reservation, the Secretary of State shall not relieve the corporation of such suspension until the corporation files in his office a certificate of amendment changing the corporate name.

(c) The Secretary of State shall promptly notify the corporation and the Franchise Tax Board of such relief from the suspension of the corporate powers pursuant to Section 984, but such relief does not revive any corporate powers then suspended pursuant to any other provision of law.

Comment. Section 985 is derived from Section 3301.2 of the Corporations Code which previously provided relief fro nonprofit corporations suspended by operation of Section 3301.1 of the Corporations Code (a section superseded to the extent that it applied to nonprofit corporations by Section 984).

§ 986. Prior compliance with Corporations Code provisions

986. For the purpose of this article, any statement filed in compliance with Section 3301 of the Corporations Code prior to the effective date of this code is deemed to be filed under this article.

Comment. Section 986 removes the burden of duplicative filing for corporations which have complied with the statement filing provisions of Section 3301 of the Corporations Code.

CHAPTER 6. CORPORATE FINANCE

Article 1. General Provisions§ 1000. Stock prohibited

1000. A corporation shall not have stock or shares or certificates for stock or for shares.

Comment. Section 1000 is derived from Section 501 of New York's Not-for-Profit Corporation Law. A nonprofit corporation may not issue stock or shares, for to do so would be inconsistent with the requirement set forth in Section 155 that no part of the income, assets, or profits of a nonprofit corporation be distributed or inure to the direct tangible benefit of members, directors, or officers. Membership certificates or cards, which are nontransferable, may be issued as provided in Section 703.

ISSUE TO BE RESOLVED:

1. Should a nonprofit corporation be permitted to have stock or shares? (Recommendation--No.)

406-239

§ 1001. Capital contributions

1001. (a) The articles may provide that members, upon or subsequent to admission, shall make capital contributions in the amount specified in the articles. The requirement of a capital contribution may apply to all members, or to the members of a single class, or to members of different classes in different amounts or proportions.

(b) The capital contribution of a member shall consist of money or other property, tangible or intangible, or labor or services actually

received by or performed for the corporation or for its benefit or in its formation or reorganization, or any combination thereof. In the absence of fraud in the transaction, the judgment of the board of directors or governing body as to the value of the consideration received by the corporation is conclusive.

(c) Unless otherwise provided in the articles, the capital contribution of a member is not transferable.

(d) A member's capital contribution shall not be repaid or redeemed by the corporation except upon dissolution of the corporation or upon redemption of the capital certificate as provided in this section. A corporation may provide in its articles of incorporation that its capital certificates, or some of them, are redeemable, in whole or in part, according to the terms set forth in the articles which are not inconsistent with this code.

(e) A member's capital certificate may be evidenced by nontransferable certificates which clearly state that the corporation is a not-for-profit corporation and that the certificate is nontransferable.

Comment. Section 1001 is modeled after Section 502 of New York's Not-for-Profit Corporation Law and Section 7541 of Pennsylvania's Corporation Not-for-profit Code. It provides rules governing member's capital contributions. These contributions--which may be transferred or redeemed according to terms specified in the articles--are useful means of raising funds for capital improvements for the corporation. Subdivision (d) makes clear that the terms for redemption may not be used as a means to circumvent the prohibition against the distribution of income, assets, or profits to the members set forth in Section 1006. Subdivision (e), which requires that capital certificates be nontransferable, is designed to reduce the danger that these certificates may be traded as securities.

Analysis

Initiation fees and other forms of capital contributions have long been used by nonprofit corporations in California to finance capital improvements for the corporation. Section 1001 establishes a set of rules governing these contributions. These rules are primarily designed to eliminate the danger that a corporation may use its redemption procedure as a device for making an unpermitted distribution of its income or assets to the members and also to reduce the danger that certificates evidencing these contributions will be traded as securities. Section 1001 is very similar to Section 502 of New York's Not-for-Profit Corporation Law and Section 7541 of Pennsylvania's Corporation Not-for-profit Code.

ISSUES TO BE RESOLVED:

1. Is a provision required outlining rules for members' capital contributions? (Recommendation--Yes.)
2. Should capital contributions be redeemable without restriction? (Recommendation--No.)

406-240

§ 1002. Subventions

1002. (a) The articles of incorporation may provide that the corporation is authorized by resolution of the board to accept subventions from members or nonmembers on terms and conditions not inconsistent with this code and to issue certificates evidencing the subvention. Subvention certificates are nontransferable unless the resolution provides that they are transferable either at will or subject to specified restrictions.

(b) A subvention shall consist of money or other property, tangible or intangible, actually received by the corporation or expended for its benefit or for its formation or reorganization or combination thereof.

In the absence of fraud in the transaction, the judgment of the board as to the value of the consideration received by the corporation is conclusive.

(c) The rights of holders of subvention certificates are subordinate to the rights of creditors of the corporation.

(d) The resolution of the board may provide that the holders of subvention certificates are entitled to a fixed or contingent periodic payment out of the corporate assets equal to a percentage of the original amount or value of the subvention, but such payment may not exceed five percent a year.

(e) The resolution of the board may provide that a subvention is redeemable, in whole or in part, at the option of the corporation at such price or prices (not to exceed the original amount or value of the subvention plus any periodic payments due or accrued thereon), within such period or periods, and on such terms and conditions, not inconsistent with this article, as are stated in the resolution.

(f) The resolution of the board may provide that holders of all or some subvention certificates have the right to require the corporation after a specified period of time to redeem such certificates, in whole or in part, at a price or prices that do not exceed the original amount or value of the subvention plus any periodic payments referred to in subdivision (d) which are due or accrued thereon, upon an affirmative showing that the financial condition of the corporation will permit the required payment to be made without impairment of its operations or injury to its creditors. The right to require redemption may be conditioned upon the occurrence of a specified event. For the purpose of enforcing their rights

under this subdivision, holders of subvention certificates are entitled to inspect the books and records of the corporation.

(g) Upon dissolution of the corporation, holders of subvention certificates are entitled, after the claims of creditors have been satisfied, to a repayment of the original amount or value of the subvention plus any periodic payments due or accrued thereon unless a lesser sum is specified in the articles or in the resolution of the board concerning such subvention.

Comment. Section 1002 introduces into the California nonprofit corporations law the subvention, a new concept for long-term investment in the activities of nonprofit corporations. This investment device is modeled after Section 504 of New York's Not-for-Profit Corporation Law and Section 7542 of Pennsylvania's Corporation Not-for-profit Code. It permits a nonprofit corporation under the limited conditions set forth in this section to receive unsecured, nonprofit-oriented loans from individuals or organizations which are to be repaid upon the occurrence of a specified event, such as the accomplishment of the purpose for which the loan was made, provided that repayment at that time does not impair the activities of the corporation or harm its creditors. To protect the principal of this loan from being diminished in value by inflation prior to the payment date, a nonprofit corporation may pay interest to the holders of subvention certificates in an amount not to exceed five percent of the value of the subvention.

Subdivision (a) establishes the requirement that all subventions be authorized by a resolution of the board which itself must be authorized by an appropriate provision in the articles that permits the acceptance of subventions and the issuance of subvention certificates. Subdivision (b), which states what constitutes proper consideration for a subvention certificate, is similar to Sections 1111 and 1112 of the Corporations Code (General Corporation Law) (rules for the issuance of no par stock). The remaining subdivisions spell out some of the characteristics of a subvention which distinguishes it from other financial interests.

Subdivision (e) is designed to prevent subventions from being used to circumvent the requirement of Section 1006 that there be no distribution of income, assets, or profits to members, officers, or directors because of their status as members, officers, or directors.

Subdivision (f) allows the board by resolution to give to holders of subvention certificates the right to require, after a specified period of time or the occurrence of a specified event, the redemption of subvention certificates. The price of redemption shall not exceed the original value of the subvention plus any periodic payments already accrued which are permitted by subdivision (d). Furthermore, the right to redemption may only be exercised upon an affirmative showing that the corporation's operations and creditors will not be damaged by the redemption. This latter provision is necessary to give effect to subdivision (c) which establishes the inferior status of subvention holders to creditors of the corporation.

Subdivision (g) permits the holders of subvention certificates to share in the proceeds after dissolution when the creditors' claims have been fully satisfied. Thus, the claim of a subvention holder is superior to that of a member.

Analysis

The ability to raise necessary capital is an important tool for every healthy and active organization. Since nonprofit corporations are not permitted to issue equity securities, their alternatives for raising capital have been somewhat limited. Traditionally, these corporations have raised additional money by soliciting gifts from the public, requiring capital contributions or assessments from members, or by creating conventional forms of debt such as mortgaging the corporate assets. In order to give nonprofit corporations increased flexibility in this matter, New York's Not-for-Profit Corporation Law has developed a new concept for long-term investment in the activities of these corporations--the subvention.¹

Pursuant to a resolution of the board authorized by an appropriate provision in the articles, a nonprofit corporation is permitted to accept subventions which are unlike other forms of debt in that: (1) they create

1. N.Y. Not-for-Profit Corporation Law § 504; see Note, New York's Not-for-Profit Corporation Law, 47 N.Y.U. L. Rev. 761, 783-784 (1971).

a conditional obligation which is unsecured and inferior to the claims of all creditors; (2) the corporation may pay only a limited amount of interest on the principal of the subvention; (3) the subvention may be redeemable by the subventor upon the occurrence of a specified event, such as the accomplishment of the purpose for which it was made, but only if the subventor at that time makes an affirmative showing that the redemption will not harm the activities of the corporation or its creditors.

Clearly, the subvention is not intended to be a profitmaking device for the subventor as the permissible interest is barely enough to balance against inflation and is far less than the amount an investor might reasonably demand from such a risky investment.² Instead, the subvention is designed to encourage individuals, organizations, or government to support the activities of nonprofit corporations through loans which, while they are not profitable, are nevertheless returnable for redeployment at a value which is essentially the same as at the time of the loan.

An important advantage of the subvention over other forms of debt is that, since it is inferior to all creditor's claims, it does not reduce the borrowing capacity of the corporation or drive the corporation toward bankruptcy.

One commentator has criticized this new concept because in essence it permits a donor to give a charitable gift and then take it back.³ However, this criticism seems to be based upon an unnecessarily prudish moral position and also it mischaracterizes a subvention which is more of a

2. The exact amount of the permitted interest is a policy question which must be resolved by the Commission. New York allows only two-thirds of the amount of interest permitted by its General Obligations Law. This presently amounts to four percent. However, five percent or more seems a more realistic figure. The main consideration in limiting the interest is to guarantee that the subvention will not be used as a device to make unpermitted distributions of income, assets, or profits to members, officers, or directors. Moreover, the subvention is intended to be a returnable subsidy for the nonprofit corporation and not a profitmaking device for the subventor.

3. Oleck, Non-Profit Types, Uses, and Abuses: 1970, 19 Cleveland State L. Rev. 207 (1970); see Oleck, Proprietary Mentality and the New Non-Profit Corporations Law, 20 Cleveland State L. Rev. 145 (1971).

loan than a gift. In general, the subvention seems to be a sound device for encouraging semicharitable investment in the activities of nonprofit corporations and should be adopted for California.

ISSUES TO BE RESOLVED:

1. Should California adopt the subvention concept for its nonprofit corporations? (Recommendation--Yes.)
2. Should the periodic payment on subventions be limited to a maximum of five percent? (Recommendation--No.)
3. Should subventions be redeemable with certain restrictions upon the occurrence of a specified event? (Recommendation--Yes.)

406-243

§ 1003. Subvention certificates

1003. (a) Each subvention certificate shall be signed by two duly authorized officers of the corporation or by a majority of the board and may be sealed with the seal of the corporation or a facsimile thereof. The signatures of the officers or directors upon a certificate may be facsimiles if the certificate is countersigned by a transfer agent or registered by a registrar other than the corporation itself or its employees. In case any officer or director who has signed or whose facsimile signature has been placed upon a certificate has ceased to be such officer or director before the certificate is issued, it may be issued by the corporation with the same effect as if he were an officer or director at the date of issue.

(b) Each subvention certificate shall, when issued, state upon its face:

- (1) The name of the person or persons to whom issued.

(2) The amount of the subvention evidenced by such certificate.

(3) The amount of the periodic payment, if any, authorized by the board.

(4) If appropriate, that the certificate is redeemable and a summary of the conditions for redemption at the option of the corporation or of the holder.

(5) If appropriate, that the certificate is transferable either at will or subject to specified restrictions.

(c) The fact that the corporation is a not-for-profit corporation and, where appropriate, that the certificate is transferable at will or subject to restrictions shall be noted conspicuously on the face or back of each certificate.

Comment. Section 1003, which sets forth the requirements of a subvention certificate, is modeled after Section 505 of New York's Not-for-Profit Corporation Law except Section 1003 requires that the certificate be signed by any two officers (which follows Section 7542(c) of Pennsylvania's Corporation Not-for-profit Code) or by a majority of the board.

ISSUE TO BE RESOLVED:

1. Should there be detailed rules governing subvention certificates? (Recommendation--Yes.)

406-244

§ 1004. Bonds; rights of bondholders

1004. (a) No corporation shall issue bonds except for money or other property, tangible or intangible, or labor or services actually received

by or performed for the corporation or for its benefit or in its formation or reorganization, or a combination thereof. In the absence of fraud in the transaction, the judgment of the board as to the value of the consideration received by the corporation is conclusive.

(b) A corporation may pay reasonable interest on its bonds, may issue its bonds at a reasonable discount, and may pay a reasonable premium for the redemption thereof prior to maturity, but the holders of the bonds are not entitled at any time to receive any part of the income or profit of the corporation nor at maturity to receive more than the principal sum plus interest due and accrued. In the absence of fraud in the transaction, the judgment of the board as to the reasonableness of any such interest, discount, or premium is conclusive. However, with respect to bonds not a part of a public offering, notwithstanding the terms of the instrument, no member of a corporation is entitled to receive, directly or indirectly, as a holder or beneficiary of the bond, prior to maturity or redemption, more than simple interest at a rate equal to the prime rate of interest then prevailing at the Federal Reserve Bank of San Francisco, or at maturity or redemption, more than the principal sum thereof plus any interest, not exceeding the maximum interest specified, due and accrued.

(c) A corporation may, in its articles or bylaws, confer upon the holders of any bonds, issued or to be issued by the corporation, rights to inspect the corporate books and records and to vote in the election of directors and on any other matter on which members may vote. In a corporation having no members, voting rights may be conferred upon bondholders only with respect to the election of directors. The articles of incorporation

may apportion the number of votes that may be cast with respect to bonds on the basis of the amount of bonds held.

Comment. Section 1004 is substantially the same as Section 506 of New York's Not-for-Profit Corporation Law. Subdivision (a) is similar to Section 1109 of the Corporations Code (General Corporation Law) (which governs proper consideration for the issuance of shares). Subdivision (b) prohibits a member from directly or indirectly receiving more than the principal sum plus simple interest, on the amount of the principal, equal to the prime rate of the Federal Reserve Bank of San Francisco. This subdivision applies to any bonds issued while the holder or beneficiary is a member of the corporation. It is designed to protect against a corporation's making unpermitted distributions of assets, profits, or income to members. Subdivision (c) is similar to Section 306 of the Corporations Code, and it authorizes the corporation to give holders of bonds special rights including inspection of corporate books and a right to vote in the election of directors.

ISSUES TO BE RESOLVED:

1. Should the corporation be limited to paying only "reasonable" interest on its bonds? (Recommendation--Yes.)
2. Should there be a restriction in the permissible amount of interest which may be paid to members on bonds not a part of a public offering? (Recommendation--Yes.)
3. Should the corporation be permitted to confer voting and other rights upon bondholders? (Recommendation--Yes.)

405-831

§ 1005. Income from corporate activities

1005. A corporation whose lawful activities involve among other things the charging of fees or prices for its services or products has the right to receive the income and, in so doing, may make an incidental

profit. All incidental profits shall be applied to the maintenance, expansion, or operation of the lawful activities of the corporation and shall not be divided or distributed among the members, directors, or officers of the corporation.

Comment. Section 1005 is derived from Section 508 of New York's Not-for-Profit Corporation Law. It does not materially alter the prior law for California nonprofit corporations found in former Section 9200 of the Corporations Code (General Nonprofit Corporation Law). Nonprofit corporations are permitted to make an incidental profit provided that this profit is applied to further the corporation's permissible purposes and not distributed to members, officers, or directors. See Section 301 (permissible purposes for not-for-profit corporations).

Analysis

Nonprofit corporations often engage in profitmaking ventures to create revenue for their activities.¹ In general, this practice should be permitted.

ISSUE TO BE RESOLVED:

1. Should a corporation be permitted to make an incidental profit?
(Recommendation--Yes.)

1. A classic example of this trend is the relationship between New York University Law School and the C.F. Mueller Company, a manufacturer of macaroni. See *C.F. Mueller Co. v. Commissioner*, 55 T.C. 275 (1970). For an excellent defense of the right to make an incidental profit, see Note, New York's Not-for-Profit Corporation Law, 47 N.Y.U. L. Rev. 761, 763-767 (1972).

§ 1006. Dividends prohibited; certain distributions allowed

1006. (a) A nonprofit corporation shall not pay dividends or distribute any part of its income or profits to its members, directors, or officers except as permitted by this code.

(b) A nonprofit corporation may pay to members, officers, or directors reasonable compensation for services rendered.

(c) A nonprofit corporation may confer benefits upon members or nonmembers in conformity with its purposes, may repay capital contributions, and may redeem its subvention certificates or evidences of indebtedness, as authorized by this code except when the corporation is currently insolvent or would thereby be made insolvent or rendered unable to carry on its corporate purposes or when the fair value of its assets remaining after the conferring of these benefits, payment, or redemption would be insufficient to meet its liabilities. A nonprofit corporation may make distributions of cash or property to members upon dissolution or final liquidation as permitted by this code.

Comment. Section 1006 is derived from Section 7553 of Pennsylvania's Corporation Not-for-profit Code. Subdivision (a) states the basic rule for nonprofit corporations (formerly found in Section 9200 of the Corporations Code (General Nonprofit Corporation Law)) which prohibits these corporations from paying dividends to members, officers, or directors. See the definition of nonprofit corporation in Section 155 and the Comment to that Section. Subdivisions (b) and (c) permit certain distributions: Members, officers, and directors may receive reasonable compensation for services rendered; the corporation may confer benefits consistent with its purposes, repay its capital certificates, or redeem its subvention certificates or evidences of indebtedness, as long as the corporation is not insolvent or rendered insolvent thereby. A nonprofit corporation may also make distributions

of cash or property upon dissolution or final liquidation as permitted by this code. See Sections 1512 and 1610.

Analysis

The rule against dividends is derived from the basic concept of a non-profit corporation and is fundamental. All major new nonprofit codes contain such a prohibition.¹ However, in order to effectively carry out its activities, the corporation must be permitted to pay its officers and directors reasonable compensation for services rendered, and it necessarily will confer certain benefits on its members consistent with its purposes. Section 1006 expressly permits these distributions. The right of a nonprofit corporation to make distributions to members upon dissolution or final liquidation is more controversial. For further discussion of this issue, see the Comment to Section 1512.

ISSUES TO BE RESOLVED:

1. Should a corporation be permitted to pay dividends? (Recommendation--No.)
2. Should there be a statutory provision permitting the payment of reasonable compensation for services rendered? (Recommendation--Yes.)
3. Should there be an "insolvency" restriction upon the right of a corporation to confer benefits upon its members or make certain other payments which are otherwise permitted? (Recommendation--Yes.)

406-248

Article 2. Trust Property

§ 1101. Property deemed held in trust

1101. (a) All property received by a corporation organized primarily for a charitable purpose or purposes, or by a corporation which conducts

1. Pa. Corporation Not-for-profit Code § 7553; N.Y. Not-for-Profit Corporation Law § 515; ABA-ALI Model Non-Profit Corporation Act § 26.

its activities and represents itself to be primarily charitable, by bequest, devise, gift, or transfer shall be held in trust to carry out the purposes for which the corporation was created or is conducted.

(b) All property received by a corporation in trust for a specific purpose or purposes by bequest, devise, gift, or transfer shall be held in trust to carry out the specific purpose or purposes for which it was vested in the corporation.

Comment. Subdivision (a) of Section 1101 essentially codifies the common law in California with regard to property received by a nonprofit corporation organized or conducting its activities for charitable purposes. All such property is to be held in trust to carry out the corporate purposes, and trust law is to govern its treatment. In re Los Angeles County Pioneer Society, 40 Cal.2d 852, 257 P.2d 1 (1953), cert. denied, 346 U.S. 888 (1953), rehearing denied, 346 U.S. 928 (1953); Lynch v. Spilman, 67 Cal.2d 251, 431 P.2d 636, 62 Cal. Rptr. 12 (1967). Subdivision (b) makes clear that all property received by a nonprofit corporation for a specific purpose or purposes shall be held in trust for that purpose or purposes. See also Section 303(g) (power to hold and administer property subject to any trust).

Analysis

When a donor makes a gift to a nonprofit corporation organized for charitable purposes, he expects that his gift will be applied to further those purposes and that it will not, for example, be distributed to members upon final dissolution of the corporation. The courts have protected this expectation by applying trust principles to all property given or transferred to charitable nonprofit corporations. Section 1101 continues this treatment.

In order to avoid that state's narrow and technical trust rules in regard to investment of trust funds, New York's Not-for-Profit Corporation Law gives a nonprofit corporation absolute ownership of all property given

to it in trust or transferred to it for specific purposes, subject to the qualification that those assets be applied in accordance with the intention and direction of the donor.¹ California trust law is progressive concerning such matters as permissible investments for trust funds and, therefore, there is little reason for adopting here New York's confusing semitrust approach.²

ISSUES TO BE RESOLVED:

1. Should this code codify the trust restrictions set forth in the common law upon property given to a charitable corporation? (Recommendation--Yes.)

2. Should the New York rule giving the corporation ownership of all property transferred to it in trust subject only to the requirement that the property be applied according to the donor's intention be adopted? (Recommendation--No.)

406-249

§ 1102. Indefinite purposes

1102. No bequest, devise, gift, or transfer of property to a corporation for a charitable purpose is invalid because of indefiniteness or uncertainty as to the purposes of the beneficiaries thereof, but, to the extent that such indefiniteness exists, it shall be resolved by the corporation in the manner which, in its judgment, is most consonant with the purpose of the donor and most conducive to the public welfare.

1. N.Y. Not-for-Profit Corporation Law § 513; for a discussion of the section, see Note, New York's Not-for-Profit Corporation Law, 47 N.Y.U. L. Rev. 761, 784-787 (1971).

2. See Section 2261 of the Civil Code which permits the trustee to invest trust funds in "every kind of property, real, or personal or mixed, and every kind of investment" subject only to the duty to use the degree of care in selecting the mode of investment which "men of prudence, discretion and intelligence exercise in the management of their own affairs."

Comment. Section 1102 is the same as part of former Section 10206(b) of the Corporations Code (Corporations for Charitable or Eleemosynary Purposes) and establishes the rule that a bequest, gift, devise, or transfer of property to a nonprofit corporation shall not fail because of indefiniteness or uncertainty of its purposes or beneficiaries.

ISSUE TO BE RESOLVED:

1. Should the corporation be permitted to resolve questions regarding a donor's purposes if they are indefinite? (Recommendation--Yes.)

406-250

§ 1103. Duty in managing trust property

1103. Corporations in investing, reinvesting, purchasing, acquiring, exchanging, selling, and managing property held in trust are bound by the obligations of trustees set forth in Article 2 (commencing with Section 2258) of Chapter 2 of Title 8 of Part 4 of Division 3 of the Civil Code.

Comment. Section 1103 makes it clear that nonprofit corporations in managing trust property are bound by the obligations set forth in Article 2 of Chapter 2 of Title 8 of Part 4 of Division 3 of the Civil Code.

ISSUE TO BE RESOLVED:

1. Should the Civil Code trust management duties apply to nonprofit corporations? (Recommendation--Yes.)

406-251

§ 1104. Accumulating income

1104. Except as approved by the Attorney General, a corporation shall not accumulate income from trust property for a period longer than five years.

Comment. Section 1104 is the same in substance as part of former Section 10207 of the Corporations Code (Corporations for Charitable or Eleemosynary Purposes).

ISSUE TO BE RESOLVED:

1. Should a corporation be granted the right to accumulate trust income for a period longer than five years? (Recommendation--No.)

406-252

§ 1105. Apportionment of expenses

1105. Expenses of the corporation may be apportioned in a manner which is just and equitable against the various trust funds and property held by the corporation, and the meeting of such expenses shall be deemed to be a charitable purpose.

Comment. Section 1105 empowers the corporation to apportion expenses over the corporate property. It is the same in substance as former Section 10208 of the Corporations Code (Corporations for Charitable or Eleemosynary Purposes).

ISSUE TO BE RESOLVED:

1. Should there be more detailed rules governing the apportionment of trust expenses over the various trust funds? (Recommendation--No.)

406-253

§ 1106. Transfer of property to an institutional trustee

1106. (a) For the purposes of earning income, a corporation may transfer any or all of its assets, including any assets held in trust

pursuant to Section 1101, to one or more trust companies or banks duly authorized to conduct a trust or banking business in this state. The transfer may be revocable or irrevocable.

(b) Upon transfer, the board is relieved of all liability for the administration of the transferred assets for as long as the assets are administered by an institutional trustee except that the designation of an institutional trustee for corporate property does not relieve any director of his duty to exercise due care in the selection of the trustee and in the continuation or termination of the trust.

(c) The institutional trustee shall pay, at least semiannually or at more frequent intervals if so agreed, the net income from the transferred assets, which may include so much of the realized appreciation of principal as the board determines to be prudent, to the corporation for use and application to the purpose or purposes for which the assets were received by the corporation.

Comment. Section 1106, which provides for the transfer of corporate property to institutional trustees, is derived in part from Section 7551 of Pennsylvania's Corporation Not-for-profit Code. It continues the power given to charitable corporations by former Section 10204 of the Corporations Code (Corporations for Charitable or Eleemosynary Purposes) to delegate management of investments and expressly expands this authority to cover any nonprofit corporation. Subdivision (b) exempts the corporate directors from all further liability for assets transferred to an institutional trustee pursuant to this section provided that due care is taken in the selection of the institutional trustee and exercised concerning the termination or continuation of the trust. Subdivision (c) creates a duty for the institutional trustee. It must pay to the corporation at least semiannually the income from the transferred assets. This

latter provision is consistent with the policy expressed in Sections 1104 and 1107 and former Section 9501.1 of the Corporations Code (General Nonprofit Corporation Law) that there should be no excessive accumulation of income by charitable foundations.

Analysis

This is a fairly noncontroversial section permitting delegation of the management of corporate assets to an institutional trustee. The present Corporations Code Section 10204 (Corporations for Charitable or Eleemosynary Purposes law) contains a similar provision for charitable corporations, and there is no persuasive reason for not expanding this power to cover all nonprofit corporations. Subdivision (b) makes transfer a practical possibility by exempting corporation directors from further liability for the management of transferred assets, and subdivision (c) protects the public interest which is harmed by an excessive accumulation of the income of charitable corporations.¹

Section 514 of New York's Not-for-Profit Corporation Law also permits transfer of corporate assets to an individual trustee as well as to an institutional trustee. However, that approach increases the danger of abuse and is not recommended for this code.

ISSUES TO BE RESOLVED:

1. Should there be any restriction upon the type of corporation which may transfer assets, including assets held in trust, to an institutional trustee? (Recommendation--No.)
2. Should directors be released from personal liability for funds transferred with due care to an institutional trustee? (Recommendation--Yes.)
3. Should a corporation be permitted to transfer assets in trust to other than an institutional trustee? (Recommendation--No.)

1. See Hearings Before Committee on Ways and Means, Tax Reform, 91st Cong. 1st Sess. (1969).

§ 1107. Private foundations; retention of tax exempt status; compliance with federal law

1107. Every nonprofit corporation, during any period or periods such corporation is deemed to be a "private foundation" as defined in Section 509 of the Internal Revenue Code of 1954 as amended by Section 101 of the Tax Reform Act of 1969 (all references in this section to the Internal Revenue Code shall refer to such code as amended by such act), shall distribute its income for each taxable year (and principal, if necessary) at such time and in such manner as not to subject such corporation to tax under Section 4942 of such code (as modified by paragraph (3) of subsection (1) of Section 101 of the Tax Reform Act of 1969), and such corporation shall not engage in any act of self-dealing as defined in subsection (d) of Section 4941 of such code (as modified by paragraph (2) of subsection (1) of Section 101 of the Tax Reform Act of 1969), retain any excess business holdings as defined in subsection (c) of Section 4943 of such code, make any investments in such manner as to subject such corporation to tax under Section 4944 of such code, or make any taxable expenditure as defined in subsection (d) of Section 4945 of such code (as modified by paragraph (5) of subsection (1) of Section 101 of the Tax Reform Act of 1969).

This section shall apply to any such corporation and any provision contained in its articles of incorporation or other governing instrument inconsistent with this section or to the contrary thereof shall be without effect.

Comment. Section 1107 is the same as former Section 9501.1 of the Corporations Code (General Nonprofit Corporation Law) and is designed

primarily to eliminate the need for foundations to amend their articles to conform to the revisions in the federal tax law as this section voids any provisions which are inconsistent with that law.

ISSUE TO BE RESOLVED:

1. Should this special provision be continued? (Recommendation-- Yes.)

§ 1108. Court action to protect trust property from misuse

1108. Upon petition of the Attorney General, any director of the corporation, or any person acting with the consent of the Attorney General, the court may where necessary take appropriate measures to carry out as nearly as is possible the original trust purposes including the appointment of a new trustee. Nothing in this section limits the court's power to modify the original trust purposes as circumstances warrant according to the doctrine of cy pres.

Comment. Section 1108 restates prior law concerning who may bring an action to protect trust property, and it codifies the common law in California which has recognized the court's general equitable power to take appropriate measures to protect trust property from misuse including the power to appoint new trustees. In re Veterans' Industries, Inc., 8 Cal. App.3d 902, 88 Cal. Rptr. 303 (1970). Nothing in this subdivision is intended to limit the application of cy pres to modify the original trust purposes as conditions change. The Attorney General may also institute protective proceedings under the Uniform Supervision of Trustees for Charitable Purposes Act (Govt. Code § 12580 et seq.). Note also that Government Code Section 12591 requires the Attorney General to be a party to any action modifying or terminating any trust.

Analysis

Section 1108 merely restates the common law concerning who may bring an action to protect trust property held by a nonprofit corporation from a misuse such as distributing it to the members. In general, since the Attorney General is given this special power to protect the public interest, it is unwise and unnecessary to permit others without a very direct interest--such as that of a dissenting director--to bring an action for misuse of trust property unless they receive the consent of the Attorney General, for to do so would create a substantial danger of harassing litigation by organizations desirous of being appointed replacement trustees.¹

ISSUES TO BE RESOLVED:

1. Is there need for a statutory provision specifying who may bring an action to protect trust property? (Recommendation--Yes.)
2. Should the right to bring such an action extend to other interested persons besides directors of the corporation or those acting with the consent of the Attorney General? (Recommendation--No.)
3. Should the court be permitted to appoint a new trustee rather than cause the trust to fail? (Recommendation--Yes.)

406-115

Article 3. Common Trust Funds§ 1151. Authorization

1151. (a) If authorized to do so by its articles, a corporation may establish one or more common trust funds for the purpose of furnishing investments to the corporation, including maintaining a common trust fund

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1. In re Veterans' Industries, Inc., 8 Cal. App.3d 902, 88 Cal. Rptr. 303 (1970), permits the use of a writ of mandate to correct abuses of the Attorney General's discretion if he fails to carry out adequately his supervisory duties. Any person may move for a writ of mandate.

in which other nonprofit corporations or organizations may commingle their funds or property for investment, or for any other purpose consistent with its purposes, whether it holds its assets or property as fiduciary or otherwise.

(b) Notwithstanding any law limiting the right of a corporation or its officers or directors, as fiduciary or otherwise, to invest funds held by them, it is lawful for such corporation or its officers or directors to invest any or all of their funds or property in shares or interests of a common trust fund or trust funds unless, in the case of funds or property held as a fiduciary, such investment is prohibited by the wording of the will, deed, or other instrument creating the fiduciary relationship.

Comment. Section 1151 authorizes the creation of common trust funds for investment or to carry out the corporate purposes. Any nonprofit corporation may establish one or more of these funds whether or not it holds its assets as a fiduciary. The authorization to create these common trust funds is not limited to corporations sole and other charitable corporations as was the case under former Section 10250 of the Corporations Code (trust funds). This broader scope follows Section 7581 of Pennsylvania's Corporation Not-for-profit Code. In other matters, this section is substantially the same as the first part of former Section 10250 except that this provision makes clear that common trust funds may be established for any reason consistent with the corporate purposes and not just for the reasons specifically listed in former Section 10250.

ISSUES TO BE RESOLVED:

1. Should the power to create a common trust fund be limited to charitable corporations? (Recommendation--No.)

2. Should there be a specific listing of the permissible purposes for such a common fund? (Recommendation--No.)

§ 1152. Powers of directors or trustees

1152. The directors or trustees of a common trust fund may employ officers or agents, define their duties, and fix their compensation. They may also appoint a trust company or bank as custodian of the trust estate and may employ an investment adviser or advisers, define their duties, and fix their compensation. Securities which constitute part or all of the trust estate may be deposited in a security depository, as defined in Section 30004 of the Financial Code, which is licensed under Section 30200 of the Financial Code or exempted from licensing thereunder by Section 30005 or 30006 of the Financial Code, and such securities may be held by a securities depository in a manner authorized by Section 775 of the Financial Code.

Comment. Section 1152 is the same as subdivision (b) of former Section 10250 of the Corporations Code (trust funds).

§ 1153. Duty to pay semiannual dividends

1153. The directors or trustees of a common trust fund shall pay semiannual dividends ratably to the holders of the shares or beneficial certificates then outstanding. The semiannual dividends shall approximately equal in each fiscal year the net income of the trust or other amount as specifically provided by law.

Comment. Section 1153 is the same in substance as a portion of subdivision (c) of former Section 10250 of the Corporations Code. It should

be noted that distributions to "educational institutions," as defined by Section 1154, are governed by a specific formula. See Section 1154(c).

ISSUE TO BE RESOLVED:

1. Is more detail necessary regarding the payment of dividends?
(Recommendation--No.)

406-119

§ 1154. Educational institution; membership in nonprofit corporation
for maintenance of common trust funds; distributions

1154. (a) "Educational institution," as used in this section, means any nonprofit corporation organized under the provisions of Chapter 1 (commencing with Section 29001) of Division 21 of the Education Code or under the provisions of this division or under any law replaced by this division for the purpose of establishing, conducting, or maintaining an institution offering courses beyond high school and issuing or conferring a diploma or for the purpose of offering or conducting private school instruction on the high school or elementary school level and any charitable trust organized for such purpose or purposes. "Educational institution," as used in this section, also means the University of California, the state colleges, the state community colleges, and any auxiliary organization, as defined in Section 24054.5 of the Education Code, established for the purpose of receiving gifts, property, and funds to be used for the benefit of a state college.

(b) It shall be lawful for any educational institution to become a member of a nonprofit corporation incorporated under the laws of any state for the purpose of maintaining a common trust fund or similar common fund

in which nonprofit organizations may commingle their funds and property for investment and to invest any and all of its funds, whenever and however acquired, in such common fund or funds unless, in the case of funds or property held as fiduciary, such investment is prohibited by the wording of the will, deed, or other instrument creating such fiduciary relationship.

(c) An educational institution electing to invest in a common fund or funds under the provisions of this section may elect to receive distributions from each such fund in an amount not to exceed for each fiscal year the greater of the income, as defined in Section 730.03 of the Civil Code, accrued on its interest in such fund or 10 percent of the value of its interest in such fund as of the last day of its next preceding fiscal year. The educational institution may expend such distribution or distributions for any lawful purpose notwithstanding the provisions of any general or special law characterizing such distribution, or any part thereof, as principal or income unless, in the case of funds or property invested as fiduciary, such expenditure is prohibited by the wording of the will, deed, or other instrument creating the fiduciary relationship. No such prohibition of expenditure shall be deemed to exist solely because a will, deed, or other such instrument, whether executed or in effect before or after the effective date of this section, directs or authorizes the use of only the "income," or "interest," or "dividends" or "rents, issues, or profits," or contains words of similar import.

Comment. Section 1154 is the same in substance as former Section 10251 of the Corporations Code (trust funds). It grants to an educational institution as herein defined the power to enter into membership in a

nonprofit corporation for the purpose of maintaining a common trust fund. Moreover, it sets forth detailed regulations governing such a common trust fund.

ISSUE TO BE RESOLVED:

1. Should "educational institutions" be given separate treatment from other types of nonprofit corporations which invest in common trust funds? (Recommendation--Yes.)

406-118

§ 1155. Application of Corporate Securities Law

1155. The provisions of the Corporate Securities Law do not apply to the creation, administration, or termination of common trust funds created pursuant to this article nor to participation in a common trust fund.

Comment. Section 1155 is the same as a portion of subdivision (c) of former Section 10250 of the Corporations Code and as subdivision (d) of former Section 10251 of the Corporations Code.

CHAPTER 7. ORGANIC CHANGES

Article 1. Disposition of Assets§ 1201. Disposition of all or substantially all assets

1201. (a) As used in this section, "disposition of the assets" means a sale, lease, exchange, or other disposition of all, or substantially all, of the assets of a corporation which are not held in trust.

(b) A disposition of the assets of a corporation may be made upon such terms, and for such consideration, as may be authorized in accordance with this section. The consideration may consist in whole or in part of cash or other property, real or personal, including shares, bonds, or other securities or any other domestic or foreign corporation or corporations of any type or kind.

(c) If there are members entitled to vote, the disposition of the assets shall be authorized as follows:

(1) The board shall adopt a resolution recommending the disposition of the assets. The resolution shall specify the terms and conditions of the proposed disposition, including the consideration to be received by the corporation and the eventual disposition to be made of the consideration.

(2) The resolution shall be approved by not less than two-thirds of the votes cast by members entitled to vote or by the written consent of two-thirds of the voting power of the corporation. The members may approve the proposed disposition according to the terms of the resolution of the board or may authorize the board to modify the terms and conditions of the disposition as set out in the resolution.

(d) If there are no members entitled to vote other than directors, the disposition of the assets shall be authorized by the vote of at least two-thirds of the entire board except that, where there are 21 or more directors, the vote of a majority of the entire board is sufficient to authorize the disposition of the assets.

(e) Notwithstanding that the disposition of the assets has been authorized as provided in subdivision (c) or (d), the board may, in its discretion and without further action or approval, abandon the disposition of the assets subject to the rights of third persons under any contract.

(f) This section does not apply to the sale or other disposition of all or substantially all of the corporation's assets after commencement of a proceeding for dissolution of the corporation as provided in Chapter 8 (commencing with Section 1501).

Comment. Section 1201 is derived in substance from Section 510 of New York's Not-for-Profit Corporation Law. It grants to a nonprofit membership corporation the power to sell, lease, exchange, or make other disposition of all or substantially all of its assets if the requirements of the section are satisfied.

The requirements set forth in Section 1201 are similar to those found in the General Corporation Law--Corporations Code Sections 3900-3903--which previously applied to nonprofit corporations pursuant to former Section 9800 of the Corporations Code (General Nonprofit Corporation Law). However, there are important changes effected by this section. Section 3901 of the General Corporation Law provides that membership approval shall be given by the consenting vote of a majority of the voting power of the corporation. Section 1201 increases the potential number of members who must consent by requiring the approval of two-thirds of the members who actually vote on this matter. Moreover, a new procedure requiring two-thirds approval of the board of directors is adopted for nonmember corporations.

Subdivision (e) makes clear that the board may abandon any planned disposition of all or substantially all of the corporation's assets without approval by the membership.

Subdivision (f) exempts the sale or disposition of all or substantially all of the corporation's assets after the commencement of the dissolution proceeding from the requirements of this section. The commencement of those proceedings requires board and membership authorization pursuant to Section 1503. Since dissolution necessarily entails the sale or other disposition of the corporation's assets, it is unnecessarily duplicative to require additional authorization for the sale of assets after dissolution has been authorized. It should be noted that the authorization requirements under Section 1503 are different and less stringent than those of Section 1201. This difference reflects the different policies to be served by the two sections. See In re Mayellen Apartments, 134 Cal. App.2d 298, 285 P.2d 943 (1955) (Corporations Code Section 3901 applies only to corporations which are not dissolving).

Analysis

The disposition of all or substantially all of the corporation's assets is an important decision which in the case of nonprofit corporations often involves a greater element of the public interest than for corporations governed by the profit constraint.¹ To insure careful deliberation and purposeful action, such a disposition should be approved by a large portion of the interested members. Section 1201 follows Section 510 of New York's Not-for-Profit Corporation Law by requiring approval of two-thirds of the voting members or, in the case of a nonmember corporation, two-thirds of the board.

After a dissolution proceeding under Chapter 8 has been initiated, the sale or other disposition of all of the corporation's assets is exempted from the operation of Section 1201 for the following reasons: The sale or other disposition of all of the corporation's assets without dissolution of the corporation necessarily alters the basic nature of the

1. See the Memorandum for a discussion of the relationship between nonprofit corporations and the public interest.

corporation under circumstances where there is a continuing relationship with the members who dissent to the action. Therefore, as stated above, a very large portion of the members should be required to approve of this change. On the other hand, corporations should be encouraged to dissolve when a majority of the members no longer believe the corporation is useful.² Dissenting members after dissolution do not remain in a continuing relationship which has been materially altered from their original expectations.³ Therefore, the authorization requirements for dissolution should be less stringent than for a sale or other disposition of assets alone, and it obviously makes no sense and defeats the purpose of the less stringent requirement for dissolution to have additional, more stringent sale of asset requirements because dissolution generally cannot be accomplished without such a sale or other disposition of all the corporation's assets.

ISSUES TO BE RESOLVED:

1. Should the "two-thirds" rule be adopted for membership approval of the sale or other disposition of all or substantially all of the corporation's assets? (Recommendation--Yes.)

2. Should a corporation without members be required to gain the authorization of two-thirds of its board prior to such a sale or other disposition? (Recommendation--Yes.)

3. Should corporations which have elected to dissolve be exempted from the requirements of this section? (Recommendation--Yes.)

2. See the analysis to Section 1503 for more discussion of this point.

3. In the sale situation, a member has no recourse but to stay if he wishes to protect his investment of time, energy, and money whereas, after dissolution, the member at least receives a share of the remaining corporate assets pursuant to Section 1512 as partial compensation for that investment.

§ 1202. Certificate of authorization

1202. Any deed or other instrument conveying or otherwise transferring any assets of a corporation may have annexed to it the certificate of the chief officer of the corporation or any two subordinate officers of the corporation, setting forth the resolution of the board authorizing such conveyance or other transfer and (a) stating that the property described in the deed, instrument, or conveyance is less than substantially all of the assets of the corporation, if such be the case, or (b) if the property constitutes all or substantially all of the assets of the corporation, stating the fact that such disposition has been authorized pursuant to Section 1201 or is exempt from the requirements of that section because the corporation has commenced proceedings to wind up the affairs of the corporation. This certificate is prima facie evidence of the existence of the facts authorizing the conveyance or other transfer of the assets and conclusive evidence in favor of any innocent purchaser or encumbrancer for value.

Comment. Section 1202 is substantially the same as Section 3904 of the Corporations Code (which previously governed nonprofit corporations pursuant to Section 9800 of the Corporations Code (General Nonprofit Corporation Law)). See Section 1504 which sets forth the time for commencement of dissolution proceedings.

§ 1203. Hypothecation of assets to secure corporate obligation

1203. The board may authorize any mortgage, deed of trust, pledge, or other hypothecation of all or any part of the corporation's property, real or personal, for the purpose of securing the payment or performance of any contract, note, bond, or obligation. Unless the articles provide otherwise, no vote or consent of the members is necessary to authorize this action by the board.

Comment. Section 1203 is the same as Section 3900 of the Corporations Code (General Corporation Law)(which previously applied to nonprofit corporations pursuant to Section 9002 of the Corporations Code (General Non-profit Corporation Law)). See also former Section 9501(e) of the Corporations Code.

Analysis

Some nonprofit codes require the corporation to gain the authorization of two-thirds of the board of directors before it can purchase, sell, mortgage, or lease any real property.¹ This requirement seems unnecessarily burdensome and is not recommended.

ISSUE TO BE RESOLVED:

1. Should a nonprofit corporation be required to gain membership authorization or two-thirds approval of the board before it mortgages its assets? (Recommendation--No.)

406-125

Article 2. Merger and Consolidation

§ 1301. Definitions

1301. As used in this article:

1. N.Y. Not-for-Profit Corporation Law § 509.

(a) "Merger" means a procedure of the character described in subdivision (a) of Section 1302.

(b) "Consolidation" means a procedure of the character described in subdivision (b) of Section 1302.

(c) "Constituent corporation" means an existing corporation that is participating in the merger or consolidation with one or more other corporations.

(d) "Surviving corporation" means the constituent corporation into which one or more other constituent corporations are merged.

(e) "Consolidated corporation" means the new corporation in which two or more constituent corporations are consolidated.

Comment. Section 1301 provides definitions for terms used in this article. The definitions of "constituent corporation," "surviving corporation," and "consolidated corporation" are the same in substance as found in Sections 4101 and 4102 of the Corporations Code (General Corporation Law).

406-126

§ 1302. Power to merge or consolidate

1302. Two or more domestic corporations may, as provided in this chapter:

(a) Merge into a single corporation which shall be one of the constituent corporations; or

(b) Consolidate into a single corporation which shall be a new corporation to be formed pursuant to the consolidation.

Comment. Section 1302 is derived from Section 901 of New York's Not-for-Profit Corporation Law. It grants to domestic corporations the power to merge or consolidate as provided in this chapter. This power was formerly granted to nonprofit corporations by Section 4100 of the Corporations Code (General Corporation Law) which applied pursuant to former Section 9700 of the Corporations Code (General Nonprofit Corporation Law).

ISSUE TO BE RESOLVED:

1. Should nonprofit corporations be permitted to merge or consolidate with other nonprofit corporations? (Recommendation--Yes.)

406-127

§ 1303. Plan of merger or consolidation

1303. The board of each corporation proposing to participate in a merger or consolidation shall adopt a plan of merger or consolidation setting forth:

(a) The name of each constituent corporation and, if the name of any of them has been changed, the name under which it was formed, and the name of the surviving corporation, or the name or the method of determining it, of the consolidated corporation.

(b) As to each constituent corporation, a description of the membership and holders of any certificates evidencing capital contributions or subventions, including their number, classification, and voting rights, if any.

(c) The terms and conditions of the proposed merger or consolidation, including the manner and basis of converting membership or other interest in each constituent corporation into membership or other interest in the surviving or consolidated corporation, or the cash or other consideration to be paid or delivered in exchange for membership or other interest in each constituent corporation, or a combination thereof.

(d) In the case of merger, a statement satisfying the requirements of Section 555 of any amendments or changes in the articles of incorporation of the surviving corporation to be effected by such merger; in the case of consolidation, all statements required to be included in the articles of incorporation of a corporation formed under this code except statements as to facts not available at the time the plan of consolidation is adopted by the board.

Comment. Section 1303 is substantially the same as Section 902 of New York's Not-for-Profit Corporation Law. It provides all the requirements of a plan of merger or consolidation and is analogous to the requirements for profit corporations set forth in Sections 4103, 4104, and 4105 of the Corporations Code (General Corporation Law).

ISSUE TO BE RESOLVED:

1. Are there additional statements which should be included in the plan of merger? (Recommendation--No.)

§ 1304. Approval of plan

1304. (a) Upon approving a plan of merger or consolidation, the board of each constituent corporation shall submit the plan to a vote of the members according to the procedure prescribed in this section.

(b) Each member entitled to vote shall be mailed or given a copy of the plan of merger or consolidation or an outline of the material features of the plan at least seven days prior to the vote. The mailing and delivery requirements of this subdivision shall be satisfied according to the provisions of subdivisions (b) and (c) of Section 754.

(c) The plan of merger or consolidation shall be approved by either:

(1) The written consent of two-thirds of the voting power of the corporation.

(2) The vote of not less than two-thirds of the votes cast by members entitled to vote, which vote also shall at least be equal to a majority of the voting power of the corporation.

(d) If a merging or consolidating corporation has no members other than directors entitled to vote on the plan of merger or consolidation, a plan of merger or consolidation shall be deemed approved by the members when it is adopted by the board.

(e) Notwithstanding authorization by the members as provided in this section, the plan of merger or consolidation may be abandoned by the board at any time prior to the effective date of the plan, subject to the rights of third parties under any contract.

Comment. Section 1304 continues the requirement of former Section 9701 of the Corporations Code (General Nonprofit Corporation Law) that

a plan of merger or consolidation must be approved by the membership; however, the numerical requirements for approval have been changed. Unless the written consent method is used, Section 1304 requires for authorization of a merger or consolidation the affirmative vote of at least two-thirds of the votes cast by the members provided the affirmative vote equals a majority or more of the voting power of the corporation ("voting power" is defined in Section 160). Cf. former Corp. Code § 9701 (General Nonprofit Corporation Law) (where members act by vote, agreement of merger or consolidation shall be approved by a majority of the members) and former Corp. Code § 9703 (General Nonprofit Corporation Law) (articles may require a greater percentage vote for membership approval of a merger or a consolidation); see also Corp. Code § 4107 (General Corporation Law) (agreement of merger or consolidation shall be approved by two-thirds of the shareholders). The change in the numerical requirements for members' approval is derived from Section 903 of New York's Not-for-Profit Corporation Law and is designed to provide additional protection from ill-conceived mergers or consolidations while at the same time protecting a corporation from being immobilized by member apathy. It should be noted that Section 1304 does not require the vote to be taken at a meeting of the members. Cf. former Corp. Code § 9702 (General Nonprofit Corporation Law) (where members act by vote on a merger or consolidation, votes shall be cast at a meeting of the members).

The provision which requires a copy or summary of the material features of the plan of merger or consolidation to be sent to the members prior to the vote is derived from Section 903 of New York's Not-for-Profit Corporation Law and is similar to the last part of former Section 9702 of the Corporations Code.

Subdivision (d) makes clear that, if the corporation has no members entitled to vote on a merger or consolidation, approval by the board of the plan is sufficient to authorize this action.

Subdivision (e) continues the power granted to the board by Section 4112 of the Corporations Code (General Corporation Law) (which governed nonprofit corporations pursuant to former Section 9700 of the Corporations

Code (General Nonprofit Corporation Law)) to abandon the plan of merger or consolidation after membership authorization prior to the effective date.

Analysis

The new requirement for nonprofit corporations that a plan of merger or consolidation be approved by two-thirds of the members is a nearly uniform requirement in the corporation codes studied.¹ It is designed to insure that there is great support for this drastic step in the corporate life. Moreover, the public interest is often closely involved so plans of merger or consolidation should be carefully and purposefully studied.² The two-thirds rule makes this kind of consideration more likely, simply because it is more difficult to persuade a larger number of people.

To be realistic, however, members of nonprofit corporations are often apathetic and do not vote at all. It might be very difficult for a corporation to ever receive the approval of two-thirds of the entire membership for such a change. Therefore, Section 1303 requires the affirmative vote of two-thirds of the interested members, those who actually vote, provided this number is at least equal to a majority of the voting power.

ISSUES TO BE RESOLVED:

1. Should each member of the constituent corporation be sent a copy of the plan or a material summary of it? (Recommendation--Yes.)
2. Should two-thirds of the members' votes cast be required to approve a merger or consolidation? (Recommendation--Yes.)
3. Should the corporation be permitted to vary from the "two-thirds" rule by an appropriate provision in its articles or bylaws? (Recommendation--No.)
4. Should a plan of merger or consolidation be approved by the membership only at a meeting of the members? (Recommendation--No.)

1. N.Y. Not-for-Profit Corporation Law § 903; ABA-ALI Model Non-Profit Corporation Act § 40; Cal. Corp. Code § 4107 (General Corporation Law). Section 7924 of Pennsylvania's Corporation Not-for-profit Code is to the contrary, requiring only a majority of the members.

2. See the Memorandum for a discussion of the public interest and non-profit corporations.

§ 1305. Certificate of approval

1305. (a) After approval as required by Section 1304 has been given, the chief officer or any two subordinate officers or a majority of the board of each corporation shall execute a certificate, verified by their affidavit, stating that the matters set forth in the certificate are true of their own knowledge.

(b) The certificate shall set forth:

(1) The time and place of the meeting of the board of directors.

(2) A copy of the resolution adopted by the board of directors showing approval of the terms and conditions of the plan of merger or consolidation.

(3) The vote in favor of the resolution.

(4) A statement that a copy of the plan of merger or consolidation or a summary of the material facts of the plan has been given or mailed to each member entitled to vote as required by Section 1304.

(5) A statement of the manner in which the plan of merger or consolidation was approved by the membership, which shall consist of a specific reference to the statutory provision or the provision of the articles or bylaws, or both, authorizing use of the procedure used for polling the membership, the number of votes entitled to be cast, and the consenting votes.

(6) The name of the surviving or consolidated corporation.

(7) That the plan for merger or consolidation filed pursuant to Section 1307 with the Secretary of State concurrently with this certificate is the plan referred to above and sets forth the terms and conditions approved by the resolution of directors and vote of the members.

(8) The effective date of the merger or consolidation if other than the official filing date as provided in Section 1307. In no case may the effective date be earlier than the official filing date or more than 30 days after that date. If a proper date is specified, it shall control.

Comment. Section 1305 is similar to Section 4110 of the Corporations Code (General Corporation Law)(which previously governed nonprofit corporations pursuant to former Section 9700 of the Corporations Code (General Nonprofit Corporation Law)). Besides a change in form, this section differs from the prior law in two major respects: (1) It takes into account the provisions of Section 819 (the corporation may have such officers and designate them by any title as is deemed appropriate) and Section 758 (the articles or a bylaw adopted by the members may specify a manner of voting on corporate affairs other than at a meeting of the members) and (2) it permits the corporation to specify in the certificate an effective date other than the date of filing by the Secretary of State provided this date is not earlier than the filing date nor more than 30 days after the filing date. This latter provision is derived from Section 904 of New York's Not-for-Profit Corporation Law.

ISSUES TO BE RESOLVED:

1. Should the certificate of merger or consolidation include other information than is contained in the proposed draft of this section? (Recommendation--No.)
2. Should the corporation be permitted to specify an effective date other than the filing date by the Secretary of State? (Recommendation--Yes.)

§ 1306. Amendment to the plan

1306. Any amendment to the plan of merger or consolidation may be adopted, and the plan so amended may be approved, in the same manner and by the same vote as the original plan. If the plan as amended is approved by the members and by the board of directors of each corporation by the vote required for approval of the original plan, the plan as amended shall be signed and acknowledged and shall have certified therewith the approval of the directors and members in the same manner as provided for the original plan and shall then constitute the merging or consolidating plan.

Comment. Section 1306 is derived from Section 4111 of the Corporations Code (General Corporation Law) (which previously governed nonprofit corporations pursuant to former Section 9700 of the Corporations Code (General Nonprofit Corporation Law)). The prior law has been changed to conform to nonprofit corporation terminology and to the provisions of Section 758 (the articles or a bylaws adopted by the members may specify a manner of voting other than at a meeting of the members).

§ 1307. Filing with Secretary of State; plan and certificate of approval

1307. The executed plan of merger or consolidation, or an executed counterpart thereof, and the respective certificate of approval of each constituent corporation shall be separately filed with the Secretary of State, and shall thereupon become effective, and the several parties thereto shall be one corporation. Neither the plan of merger or consolidation

nor any certificate shall be filed, however, until there has been filed with the Secretary of State by or on behalf of each corporation, taxed under the Bank and Corporation Franchise Tax Act, the existence of which is terminated by the merger or consolidation, the certificate of satisfaction of the Franchise Tax Board that all taxes imposed by that act have been paid or secured.

Comment. Section 1307 is the same in substance as Section 4113 of the Corporations Code (General Corporation Law) (which previously governed nonprofit corporations pursuant to former Section 9700 of the Corporations Code (General Nonprofit Corporation Law)).

ISSUE TO BE RESOLVED:

1. Should the provisions in this section concerning the approval of the Franchise Tax Board be retained? (Recommendation--Yes.)

404-083

§ 1308. Filing with the county clerk and recorder

1308. (a) A copy of the plan of merger or consolidation, certified by the Secretary of State, shall be filed with all of the following:

(1) The county clerk of the county in which the principal office of each constituent corporation is located.

(2) The county clerk of the county in which the principal office of the consolidated or surviving corporation is located.

(3) The county clerk of each county in which each corporation, including the consolidated or surviving corporation, holds real property.

(b) There shall also be recorded in the office of the recorder of every county in this state in which any real property owned by a constituent corporation is located a certificate prescribed by the Secretary of State.

Comment. Section 1308 is the same as Section 4114 of the Corporations Code (General Corporation Law) (which previously governed nonprofit corporations pursuant to former Section 9700 of the Corporations Code (General Nonprofit Corporation Law)).

404-084

§ 1309. Effect of merger or consolidation

1309. (a) Upon the official filing by the Secretary of State of the certificate of approval and the executed plan of merger or consolidation, or an executed counterpart thereof, or upon the effective date as specified in the certificate of approval, the merger or consolidation is effected.

(b) When such merger or consolidation has been effected:

(1) The surviving or consolidated corporation thereafter, if consistent with its articles of incorporation as altered or established by the merger or consolidation, possesses all the rights, privileges, immunities, powers, and purposes of each of the constituent corporations.

(2) All the property, real and personal, including causes of action and every other asset of each of the constituent corporations, vests in the surviving or consolidated corporation without further act or deed.

(3) The surviving or consolidated corporation assumes and is liable for all the liabilities, obligations, and penalties of each of the constituent corporations. All rights of creditors and all liens upon the property of each of the constituent corporations are preserved unimpaired, limited in lien to the property affected by such liens immediately prior to the effective date of merger or consolidation. No liability or obligation due or to become due, claim or demand for any cause existing against

any corporation, or any member, officer, or director is released or impaired by the merger or consolidation. No action or proceeding, whether civil or criminal, then pending by or against any constituent corporation, or any member, officer, or director abates or is discontinued by the merger or consolidation, but may be enforced, prosecuted, settled, or compromised as if the merger or consolidation had not occurred or the surviving or consolidated corporation may be substituted in the action or proceeding in place of any constituent corporation.

(4) In the case of a merger, the articles of incorporation of the surviving corporation are automatically amended to the extent, if any, that changes in its articles of incorporation are set forth in the plan of merger; and, in the case of a consolidated corporation, the statements set forth in the articles of incorporation and which are required or permitted to be set forth in the articles of incorporation of a corporation formed under this code constitute its articles of incorporation.

Comment. Section 1309 is derived from Section 905 of New York's Not-for-Profit Corporation Law. It is very similar to Section 4116 of the Corporations Code (General Corporation Law) (which previously governed nonprofit corporations pursuant to former Section 9700 of the Corporations Code (General Nonprofit Corporation Law)). It establishes the effective date for merger or consolidation and the consequences which follow from that date. Thereafter, the surviving or consolidated corporation possesses all of the rights, privileges, immunities, powers, and purposes of the constituent corporations which are consistent with its articles, all of the assets of the constituent corporations vest in it, and it assumes all of the liabilities, obligations, and penalties of the constituent corporations. Moreover, the articles of incorporation are deemed amended

consistent with any changes set forth in the plan of merger or, in the case of a consolidated corporation, the statements set forth in the new articles of incorporation which are required or permitted by this code constitute its articles of incorporation. Cf. Corp. Code §§ 4104, 4105.

Analysis

Section 905 of New York's Not-for-Profit Corporation Law contains a provision which permits a consolidated corporation to automatically receive any testamentary disposition made to a constituent corporation. This approach seems unwise as the consolidated corporation may have altered the original purposes of the constituent corporation. A court should be free to decide whether or not the consolidated corporation is the proper recipient for such a gift. However, it is expected that, in most situations, the consolidated corporation should receive the gift as this best serves the donor's intent.¹

ISSUE TO BE RESOLVED:

1. Should a consolidated corporation automatically receive any testamentary disposition made to a constituent corporation? (Recommendation--No.)

404-086

§ 1310. Merger or consolidation involving foreign corporation

1310. (a) One or more foreign corporations and one or more domestic corporations may be merged or consolidated into a corporation of this state or another jurisdiction if such merger or consolidation is permitted by the laws of the jurisdiction under which each foreign corporation is incorporated. With respect to merger or consolidation, the references in Section 1302 to a corporation shall, unless the context otherwise requires, include both domestic and foreign corporations.

1. See In re Los Angeles County Pioneer Society, 40 Cal.2d 852, 257 P.2d 1 (1953), cert. denied, 346 U.S. 888 (1953), rehearing denied, 346 U.S. 928 (1953).

(b) If the consolidated or surviving corporation is a domestic corporation, the consolidation or merger proceedings with respect to that corporation shall conform to the provisions of this article governing the consolidation or merger of domestic corporations, and each domestic constituent corporation shall satisfy the filing requirements of Section 1307; thereupon the merger or consolidation is effective to any such domestic corporation. Each constituent foreign corporation which is qualified to conduct intrastate activities in this state shall file in the office of the Secretary of State a certificate of surrender of the right to conduct intrastate activities as provided in Section 1756. There shall also be recorded in the office of the recorder of every county in this state in which any real property owned by a constituent corporation, domestic or foreign, is located a certificate as prescribed by the Secretary of State as provided in Section 1308.

(c) If the consolidated or surviving corporation is a foreign corporation, the consolidation or merger proceedings may be in accordance with the laws of the state of incorporation or proposed incorporation of the consolidated or surviving corporation except that each constituent domestic corporation must comply with the requirements of Section 1304. In addition, each constituent consolidated or merged foreign corporation which is qualified to conduct intrastate activities in this state shall file in the office of the Secretary of State a certificate of surrender of its right to transact intrastate activities as provided in Section 1756. No filing need be made in this state by or on behalf of the surviving foreign corporation. Each constituent domestic corporation shall file

in the office of the Secretary of State a copy of the plan, certificate, or other document filed by the consolidated or surviving foreign corporation in the state or place of its incorporation for the purpose of effecting the consolidation or merger, which copy shall be certified by the public officer having official custody of the original or, in lieu thereof, an executed counterpart of the plan or certificate, and thereupon the consolidation or merger shall be effective as to the domestic corporation; certified copies of the plan, certificate, or other document shall be filed as provided in Section 1308. There also shall be recorded in the office of the recorder of every county in this state in which real property owned by a constituent corporation, domestic or foreign, is located a certificate prescribed by the Secretary of State as provided in Section 1308.

Comment. Section 1310 continues unaltered the substance of the provisions for merger or consolidation of foreign and domestic corporations found in Sections 4118 and 4119 of the Corporations Code (General Corporation Law) (which previously governed nonprofit corporations pursuant to former Section 9700 of the Corporations Code (General Nonprofit Corporation Law)). It establishes the power of these corporations to merge or consolidate subject to the filing and other requirements set forth in this section.

ISSUES TO BE RESOLVED:

1. Should mergers or consolidations between domestic and foreign nonprofit corporations be permitted? (Recommendation--Yes.)

2. When the surviving or consolidated corporation is a domestic corporation, should foreign constituent corporations be required to follow California authorization procedures? (Recommendation--No.)

§ 1311. Realty of constituent foreign corporations; transfer by recording agreement

1311. Whenever a foreign corporation having any real property in this state consolidates or merges with another foreign corporation pursuant to the laws of the state or place in which it was incorporated, and the laws of that state or place provide substantially that the making and filing of the agreement of consolidation or merger vests in the consolidated or surviving corporation all the real property of the constituent corporation, the filing for record, in the office of the recorder of any county in this state in which any of the real property of the constituent corporation is located, of either (a) a certificate, prescribed by the Secretary of State as provided for by Section 1308, executed by the Secretary of State or other official of the state or place pursuant to the laws under which the consolidation or merger is effected or (b) a copy of the plan of consolidation or merger, certified by the Secretary of State or other official of the state or place pursuant to the laws of which the consolidation or merger is effected, shall vest in the consolidated or surviving corporation all interest of the constituent corporation in and to the real property located in that county.

Comment. Section 1311 is the same as Section 4122 of the Corporations Code (General Corporation Law) (which previously governed nonprofit corporations pursuant to former Section 9700 of the Corporations Code (General Nonprofit Corporation Law)). It provides a procedure for the orderly transfer of realty of constituent foreign corporations to the surviving or consolidated foreign corporation.

§ 1312. Action by the Attorney General, director, or member

1312. The Attorney General or any director or member may bring an action to enjoin or rescind any merger or consolidation which serves as a device to defraud members or the public at large or which is manifestly unfair to either corporation.

Comment. Section 1312 creates for the Attorney General, a member, or a director a statutory action to enjoin or rescind any merger or consolidation which serves as a device to defraud members or the public at large or which is manifestly unfair to either corporation. This action is entirely new for members as Section 4123 of the Corporations Code (General Corporation Law) (which previously governed nonprofit corporations pursuant to former Section 9700 of the Corporations Code (General Nonprofit Corporation Law)) expressly prohibited a member from attacking the validity of a merger or consolidation. Under that provision, a member was limited to dissenter's appraisal rights which were generally of little help in the nonprofit situation as the member owned nothing of estimable value, for he was not entitled to share in the assets of the corporation except upon the very contingent event of dissolution as provided in former Section 9200 of the Corporations Code (General Nonprofit Corporation Law). Similarly, under this code, a member may not share in the corporate assets except upon dissolution pursuant to Chapter 8 (commencing with Section 1501). This provision is designed to give him a statutory cause of action as an alternative to the profit corporation's dissenter's appraisal rights. It is intended that the concept of fraud should be interpreted in a very broad fashion so as to embrace anything which is intended to deceive and which results in the injury of one who has justifiably relied upon the previous nature of the corporation. See Arch v. Finkelstein, 264 Cal. App.2d 667, 20 Cal. Rptr. 472 (1968).

Analysis

The right to enjoin or rescind fraudulent or manifestly unfair mergers or consolidations is proposed as an alternative not only to

dissenter's appraisal rights (see the Comment above) but also to the approval and consent procedure of Sections 907 and 909 of New York's Not-for-Profit Corporation Law which require certain types of nonprofit corporations (e.g., charitable corporations) to gain the approval of the court and also the government official required by Section 404 of that code for the formation of that type of corporation before a plan of merger or consolidation may be filed. This proposed code rejects the consents and approvals approach as lacking appropriate standards and inviting administrative arbitrariness. It is also time consuming and expensive. See the Comment and Analysis to Section 301.

However, some procedure is advisable to protect members and the public from mergers and consolidations which are designed to cheat the corporation or its members or mislead the public. Section 1312 proposes this broad statutory right to enjoin unfair or fraudulent mergers or consolidations. Perhaps a more precise standard can be developed to aid the courts in this matter, but none seems to be readily available.

ISSUES TO BE RESOLVED:

1. Should nonprofit corporations be required to gain the consent of a governmental body prior to merger or consolidation? (Recommendation--No.)
2. Should members of nonprofit corporations undergoing merger or consolidation be given some form of dissenting members' appraisal rights? (Recommendation--No.)
3. Should a statutory action be created as a remedy for unfair or fraudulent mergers or consolidations? (Recommendation--Yes.)
4. Should a standard other than "fairness" or "fraud" be applied? (Recommendation--No.)

404-090

§ 1313. Limitation on action

1313. No action to enjoin or rescind a merger or consolidation may be commenced more than 60 days after the effective date of the merger or consolidation.

Comment. Section 1313 places a time limit upon actions begun pursuant to Section 1312.

Analysis

A limit is placed upon actions begun pursuant to Section 1312 in order to protect the merging or consolidating corporations from a perpetual doubt as to the validity of their action. Sixty days gives all parties enough time to investigate and initiate action.

ISSUE TO BE RESOLVED:

1. Should there be a short statute of limitations for actions brought to enjoin or rescind fraudulent or unfair mergers or consolidations? (Recommendation--Yes.)

404-091

Article 3. Conversion Into Business Corporation

§ 1401. Definitions

1401. As used in this article:

(a) "Constituent corporation" means the corporation undergoing conversion.

(b) "Surviving corporation" means the resulting profit-oriented corporation.

Comment. Section 1401 makes clear that, for the purposes of this article, "constituent corporation" as used in Article 2 means the not-for-profit corporation undergoing conversion and "surviving corporation" means the resulting profit-oriented corporation.

§ 1402. Conversion into business corporation

1402. A corporation not organized primarily for charitable purposes may convert into a business corporation organized for profit. Except as specifically provided in this article, the procedures for conversion are the same as those required for merger with a domestic corporation under Article 2 (commencing with Section 1301).

Comment. Section 1402, which enables a nonprofit corporation not organized primarily for charitable purposes to convert into a business corporation, is entirely new for California. It is designed to encourage a corporation with a quasi-public purpose--such as one providing jobs for disadvantaged areas--to convert into a fully operative business corporation owned by the local community once sufficient experience and financial backing have been gained. The model for conversion is derived from Pennsylvania's Corporation Not-for-profit Code, Title 15, Chapter 79, Subchapter D, Sections 7951-7956. Essentially, the procedures which must be followed are those established in Article 2 for mergers, including the approval of two-thirds of the members who vote on this matter as provided in Section 1304.

Analysis

Excluding for obvious reasons charitable corporations and, if adequate protection is developed for trust property held by the corporation, a corporation which overwhelmingly desires to do so should be permitted to convert into a profit-oriented corporation. Upon conversion, the corporation becomes subject to the more restrictive rules governing business corporations, and it loses its special public benefits such as tax exemptions. Conversion can be a useful device for developing disadvantaged areas. A ghetto business can be helped to get on its feet via the outside support and supervision of a nonprofit corporation. Once the business becomes viable, it may then convert into a profit-oriented corporation owned by the local businessmen.¹

1. See Note, New York's Not-for-Profit Corporation Law, 47 N.Y.U. L. Rev. 761, 778-779 (1971).

In general, merger or consolidation procedures are well suited as a vehicle for conversion. These actions represent similar fundamental changes in the corporation. Both New York and Pennsylvania follow that approach.²

ISSUES TO BE RESOLVED:

1. Should nonprofit corporations which are not organized for charitable purposes be permitted to convert into business corporations? (Recommendation--Yes.)

2. Should merger procedures be used to accomplish conversion? (Recommendation--Yes.)

404-093

§ 1403. Transfer of trust property

1403. (a) Before submitting the certificate of conversion required by Section 1305, the corporation shall transfer all property held in trust to one or more domestic or foreign corporations or organizations engaged in activities substantially similar to those of the corporation undergoing conversion.

(b) The Attorney General, any director, or any person acting with the consent of the Attorney General, may petition the court to appoint an alternative trustee for any trust property transferred under subdivision (a) if this action is necessary to protect the original donor's intended purposes.

Comment. Section 1403 provides that, prior to conversion, the corporation shall transfer all property held in trust to one or more

2. Section 908 of New York's Not-for-Profit Corporation Law permits conversion through the device of merging into a dummy profit corporation; Section 7952 of Pennsylvania's Corporation Not-for-profit Code directly applies merger procedures to the conversion process.

corporations or organizations engaged in substantially similar activities. Under this provision, the corporation need not seek court supervision of the disposition of its trust property. This approach alters the prior law. See generally Bowles v. Superior Court, 44 Cal.2d 574, 283 P.2d 704 (1955); Civil Code § 2287 (court's power to appoint trustees to fill vacancy); see also Mosk v. Summerland Spiritualist Ass'n, 22 Cal. App.2d 376, 37 Cal. Rptr. 366 (1964). For an explanation of a similar provision, see the Comment to Section 1512 (disposition of assets held in trust during dissolution of the corporation).

Subdivision (b) permits the Attorney General, any director, or any person acting with the consent of the Attorney General, to petition the court to appoint another trustee. The court may order such an action when it is necessary to protect the donor's intent. This provision essentially restates the common law. In re Veteran's Industries, Inc., 8 Cal. App.3d 902, 88 Cal. Rptr. 303 (1970). For a similar provision, see Section 1108.

ISSUES TO BE RESOLVED:

1. Should the corporation undergoing conversion be required to transfer its trust property prior to conversion to another corporation or organization engaged in activities substantially similar to those of the corporation undergoing conversion? (Recommendation--Yes.)
2. Should court supervision of the transfer process be required? (Recommendation--No.)
3. Should transfer to a foreign corporation or organization be permitted? (Recommendation--Yes.)

404-094

§ 1404. Certificate of conversion; filing; effect

1404. (a) The certificate of conversion required by Section 1305 shall be filed in the manner prescribed by Sections 1307 and 1308. It

shall clearly set forth the disposition of all trust property held by the converting corporation as well as the matters required by Section 1305.

(b) Upon the official filing of the certificate of conversion and the executed plan of conversion, or an executed counterpart thereof, by the Secretary of State or upon the effective date specified in the certificate of conversion pursuant to Section 1305, the conversion is effective as specified in Section 1309 and, from that date except as specifically otherwise provided in this article, the surviving corporation shall be governed by the General Corporation Law, Division 1 (commencing with Section 100) of the Corporations Code.

Comment. Subdivision (a) of Section 1404 restates the applicability of Sections 1305, 1307, and 1308 to the conversion of a nonprofit corporation and establishes the additional requirement that the certificate of conversion state the disposition of all trust property.

Subdivision (b) sets forth the effective date for conversion which is the official filing date unless a proper date is specified in the certificate of conversion as provided in Section 1305. If such a date is specified, it shall be the effective date. Several of the consequences of conversion are set forth in Section 1309. In addition, after the effective date, the corporation shall be governed by the General Corporation Law (which regulates business corporations) except as specifically otherwise provided in this article.

ISSUE TO BE RESOLVED:

1. Should the effect of conversion be to bring the corporation under the provisions of the Corporations Code? (Recommendation--Yes.)

§ 1405. Action by the Attorney General, director, or member

1405. The Attorney General, any director, or member may bring an action to enjoin or rescind the conversion of a corporation which serves as a device to defraud members or the public at large.

Comment. Section 1405 is similar to Section 1312 (action to enjoin a fraudulent merger). See the Comment to Section 1312. It is intended that the concept of fraud should be interpreted in a very broad fashion so as to embrace anything which is intended to deceive and which results in the injury of one who has justifiably relied upon the previous nature of the corporation. See Arch v. Finkelstein, 264 Cal. App.2d 667, 20 Cal. Rptr. 472 (1968).

ISSUE TO BE RESOLVED:

1. Is "fraud" an acceptable standard for this statutory action?
(Recommendation--Yes.)

CHAPTER 8. DISSOLUTION

Article 1. Voluntary Dissolution§ 1501. "Plan of dissolution"

1501. As used in this chapter, "plan of dissolution" means a general plan adopted by the board pursuant to Section 1502 for winding up the affairs of the corporation and distributing its assets.

Comment. Section 1501 defines "plan of dissolution," thus permitting the simplification of subsequent sections.

404-097

§ 1502. Adopting a plan of dissolution

1502. To initiate voluntary dissolution of the corporation, the board shall adopt a general plan for winding up the affairs of the corporation and the distribution of its assets. This plan shall implement any provision in the articles or bylaws as provided for by Section 1513 prescribing the distributive rights of members to the corporate assets which are distributable to members upon final dissolution pursuant to Section 1512.

Comment. Section 1502 is substantially the same as Section 1001 of New York's Not-for-Profit Corporation Law. It requires the board of directors to enact a general plan for the winding up of the affairs of the corporation and the distribution of its assets as a prerequisite to voluntary dissolution. Such a plan should provide for the disposition of

all assets held in trust pursuant to Section 1101 according to the guideline set forth in Section 1512, it should provide an outline plan for the sale or other disposition of the corporate property and for the liquidation of all of the corporate debts and obligations in a manner consistent with the provisions of this chapter, and it should provide for the distribution of all remaining assets to the members according to their respective rights established pursuant to Section 1513.

Section 1502 is a new requirement for nonprofit corporations as the General Corporation Law (which previously applied to the dissolution of nonprofit corporations pursuant to former Section 9800 of the Corporations Code) requires only that the membership elect to dissolve to initiate dissolution proceedings. There is no requirement that the board adopt a plan of dissolution except in a few limited situations where only board approval is required for a corporation to commence dissolution (e.g., the corporation has no members). See Corp. Code §§ 4600 and 4601. This change is designed to provide a more orderly procedure for voluntary dissolution in order to encourage dissolution without court supervision. Moreover, creation and approval of a plan of dissolution by the board prior to membership authorization encourages more detailed consideration of the decision to dissolve. The precise terms of the plan, however, unless it specifically provides otherwise, are not binding on the board after membership authorization but rather may be altered by board resolution. See the Comment to Section 1503.

ISSUES TO BE RESOLVED:

1. Should voluntary dissolution require the adoption by the board of a plan of dissolution? (Recommendation--Yes.)
2. Should the details of this plan be binding after membership authorization if the plan itself does not so specifically provide? (Recommendation--No.)
3. In any case, should the board be required to approve the decision to dissolve the corporation? (Recommendation--Yes.)

§ 1503. Authorization of plan to dissolve

1503. (a) Except as provided in subdivisions (b), (c), and (d), upon the adoption of a plan of dissolution, the board shall submit it to the membership for approval either at a meeting of the members or otherwise as provided in Section 758 or 764. The plan shall be approved by the vote or written consent of 50 percent or more of the voting power of the corporation. Unless the plan specifically provides otherwise, membership authorization is deemed a general grant of authority to dissolve the corporation and does not bind the board to the precise terms of the plan.

(b) If there are no members except directors entitled to vote on the dissolution, the plan of dissolution is deemed authorized upon its adoption by the board.

(c) If the term of existence for which the corporation was organized expires without extension, the board shall wind up its affairs and distribute its assets pursuant to a plan of dissolution adopted by the board as provided in Section 1502.

(d) If a corporation has been adjudged bankrupt, it may elect to dissolve and wind up its affairs by resolution of the board adopting a plan of dissolution as provided in Section 1502.

Comment. Subdivision (a) of Section 1503 requires that the plan to dissolve the corporation be authorized by the vote or written consent of members representing 50 percent or more of the voting power of the corporation. This rule contains the same numerical membership approval requirement as is found in Section 4600 of the Corporations Code (General Corporation Law) (which previously governed the dissolution of nonprofit corporations pursuant to former Section 9800 of the Corporations Code). The

last sentence of subdivision (a) provides that, unless the plan specifically provides otherwise, membership authorization is deemed a general grant of authority to dissolve the corporation and shall not bind the board to the precise terms of the plan. This provision addresses the practical reality that the board may not be able to anticipate and prepare for all circumstances in winding up the corporation prior to the beginning of the process itself; and, therefore, absent an express membership determination to the contrary, the board should not be hampered in actual windup by the precise terms of the plan adopted pursuant to Section 1502. That plan is designed to merely provide a general outline for dissolution although the terms of the plan may be made binding if the corporation desires in order to satisfy the conditions of Section 1508 (membership approval required for sale of the corporate assets for any consideration other than money).

Subdivision (b) makes clear that, for a corporation without members, no authorization is required for dissolution beyond the approval of the board of directors.

Subdivision (c) requires a corporation to dissolve after the expiration of its term of existence; membership approval is not required. A corporation organized under this code may have perpetual existence or it may elect to limit the term of its existence by an appropriate provision in the articles. See Section 303.

Subdivision (d) is substantially the same as Section 4601(b) of the Corporations Code (General Corporation Law) (which previously governed nonprofit corporations pursuant to former Section 9800 of the Corporations Code). Here again, membership approval is not required.

Analysis

Section 1002 of New York's Not-for-Profit Corporation Law requires that a plan of dissolution be approved by two-thirds vote of members who cast their vote at a meeting of the members. For a corporation with an interested membership, this number is potentially much larger than the proposed requirement of Section 1503. The smaller number for membership approval is advisable for, after appropriate measures have been taken to protect the dissenting members, creditors, and the public, it is in the

public interest to permit and even encourage nonprofit corporations to dissolve when as many as 50 percent or more of the membership desires this step. The social usefulness of these organizations depends upon how well they serve their intended purposes, and members are the best and, perhaps, only judge of this effectiveness. When half of the members believe the organization is no longer necessary, it is in society's interest to facilitate dissolution.

It should be noted that other types of fundamental changes in the corporation such as merger or the sale of all or substantially all of the corporate assets, without dissolution, which transform the nature of the corporation may require a different legal treatment. In those cases, the dissenting member, if he wishes to protect his investment of time and money, is forced into a continuing relationship with an organization which may be materially different from his original expectations; whereas in the dissolution situation, the member's relationship is severed and he also receives his share of the remaining corporate assets after the corporate liabilities and obligations have been satisfied (see Section 1512).¹ Given this continuing relationship factor, fairness argues for a stricter legal rule concerning the numerical requirement of membership approval in these other situations than in dissolution proceedings.² Besides, there is no clear public policy favoring such transformations as there is in the case of dissolution.

Turning to another policy issue, another approach to the dissolution of an insolvent corporation is presented by Section 1102(a)(1) of New York's Not-for-Profit Corporation Law. Under that provision, a majority of the directors may petition the court for judicial dissolution of the corporation when it is insolvent³ whereas the Corporations Code permits

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1. Practically speaking, a member's property interest in a nonprofit corporation at the point of merger is too contingent (depends upon the value at dissolution) to permit the use of dissenter's appraisal rights in that situation. See the Comment to Section 1311.
 2. See the Analysis of Section 1201 for more discussion of this point.
 3. Section 1102(a)(1) of New York's Not-for-Profit Corporation Law also permits the members to petition for dissolution upon grounds of insolvency. Moreover, Section 7982 of Pennsylvania's Corporation Not-for-profit Code creates a similar right for unsatisfied judgment creditors.

the board to itself initiate voluntary dissolution when the corporation has been adjudged bankrupt in some other proceeding (note the difference between bankruptcy and insolvency).

ISSUES TO BE RESOLVED:

1. Should 50 percent of the members be sufficient to authorize dissolution of the corporation? (Recommendation--Yes.)

2. Should a special action be created for the judicial dissolution of "insolvent" corporations? (Recommendation--No.)

404-100

§ 1504. Time of commencement of proceedings

1504. (a) Except as provided in subdivision (b), voluntary proceedings for winding up the affairs of the corporation commence when the authorization procedures required by Section 1503 are complete.

(b) If a corporation is dissolving because of the expiration of its term of existence, the proceedings for winding up the affairs of the corporation commence on the termination date.

Comment. Section 1504, which states that dissolution commences upon the completion of authorization or in the case of a corporation dissolving because of the expiration of its term, upon the expiration date, is substantially the same as Section 4604 of the Corporations Code (General Corporation Law) (which previously governed nonprofit corporations pursuant to former Section 9800 of the Corporations Code).

ISSUE TO BE RESOLVED:

1. Should dissolution proceedings commence upon filing the certificate of commencement of proceedings? (Recommendation--No.)

§ 1505. Effect of commencement of proceedings

1505. When a voluntary proceeding for winding up the affairs of the corporation has been commenced, the corporation shall cease to carry on its activities except to the extent necessary for the successful winding up of those activities and to preserve the value of the corporation's assets pending sale or other disposition.

Comment. Section 1505 requires that the corporation cease its normal activities upon the commencement of proceedings to wind up its affairs. However, the corporation may continue to engage in such activities as are required to successfully complete winding up and preserve the value of the corporation's assets. This provision is essentially the same as the first part of Section 4605 of the Corporations Code (General Corporation Law) (which governed non-profit corporations pursuant to former Section 9800 of the Corporations Code).

405-956

§ 1506. Filing certificate of commencement of proceedings

1506. (a) Forthwith upon commencement of the proceedings to wind up the affairs of the corporation, a certificate of commencement of proceedings to dissolve the corporation shall be filed with the Secretary of State and with the county clerk in which the principal officer of the corporation is located.

(b) The certificate shall be signed and verified by a signed affidavit stating that the matters set forth in the certificate are true of his own knowledge by the chief officer of the corporation or any two subordinate officers or by a majority of the board.

(c) The certificate shall set forth:

(1) The name of the corporation and, if its name has been changed, the name under which it was formed.

(2) The date its articles of incorporation was filed by the Secretary of State.

(3) The name and address of each of its officers and directors.

(4) A statement as to whether or not the corporation holds assets at the time of the dissolution in trust pursuant to Section 1101 and a list of such assets if there are any.

(5) A statement that the corporation has commenced proceedings to wind up its affairs and distribute its assets.

(6) A copy of the resolution of the board adopting the plan of dissolution.

(7) If membership approval is required, a statement of the voting procedure used, including a specific reference to the statutory provision or provision in the articles or bylaws, or both, authorizing use of the procedure used, the number of votes entitled to be cast, and the consenting votes.

(c) A copy of the plan of dissolution shall be filed at the same time and with the same persons as the certificate of commencement of proceedings to dissolve the corporation.

Comment. The certificate required by Section 1506 is very similar to the certificate of amendment required by Section 556 for amendments to the articles, and it is similar in effect to Section 4603 of the Corporations Code (General Corporation Law) (which previously governed the

dissolution of nonprofit corporations pursuant to former Section 9800 of the Corporations Code). The time when the proceedings to wind up the affairs of the corporation "commence" is specified in Section 1504.

ISSUES TO BE RESOLVED:

1. Should the corporation be required to file a certificate of commencement of proceedings with the Secretary of State? (Recommendation--Yes.)

2. Should a copy of the plan of dissolution be filed along with the certificate? (Recommendation--Yes.)

405-957

§ 1507. Notice of commencement of proceedings

1507. Upon commencement of voluntary proceedings to wind up the affairs of the corporation, written notice of the commencement of the proceeding shall forthwith be sent to the Attorney General, all members, and all persons believed to be creditors or claimants whose addresses appear on the records of the corporation, are known to the corporation, or can and with due diligence be ascertained by the corporation and, in addition, notice shall be published pursuant to Section 6066 of the Government Code in a newspaper of general circulation in the county in which the office of the corporation was located at the date of commencement of proceedings for winding up the corporation. Any person whose claim is, at the date of commencement, barred by any statute of limitations is not entitled to notice under this section. Notice required by this section may include a time limit and procedure for the presentation of claims against the corporation as provided in Section 1510.

Comment. Section 1507 contains general notice requirements which are more demanding than those set forth in the second part of Section 4605 of the Corporations Code (General Corporation Law) (the provisions of Section 4605 previously governed nonprofit corporations undergoing dissolution pursuant to former Section 9800 of the Corporations Code). Section 1507 requires the corporation to give written notice to the Attorney General and to all persons believed to be creditors or claimants whose addresses are known or discoverable as stated above. In addition, published notice is also now required. These notice provisions are derived from Section 1007 of New York's Not-for-Profit Corporation Law and are designed to maximize the opportunity of fair notice to claimants who may have a cause of action against the corporation. Moreover, this notice may be used to specify a time and procedure for the presentation of claims against the corporation as provided in Section 1510. The time when the proceedings to wind up the affairs of the corporation "commence" is specified in Section 1504.

Analysis

The requirements for notice at the time of the commencement of dissolution proceedings have been expanded to: (1) insure that creditors and potential claimants are given a better opportunity for fair notice of the dissolution, (2) facilitate the discharge of the Attorney General's duties under this code, and (3) eliminate any necessity to send additional notice pursuant to the procedures for the presentation of claims against the corporation or its property.¹

ISSUES TO BE RESOLVED:

1. Should the corporation be required to send notice of the commencement of proceedings to members or creditors whose addresses do not appear on the corporate records but nevertheless may be discovered with due diligence? (Recommendation--Yes.)
2. Should published notice of the commencement of proceedings also be required? (Recommendation--Yes.)
3. Should notice of commencement be sent to the Attorney General? (Recommendation--Yes.)

1. For the old requirements, see Corp. Code § 4605.

§ 1508. Function of directors in voluntary proceedings

1508. (a) When voluntary proceedings for winding up the affairs of the corporation have been commenced, the board of directors shall continue to act as a board and, subject to the supervision of the court as provided in Section 1509, has the powers specified in this section.

(b) Subject to subdivision (c), the board has the power to sell at public or private sale, exchange, convey, or otherwise dispose of, all or any part of the assets of the corporation upon such terms and conditions and for such consideration as the board deems reasonable or expedient and to execute bills of sale and deeds of conveyance in the name of the corporation.

(c) If the sale or exchange of all or substantially all of the corporate assets of a membership corporation is made for any consideration other than money, such sale or exchange shall be approved or ratified by the vote or written consent of 50 percent or more of the voting power of the corporation unless the specific terms of the transaction were contained in the plan of dissolution adopted by the board pursuant to Section 1502 and authorized by the membership pursuant to Section 1503; in the latter case, no further authorization is required for the transaction.

(d) The board has the power to make contracts and do any and all other things in the name of the corporation which may be proper and convenient for the purpose of winding up, settling, and liquidating the affairs of the corporation, including filling vacancies on the board of directors pursuant to Section 807.

Comment. Section 1508 provides that, after dissolution proceedings have been commenced as provided in Section 1504, the board of directors continues to function as a board and has full power to do anything necessary and proper for winding up the affairs of the corporation. This section continues the board's general grant of authority to wind up the corporation found in Sections 4800 and 4801(h) of the Corporations Code (General Corporation Law) (which previously governed the dissolution of nonprofit corporations pursuant to former Section 9800 of the Corporations Code). The section specifically authorizes the board to sell, exchange, convey, or otherwise dispose of the corporate property provided that, if a sale or other disposition of all or substantially all of the corporate property is for any consideration other than money, a membership corporation must obtain the approval of 50 percent or more of the voting power of the corporation unless the specific terms of this transaction were included in the plan of dissolution which was authorized by the membership pursuant to Section 1503. This provision is very similar to Section 4801(g) of the Corporations Code (General Corporation Law) which also requires membership authorization for the sale or other disposition of all or substantially all of the corporate assets if the consideration received is other than money. It should be noted that, even though the language of Section 1508 has been altered for conciseness, there is no intention to limit the board's power to wind up the corporation in any respect different from the Corporations Code provisions on this matter.

Analysis

Section 1507, like Section 4801(g) of the Corporations Code, requires membership approval if the corporation sells or otherwise disposes of all or substantially all of the corporation's assets for a consideration other than money. This is a sound rule as such a disposition of the corporate assets would likely require the corporation to resell the acquired asset prior to a distribution to the members of their share of the assets or at least it would probably require a more complex distribution than in the case of cash. The added complexity and opportunity for misappropriation or financial loss warrants membership approval of this type of transaction.

Membership approval should not be required for a sale of the corporate assets for cash as such a disposition is subsumed by the general authorization to dissolve the corporation given pursuant to Section 1503. See the Analysis to Section 1503 for more discussion of this issue.

ISSUES TO BE RESOLVED:

1. Should the sale of all or substantially all the corporate assets for a consideration other than money require membership approval? (Recommendation--Yes.)

2. Should there be other specific limitations on the power of the board during windup of the corporation? (Recommendation--No.)

405-960

§ 1509. Court supervision

1509. (a) At any time after voluntary proceedings for winding up the affairs of the corporation have been commenced, upon petition of the corporation, Attorney General, any director or officer, five percent of the members, the holders of five percent of the outstanding capital or subvention certificates, or any three creditors, the superior court of the county in which the principal office of the corporation is located may continue all or part of the winding up and dissolution of the corporation under the supervision of the court.

(b) In acting under this section, the court may make such orders and issue such injunctions as justice and equity require in connection with the winding up and dissolution of the corporation and, by way of illustration and not by way of limitation, the court may:

(1) Bar all creditors and claimants who have not filed claims pursuant to Section 1510 or whose claims have been disallowed by the court as against the corporation's assets, directors, or officers.

(2) Determine and enforce the liability of any director, officer, member, or subscriber for capital certificates to the corporation.

(3) Hear the presentation and filing of intermediate and final accounts of the directors and decide the allowance, disallowance, or settlement of such accounts and discharge the directors from their liabilities.

(4) Appoint a referee to hear and determine any matter in connection with the proceeding, with such powers and authority as the court deems proper, or appoint a receiver pursuant to Section 565 of the Code of Civil Procedure to take charge of the process of winding up the corporation.

(5) Determine the administration of any trust or the disposition of any or all property held in trust by or for the corporation.

(6) Settle or determine the payment, satisfaction, or compromise of all claims of every nature against the corporation or its property, provide for the retention of assets for this purpose, and determine the adequacy of provisions made for payment of the liabilities of the corporation.

(7) Remove any director the court finds is guilty of misconduct, neglect, or abuse of trust in conducting the windup or who is unable to act. The court may order an election to fill any vacancy so created and bar the reelection of the director who was removed or, in lieu of an election, may appoint a new director to fill the vacancy.

(8) Fill any vacancy on the board which the board or the members are unable to fill.

(9) Stay the prosecution of any action or proceeding against the corporation requiring the parties to present and prove their claims in the manner of creditors.

(10) Determine the rights of members or classes of members in and to the assets of the corporation in a manner consistent with the provisions of this code.

(11) Upon the allowance or settlement of the final accounts of directors, make an order that the corporation has been wound up and is dissolved. A copy of the order, certified by the clerk of the court, shall be filed in the same manner and with the same persons as the certificate of final windup and dissolution provided for in Section 1518.

(c) Orders under this section may be entered ex parte, except notice shall be given to the corporation and all other interested persons as the court deems proper. All orders made by the court under this section are binding upon the Attorney General, the corporation, its directors, officers, members, subscribers for capital certificates, incorporators, creditors, and claimants.

(d) Subject to Section 1510, this section does not preclude a creditor or claimant from bringing an action to recover on his individual claim if disputed by the corporation and unpaid.

Comment. Section 1509 contains a general grant of authority to the superior court to supervise part or all of the dissolution and windup of a corporation and to issue such orders as may be deemed proper in connection with the process of winding up. The court may exercise this authority upon petition of the persons listed in subdivision (a). Section 4607 of the Corporations Code (General Corporation Law) contains similar provisions.

However, the number of persons who may petition for court supervision is expanded in Section 1509 in a manner consistent with the other provisions of this code. For example, the Attorney General is given the power to petition for supervision which is consistent with his expanded powers and duties under this code. See Section 1901.

Paragraphs (1)-(11) of subdivision (b), which are derived in part from Section 1008 of New York's Not-for-Profit Corporation Law, list particular matters over which the court has jurisdiction. This list is not intended to limit in any way the court's general grant of authority described in the introductory portion of subdivision (b). Many of these specific areas over which the court may entertain jurisdiction and issue appropriate orders are also contained in various provisions of the General Corporation Law (Division 1 of the Corporations Code) (which previously governed the dissolution of nonprofit corporations pursuant to former Section 9800 of the Corporations Code). See Sections 4609 (determination of claims and assets available for distribution to shareholders), 4610 (right of shareholders to assets), 4611 (accounts of directors), 4612 (appointment and power of referees), 4613 (filling vacancies on the board), 4614 (removal, election, and appointment of directors), 4616 (staying actions and proceedings), and 4619 (order of dissolution).

Subdivision (c) is derived from Section 1008(c) of New York's Not-for-Profit Corporation Law. It expressly provides that orders granted pursuant to this section may be ex parte provided that notice is always given to the corporation and such other parties as the court deems proper. Such orders are binding on the Attorney General, the corporation, its directors, officers, members, subscribers for capital certificates, incorporators, creditors, and claimants. Since the court has the power to require notice to relevant interested parties, petitioners should not be required to litigate the same issue more than once. Note, however, that Government Code Section 12591 requires the Attorney General to be a party to any proceeding modifying or terminating any trust.

Subdivision (d) makes clear that an individual creditor or claimant may bring an action for recovery of his own claim, notwithstanding any limitation in this section on who may petition the court.

Analysis

An important policy issue in this section is who is permitted to petition the court for court supervision over the process of windup. As proposed, Section 1509 follows the approach of the Corporations Code requiring, for example, five percent of the members or three creditors to join in the petition for supervision whereas, under Section 1008 of New York's Not-for-Profit Corporation Law, such an action may be brought by any member, creditor, or claimant. While it seems clear that some persons not included in the Corporations Code provision should be permitted to bring this action (e.g., officers, directors, or the Attorney General) as these persons have an interest in these proceedings close enough to warrant this power, it seems advisable generally to follow the more restrictive approach of the Corporations Code. Nonprofit corporations should be permitted and encouraged to wind up their affairs with little or no court supervision. This approach conserves judicial resources. If there is a substantial problem with the corporation's plan of dissolution, the appropriate parties will certainly invoke Section 1509. Moreover, any member or creditor may still bring an action to recover his own claim or he may sue under Section 1517 to suspend or annul the dissolution proceeding if it is fraudulent or improperly authorized. The interested parties should be adequately protected by the operation of these two sections.

ISSUES TO BE RESOLVED:

1. Should the court be required to supervise the windup of a corporation after the commencement of dissolution proceedings whether or not members or others so petition? (Recommendation--No.)
2. Should any dissatisfied member be permitted to petition the court for judicial supervision of the process of winding up the corporation? (Recommendation--No.)
3. Should court orders under this section be granted ex parte after limited appropriate notice is given? (Recommendation--Yes.)

§ 1510. Presentation and proof of claims

1510. (a) As a part of the notice required by Section 1507, or by a notice given at a later date in the same manner as that required by Section 1507, the corporation or the court pursuant to Section 1509 may require that all creditors and claimants, including any with unliquidated or contingent claims and any with whom the corporation has unfulfilled contracts, present their claims in writing and in detail at a specified place and by a specified day, which day shall be not less than four nor more than six months after first publication of the notice. Any notice given pursuant to this section shall state that claims which are not presented as required are subject to being barred as against the corporation or its assets. The court, pursuant to Section 1509, may order additional notice as it deems proper.

(b) All claims which are not timely filed as provided in the notice, except claims which are the subject of litigation on the date of first publication of the notice, are forever barred as against the corporation or its assets except that, where it is shown that a claimant did not receive notice because of absence from the state or other good cause, the court may allow a claim to be filed or presented at any time prior to distribution of the assets to the members or other final disposition of the assets as provided in Section 1512. Creditors with secured claims who fail to present their claims are barred only as to any right to claim against the general assets for any deficiency in the amount realized on their security.

(c) Before any distribution is made, the amount of any unmatured, contingent, or disputed claim against the corporation which has been

presented and has not been disallowed, or such part of any such claim as the holder would be entitled to if the claim were due, established, or absolute shall be deposited as provided in Section 1511 or, if the court so orders, shall be paid to the court for holding until the claim comes due or the claimant establishes his claim. If the claimant fails to establish his claim, the amount deposited or held shall be distributed with the other assets of the corporation. If a creditor whose claim has been allowed but is not yet due consents to the payment of the present value of his claim, he is entitled to immediate payment of its present value.

(d) An action against the corporation on a claim which is rejected shall be commenced within 30 days after written notice of rejection is given the claimant.

Comment. Section 1510 establishes a procedure for the presentation of claims against the corporation or its assets. Notice of a time and place for this presentation may be given by the corporation or required to be given by the court in the manner specified in Section 1507 or may be included in the notice required by that section. Any notice shall state that claims which are not presented as required are subject to being barred as against the corporation or its assets. This statement notifies claimants of the effect of subdivision (b) which provides that claims which are not timely filed as required in the notice are forever barred as against the corporation or its assets subject to the limitations of subdivision (b). These requirements are similar to the provisions of Section 4608 of the Corporations Code (General Corporation Law) except that, unlike the Corporations Code provisions, Section 1510 does not require the presentation process to be undertaken pursuant to court supervision. This code seeks to eliminate or reduce the need for court

supervision where possible and, in this respect, Section 1510 follows the presentation of claims procedure of Section 1007 of New York's Not-for-Profit Corporation Law.

Subdivision (c) is similar to part of Section 4608 of the Corporations Code (General Corporation Law). It provides for the deposit under Section 1511 or the payment to the court of the amount of any disputed claim or unmatured or contingent obligation. Upon maturity or a favorable decision, any amount owed is to be paid to the claimant. All remaining amounts are to be distributed as provided in Section 1512. See also Section 1520 (assets omitted from winding up).

Subdivision (d) places a 30-day limitation on actions brought to recover a disputed claim. It is the same as part of Section 4608 of the Corporations Code (General Corporation Law).

ISSUES TO BE RESOLVED:

1. Should this code provide a nonjudicial procedure for the presentation and proof of claims against a dissolving corporation? (Recommendation--Yes.)

2. Should this procedure provide for the barring of claims which are not timely filed? (Recommendation--Yes.)

3. Should special provision be made for unmatured, contingent, or disputed claims? (Recommendation--Yes.)

4. Should there be a 30-day limitation upon actions brought upon rejected claims? (Recommendation--Yes.)

§ 1511. Deposit of amount due

1511. (a) The corporation may deposit the amount of any unmatured, contingent, or disputed debt or claim against the corporation or the amount of any debt owed to any person whose whereabouts are unknown with the State Treasurer or with any bank or trust company in this state for

the benefit of those who appear and establish their claim to the amounts deposited. The deposit shall be accompanied by a statement of the name of the person (and his address if known) entitled to the deposit and the date when the debt or obligation will mature, become due, or when the claim will be decided.

(b) Amounts deposited as provided in subdivision (a) which remain unclaimed six months after the debt has matured, become due, or the claim has been established may be reclaimed by the corporation for distribution with the other assets or, if final windup has been completed, may be recovered for distribution in the manner of assets omitted from final windup by the person, corporation, or group specified pursuant to Section 1520.

Comment. The deposit procedure of Section 1511 is similar to Section 5010 of the Corporations Code (General Corporation Law) which provides for the deposit of amounts owed to a person of unknown whereabouts with the State Treasurer or any bank or trust company. However, Section 1511 expands this procedure to cover all unmatured debts and disputed claims as well as amounts owed to persons of unknown address. This new approach facilitates dissolution without court supervision, for, under the prior law--Section 4608 of the Corporations Code (General Corporation Law)(which governed nonprofit corporations pursuant to former Section 9800 of the Corporations Code)--the corporation was required to deposit all such amounts with the court prior to making a distribution of its assets.

In order to aid the person entrusted with the deposit, the corporation is required to file a statement containing the name of the person or persons entitled to the deposit, his or their address if it is known, and the date on which the debt or claim will be due or become payable.

Subdivision (b) is a new provision. Coupled with Section 1515 (amounts deposited, unclaimed after the period specified in subdivision (b) of Section 1511, when reclaimed and distributed with the other assets, may not be recovered from the members or other distributees), subdivision (b) settles the final right of members or other distributees to the amounts distributed to them.

ISSUES TO BE RESOLVED:

1. Should a procedure be specified for the deposit of unmatured, contingent, or disputed debts or claims? (Recommendation--Yes.)

2. Should the corporation be permitted to deposit these amounts with others besides the State Treasurer or any bank or trust company? (Recommendation--No.)

3. Should amounts deposited which are not claimed six months after the debt has matured, become due, or the claim has been established be recoverable by the corporation for distribution with the other assets? (Recommendation--Yes.)

405-966

§ 1512. Disposition of assets

1512. (a) Except as provided in subdivision (b), the board or persons in charge of the winding up of the corporation and distribution of its assets shall divide all remaining assets among the members as provided in Section 1513 or dispose of them in such other manner as the articles provide after all of the following have occurred:

(1) The period for presentation of claims prescribed by Section 1510 has expired.

(2) All debts and obligations of the corporation have been paid, discharged, or provided for according to the provisions of Section 1511.

(3) All capital contributions have been redeemed, repaid, satisfied, or provided for according to the provisions of Section 1511.

(4) All subvention certificate holders have been paid or satisfied as required or permitted by Section 1002(g) or provided for according to the provisions of Section 1511.

(b) All property held in trust pursuant to Section 1101 shall be distributed to one or more domestic or foreign corporations or organizations engaged in activities substantially similar to those of the dissolved corporation pursuant to a plan of distribution adopted as provided in Section 1502 or, if held upon condition requiring return, transfer, or conveyance, disposed of according to such requirements.

Comment. Section 1512 provides that, after all the obligations and debts of the corporation have been paid, discharged, or provided for according to Section 1511, including all outstanding capital and subvention certificates, the remaining assets which are not held in trust shall be distributed to the members according to their shares established pursuant to Section 1513. This provision is essentially the same as former Section 9801 of the Corporations Code (General Nonprofit Corporation Law). The right of members under the limitations set forth to share in the final distribution of a dissolving corporation has long been established in this state.

Subdivision (b) provides that trust property shall either be distributed to one or more corporations or organizations engaged in substantially similar activities or, if held upon a condition requiring return, transfer, or conveyance upon dissolution, disposed of in a manner consistent with the condition. The latter requirement involving property held upon a condition requiring return or other disposition is consistent with the common law in California. See In re Los Angeles County Pioneer Society, 40 Cal.2d 852, 866, 257 P.2d 1, 9 (1953), cert. denied, 346 U.S. 888 (1953), rehearing

denied, 346 U.S. 128 (1953). However, under the prior law, if there was no express provision in the gift for reversion or other disposition of the assets, the court directed the disposition of all such trust property pursuant to former Section 9801, and the Attorney General was a necessary party to any proceeding affecting the disposition of the assets of a charitable trust. People v. Cogswell, 113 Cal. 129, 136, 45 P. 270, 271 (1896); Society of California Pioneers v. McElroy, 63 Cal. App.2d 332, 342, 146 P.2d 962, 967 (1944). Under Section 1512, the corporation may dispose of its trust property without court proceedings or the Attorney General's consent. This new procedure is derived from Section 1005(a)(3)(A) of New York's Not-for-Profit Corporation Law and also Section 46(c) of the ABA-ALI Model Non-Profit Corporation Act and is designed to reduce the burden on the courts and the Attorney General. Moreover, the corporation is in the best position to know which corporations or organizations have purposes and activities most similar to its own. If the Attorney General deems it necessary, he may petition the court pursuant to Section 1509 to review and alter the corporation's proposed disposition in order to protect the original donor's intended purpose.

Analysis

The most important issue to be considered in regard to this section is whether members should be permitted to share in the distribution of the assets of a nonprofit corporation after dissolution. Present law and the modern nonprofit corporation codes permit members to share in all nontrust assets remaining after the corporate obligations and liabilities have been paid or discharged.¹ This is a sound policy, for after appropriate measures have been taken to protect trust property, including property given without specific limitation to a charitable corporation, there is no reason why members should not be allowed to receive such a distribution. In many organizations, members have invested their time, energy, and resources. Fairness warrants at least a partial return of

1. Cal. Corp. Code § 9801 (General Nonprofit Corporation Law); N.Y. Not-for-Profit Corporation Law § 507(d); Pa. Corporation Not-for-profit Code § 7967(c); ABA-ALI Model Non-Profit Corporation Act § 46(d).

this investment upon dissolution. Moreover, no other group or body has a better claim to these assets.

ISSUES TO BE RESOLVED:

1. With appropriate limitations, should members be permitted to divide among themselves the remaining assets after dissolution of the corporation? (Recommendation--Yes.)

2. Should a dissolving nonprofit corporation be permitted to transfer its trust property without judicial or governmental supervision? (Recommendation--Yes.)

405-968

§ 1513. Member's share in assets distributable to members upon dissolution

1513. If the articles or bylaws provide a reasonable plan for the distribution of the corporation's assets to the members upon dissolution of the corporation, the assets distributable to the members under Section 1512 shall be distributed according to such plan. In the absence of such a plan, all members shall share equally in all assets distributable to the members under Section 1512.

Comment. Section 1513 continues the power set forth in former Section 9301 of the Corporations Code (General Nonprofit Corporation Law) to establish in the articles or bylaws the property interest of each member or class of members upon dissolution of the corporation. However, Section 1513 provides that, unless the articles or bylaws provide otherwise, all members shall share equally in all assets distributable to the members upon dissolution. The total amount distributable to the members upon dissolution is set forth in Section 1512.

ISSUE TO BE RESOLVED:

1. Should the articles or bylaws be permitted to specify a reasonable plan for the distribution of the corporation's assets to the members which provides other than that each member shall share equally in such assets? (Recommendation--Yes.)

§ 1514. Disposition to dissolved charitable corporation

1514. A disposition contained in a will, in trust or otherwise, made before or after the dissolution, to or for the benefit of any charitable corporation that is dissolved, inures to the benefit of the corporation or organization acquiring the trust assets of the dissolved corporation pursuant to subdivision (b) of Section 1512 and shall be held in trust by the acquiring corporation or organization for the purposes intended by the testator; so far as is necessary for that purpose, the corporation or organization acquiring the disposition shall be deemed a successor to the dissolved corporation.

Comment. Section 1514 is derived from a provision of Section 1005 of New York's Not-for-Profit Corporation Law. It is clear that charitable corporations can receive bequests under the law of this state. Prob. Code § 27. Estate of Hurwitz, 109 Cal. App.2d 320, 240 P.2d 990 (1952). Courts have often applied cy pres doctrine to sustain gifts to corporations not in existence at the time the gift was made. In re Estate of Lamb, 19 Cal. App.3d 859, 97 Cal. Rptr. 46 (1971). However, cy pres requires litigation, and Section 1513 is designed to promote orderly transfer of property given to a dissolved charitable corporation without court action. This approach is consistent with Section 1512(b). See the Comment to that section.

ISSUE TO BE RESOLVED:

1. Should property given to a dissolved charitable corporation automatically inure to the corporation or organization receiving the dissolved corporation's assets? (Recommendation--Yes.)

§ 1515. Recovery of improper distributions from members or distributees

1515. (a) Whenever in the process of winding up a corporation any distribution of assets has been made without prior payment or adequate provision for payment of any debt or obligation of the corporation not barred by operation of Section 1510 or any statute of limitations, any amount improperly distributed to any member or otherwise may be recovered by the court on motion of the board, the person directing the winding up process, or any creditor or claimant whose debt or claim is due, unpaid and not barred, except any asset which has been deposited for the benefit of that creditor or claimant as provided in Section 1511 and has not been claimed within the period prescribed, is not recoverable from the members or other distributees. Any member or distributee who has shared in an improper distribution may be joined as a defendant and is liable for the amount improperly distributed to him.

(b) Members who satisfy any liability under this section have a right of ratable contribution from other distributees similarly liable. Any member compelled to return to the corporation more than his ratable share of the amount needed to pay the debts and liabilities of the corporation may require that the corporation recover from any or all of the other distributees such proportion of the amounts received by them upon the improper distribution as to give contribution to those held liable under this section and make the distribution of the assets fair and ratable.

(c) As used in this section, "winding up" includes any distribution to members or other distributees prior to the commencement of proceedings under this article which is not otherwise permitted by this code.

Comment. Section 1515 is similar to Section 5012 of the Corporations Code (General Corporation Law) (which previously governed nonprofit corporations undergoing dissolution pursuant to former Section 9800 of the Corporations Code). It provides for the recovery of improper distributions from members or distributees. An improper distribution is one made without adequate provision for the payment of all corporate debts or obligations which are not barred by the operation of Section 1510 or any statute of limitations. Unlike Corporations Code Section 5012, Section 1515 creates a statutory right for any creditor or claimant with an unpaid, unbarred claim to petition the court for recovery of the amount of his claim from members or distributees who received an improper distribution. Previously, a creditor or claimant had to resort to the common law for such an action. See Trubowitch v. Riverbank Canning Co., 30 Cal.2d 335, 182 P.2d 182 (1947). Section 1515 establishes that amounts deposited pursuant to Section 1511 for the benefit of a creditor or claimant and not claimed by him within the period are not recoverable from members or distributees. See the Comment to Section 1511 for an explanation of this provision. It should be noted that creditors or claimants may have a cause of action against directors for improper distributions. See Section 824 (liability of directors).

Subdivision (b) is the same in substance as a part of Section 5012 of the Corporations Code.

Subdivision (c) makes clear that distributions made unlawfully prior to the commencement of dissolution may also be recovered pursuant to this section.

ISSUES TO BE RESOLVED:

1. Should there be a special statutory action for the recovery of improper distributions? (Recommendation--Yes.)
2. Should this action extend to creditors or claimants whose debts or claims are due, unpaid, and not barred by law? (Recommendation--Yes.)
3. Should members held liable under this section be given a right of contribution from others similarly liable? (Recommendation--Yes.)

§ 1516. Revocation of election; certificate of revocation

1516. A voluntary election to wind up and dissolve may be revoked prior to the sale or other disposition of all or substantially all of the corporation's assets by the vote or written consent of the members representing no less than a majority of the voting power or, if the corporation has no members other than directors, by resolution of the board prior to the distribution of the corporate assets. Thereupon, a certificate evidencing the revocation shall be subscribed, verified, and filed in the manner prescribed by Section 1506. The certificate shall set forth:

(a) A statement that the corporation has revoked its election to wind up and dissolve.

(b) A statement that there has not been a sale or other disposition of all or substantially all of the corporation's assets or, in the case of a corporation without members, a distribution of the assets.

(c) The manner in which revocation of the election to dissolve was authorized, if membership authorization is required, the voting procedure used including a specific reference to the statutory provision or the provision in the articles or bylaws, or both, authorizing use of the procedure used, the number of votes entitled to be cast, and the consenting votes.

Comment. Section 1516 is similar to Section 4606 of the Corporations Code (General Corporation Law) (which previously governed nonprofit corporations pursuant to former Section 9800 of the Corporations Code). However, Section 1516 permits a membership corporation to revoke its election only prior to the sale or other disposition of all or substantially all of the corporate assets whereas Section 4606 of the Corporations Code permits revocation prior to

distribution of the assets. This change is to prevent circumvention of the stricter membership authorization requirements of Section 1201 which governs the sale or other disposition of all or substantially all of the corporate assets when a dissolution proceeding has not been commenced. See the Comment to Section 1201. Section 1516 permits a nonmember corporation to revoke prior to distribution of its assets. The certificate evidencing revocation is substantially the same in form as the one specified in Section 4606 of the Corporations Code, and it shall be signed, verified, and filed in the manner prescribed by Section 1506 (certificate of commencement of proceedings).

ISSUE TO BE RESOLVED:

1. Should a membership corporation be permitted to revoke its election to dissolve after a sale of all or substantially all of its assets? (Recommendation--No.)

405-973

§ 1517. Action to suspend or annul dissolution

1517. (a) The Attorney General, or any director, officer, member, holder of an outstanding capital or subvention certificate, creditor, or claimant may bring an action to suspend or annul the voluntary dissolution of the corporation on any of the following grounds:

(1) The authorization required by Section 1503 was not properly obtained.

(2) The dissolution of the corporation serves as a device to defraud members, creditors, capital or subvention certificate holders, claimants, or the public at large.

(b) No action shall be brought under this section after the corporation has filed a certificate of final windup and dissolution or after the court has issued an order of final windup and dissolution.

Comment. Section 1517 creates for the persons listed a new statutory right to bring an action to suspend or annul the election to dissolve if that election has been improperly authorized or is fraudulent. It is intended that the concept of fraud should be interpreted in a very broad fashion so as to embrace anything which is intended to deceive and which results in the injury of one who has justifiably relied on a state of facts. See Arch v. Finkelstein, 264 Cal. App.2d 667, 70 Cal. Rptr. 472 (1968). Subdivision (b) places a limitation on actions brought under this section in order to encourage timely actions.

ISSUES TO BE RESOLVED:

1. Should this code provide a special action to suspend or annul the fraudulent, voluntary dissolution of a corporation? (Recommendation--Yes.)
2. Should the right to bring such an action extend to the listed persons including any member or creditor? (Recommendation--Yes.)
3. Should such an action be permitted to be brought after the filing of the certificate of final windup or after the court has issued an order of final windup? (Recommendation--No.)

§ 1518. Certificate of final windup and dissolution

1518. (a) Except as provided in Section 1519, when a corporation has wound up its affairs without court supervision, a certificate of final windup and dissolution shall be filed with the Secretary of State and with the county clerk of the county in which the principal office of the corporation is located.

(b) The certificate shall be signed and verified by a signed affidavit stating that the matters set forth in the certificate are true of

his own knowledge by the chief officer of the corporation or any two subordinate officers, or by a majority of the board.

(c) The certificate shall set forth:

(1) A statement that the corporation has been wound up.

(2) A statement that its known debts and liabilities have been paid or adequately provided for, or paid as far as its assets permitted, or that it has incurred no known debts or liabilities if this be the case.

(3) If known debts or liabilities have been adequately provided for but not actually paid, the name and address of the corporation or person or governmental agency that has assumed or guaranteed payment, or the name and address of the depository with which deposit has been made pursuant to Section 1511, or such other information as may be necessary to enable the creditor or other person to whom payment is to be made to appear and claim payment of debt or liability.

(4) The name of the person, group, or corporation designated pursuant to Section 1520 to direct the distribution of assets omitted from winding up and its address.

(5) The disposition of all known assets, including trust property, distributed pursuant to Section 1512 after all debts or obligations have been satisfied.

(6) A statement that there are no actions pending against the corporation in any court or that adequate provision has been made for the satisfaction of any judgment, order, or decree which may be entered against it in any pending action.

(d) After the certificate is filed by the Secretary of State, the corporate existence ceases, except for the purpose of any further winding up.

Comment. The certificate required by Section 1518 is derived from Section 5200 of the Corporations Code (which previously governed the dissolution of nonprofit corporations pursuant to former Section 9800 of the Corporations Code). The form used is similar to the certificate required by Section 1506 (certificate of commencement of proceedings). In lieu of this certificate, a corporation may elect to petition the court for an order of final windup. See Section 1515 (court order of final windup and dissolution).

Analysis

Under New York's Not-for-Profit Corporation Law, dissolution is complete after the filing of a certificate similar to the one required by Section 1506. The corporation then proceeds with or without court supervision to wind up its affairs. No final order or certificate of windup is required. On the other hand, under the Corporations Code procedures, dissolution is only commenced upon the completion of authorization and is not finally complete until a certificate of final windup is filed or, in the alternative, a court order of final windup is procured. The Corporations Code approach seems preferable as it helps insure that the corporation has properly conducted its windup and provides a manner of giving creditors or claimants notice of where they may go to receive payment of the amounts owed.

ISSUES TO BE RESOLVED:

1. Except when a court order of final windup is issued, should this code require the filing of a certificate signifying that windup is complete? (Recommendation--Yes.)
2. Is there additional information which should be contained in such a certificate? (Recommendation--No.)

§ 1519. Court order of final windup and dissolution; filing; officer's and director's liability

1519. (a) After windup has been accomplished, in lieu of filing the certificate of final windup and dissolution required by Section 1518, the corporation may petition the superior court of the county in which the principal office of the corporation is located for an order declaring the corporation wound up and dissolved. The making of such an order releases directors and officers from any liability which arises from the process of winding up the corporation except liability which arises from the expropriation of corporate property to their own use or benefit.

(b) Upon the filing of the petition, the court shall make an order requiring all interested persons to show cause why an order should not be made declaring the corporation wound up and dissolved and shall direct that the order be published pursuant to Section 6066 of the Government Code in a newspaper of general circulation in the county in which the principal office of the corporation is located. The court may order such other notice as it deems appropriate.

(c) Any person with an interest in the corporation may appear and contest the issuance of an order of final windup and dissolution at any time prior to the expiration of 30 days from the completion of publication.

(d) A copy of the order, decree, or judgment issued pursuant to this section, certified by the clerk of the court, shall be filed in the same manner and with the same persons as the certificate of final windup and dissolution provided for in Section 1518.

Comment. Section 1519 is an alternative to the filing of a certificate of final windup and dissolution required by Section 1518 for corporations dissolving without court supervision. The advantage of seeking a court order of final windup is that such an order releases directors and officers of the corporation from all further liability arising out of the windup process--except liabilities for expropriating corporate assets to their own benefit. Under prior law, the court had the power to release any or all directors from liability. Section 4611 of the Corporations Code (which previously governed nonprofit corporations pursuant to former Section 9800 of the Corporations Code). However, Section 1519 makes this consequence flow automatically from the issuance of an order of final windup and dissolution.

The remaining procedures and requirements for the issuance of a final order of dissolution are derived from Sections 5202 and 5203 of the Corporations Code.

ISSUES TO BE RESOLVED:

1. Should a court order of final windup automatically release all directors and officers from liability for their decisions during the windup? (Recommendation--Yes.)

2. Should the period to contest a court order of final windup be longer than 30 days from the completion of publication? (Recommendation--No.)

405-977

§ 1520. Assets omitted from winding up

1520. (a) Any assets inadvertently or otherwise omitted from winding up continue in the dissolved corporation for the benefit of the persons entitled thereto upon dissolution of the corporation and upon realization shall be distributed accordingly.

(b) The corporation or the court pursuant to Section 1509 shall specify a person, corporation, or group to direct the distribution of all assets omitted for any reason from winding up. This person, corporation, or group and his or their address shall be listed in the certificate of final windup and dissolution or the order of final windup and dissolution which is filed with the Secretary of State and the county clerk as provided in Section 1518.

Comment. Subdivision (a) of Section 1520 is the same as Section 5402 of the Corporations Code (General Corporation Law). It provides that assets omitted from final windup shall be distributed upon realization in the same manner as the other corporate assets. Subdivision (b) is new. It requires that a person, group, or corporation be specified in the certificate of final windup and dissolution or the court order of final windup to direct the distribution of omitted assets. This provision is designed to insure that assets omitted from final windup and those deposited pursuant to Section 1511 (deposit of unmatured, disputed, or contingent debts or claims) will be properly distributed with the other assets of the corporation.

ISSUES TO BE RESOLVED:

1. Should some person or group be specified by the corporation or the court to supervise the distribution of assets omitted from winding up? (Recommendation--Yes.)
2. Should assets omitted from winding up be distributed with the other assets upon discovery? (Recommendation--Yes.)

Article 2. Involuntary Dissolution

§ 1601. Action for involuntary dissolution; plaintiffs

1601. An action for the involuntary dissolution of a corporation may be brought in the superior court of the county in which the principal office of the corporation is located by the persons described in any of the following subdivisions:

(a) Any director.

(b) Ten percent of the membership.

(c) Any member if the reason for the dissolution is that the period for which the corporation was formed has terminated without extension of such period.

(d) The Attorney General if the reason for the dissolution is one specified in Section 1603.

Comment. Section 1601, which specifies who may bring an action for involuntary dissolution, is derived from Section 1102(a)(2) of New York's Not-for-Profit Corporation Law. The section is more liberal than former law; Section 4650 of the Corporations Code was more stringent, requiring half of the directors or a third of the membership to join in a complaint for involuntary dissolution. The "10 percent of the membership" rule is consistent with other provisions of this code governing special actions by the membership. See, e.g., Sections 752 (right of 10 percent of the members to call a special meeting). As to the right of the Attorney General to bring an action for involuntary dissolution, see Section 1603 and the Comment thereto.

Analysis

See Analysis under Section 1602.

ISSUE TO BE RESOLVED:

1. Should the more stringent provisions of the Corporations Code (which require one-half of the directors or one-third of the members to join in an action for involuntary dissolution) be followed? (Recommendation--No.)

§ 1602. Grounds for dissolution

1602. An action may be brought for involuntary dissolution on any one or more of the following grounds:

(a) The directors are so divided with respect to the management of the corporation's affairs that the votes required for action by the board cannot be obtained.

(b) The members are so divided that the votes required for the election of directors cannot be obtained.

(c) There is internal dissention and two or more factions of the members are so divided that dissolution would be beneficial to the members.

(d) The directors or those in control of the corporation have looted or wasted the corporate assets, have perpetuated the corporation solely for their personal benefit, or have otherwise acted in an illegal, oppressive, or fraudulent manner.

(e) The corporation is no longer able to carry out its purposes.

(f) Liquidation is reasonably necessary for the protection of the rights and interests of a substantial number of the members.

(g) The period for which the corporation was formed has terminated without extension of such period.

(h) Any ground for which the Attorney General may seek dissolution of the corporation under Section 1603 provided that the Attorney General and the corporation are given written notice 30 days prior to the institution of proceedings of the act or omission which subjects the corporation to dissolution under this subdivision. The Attorney General, unless he is a party, is not bound by the decision if it is favorable to the corporation.

Comment. Section 1602 sets forth the grounds for dissolution. Subdivisions (a) through (h) are similar to the previous law governing the dissolution of nonprofit corporations. Corp. Code § 4651 (governed nonprofit corporations pursuant to former Section 9002 of the Corporations Code). However, there are two major differences:

(1) Subdivision (e) permits a court to entertain dissolution if the corporation is unable to carry out its purposes. This provision is derived from Section 1102(a)(2)(E) of New York's Not-for-Profit Corporation Law.

(2) Subdivision (h) permits dissolution of the corporation for any ground or grounds for which the Attorney General may seek dissolution under Section 1603 provided that he and the corporation are given 30 days' notice of the act or omission which subjects the corporation to an action for dissolution. It should be noted that subdivision (h) reverses the common law which held that only the Attorney General could inquire into the propriety of the corporation's existence or conduct under the law. Collins v. Consolidated Water Co., 122 Cal. App. 348, 9 P.2d 872 (1932); Paramount Plastering, Inc. v. Local No. 2, Operative Plasterers & Cement Masons Int'l Ass'n, 195 F. Supp. 287 (D.C. 1961), aff'd, 310 F.2d 179 (1962), cert. denied, 372 U.S. 944 (1962). This change is designed to increase the likelihood that serious abuses of the provisions of this code or any other law regulating nonprofit corporations will not go unnoticed and uncorrected. Nonprofit corporations because of this status are given special rights and privileges including tax exemptions and, therefore, the public interest demands closer supervision of their activities. It should be further noted that, to reduce the danger of collusive suits, the Attorney General is not bound by decisions under subdivision (h) unless he is a party to the action.

Analysis

Consistent with the modern nonprofit codes, Section 1601 broadens the requirement for who may petition the court for dissolution of the corporation.¹ The new requirement that any director or 10 percent of the members

1. Section 1102(a)(2) of New York's Not-for-Profit Corporation Law, Section 7981 of Pennsylvania's Corporation Not-for-profit Code, and Section 54 of the ABA-ALI Model Non-Profit Corporation Act permit any director or any member to petition for involuntary dissolution.

may institute such an action is sufficiently stringent to reduce any danger of "strike" suits brought merely to harass the corporation. At the same time, the changes in Section 1602 from the more restrictive Corporations Code provisions increase the protection afforded the public interest by making it easier for actions to be brought to dissolve a corporation which is unable to function--and, therefore, is socially useless--or which is seriously violating the law or the protective provisions of this code.

ISSUES TO BE RESOLVED:

1. Should the corporation's inability to carry out its purposes be a ground for judicial dissolution? (Recommendation--Yes.)
2. Should the members' or director's action for judicial dissolution include the grounds for which the Attorney General may seek judicial dissolution? (Recommendation--Yes.)

406-156

§ 1603. Grounds for action brought by Attorney General

1603. (a) The Attorney General may bring an action for the dissolution of a corporation on any one or more of the following grounds:

(1) The corporation procured its formation through fraudulent misrepresentation or concealment of a material fact or has not been duly formed.

(2) The corporation is engaging or has engaged in activities which violate the requirements for not-for-profit corporations set forth in Section 155 including but not limited to improper distributions to members, officers, or directors as provided in Section 1006.

(3) The corporation is engaging or has engaged in activities which seriously offend against any provision of this code.

(4) The corporation conducts its activities in a persistently fraudulent or illegal manner or abuses its powers in a manner contrary to the public policy of this state by conducting unauthorized activities in violation of the statement in its articles setting forth the objects, purposes, and authorized affairs of the corporation.

(5) The corporation has violated any provision of law by any act or default which under that law is a ground for forfeiture of the corporate existence.

(b) If the cause of action is based on a matter or act which the corporation has done or omitted to do which can be satisfactorily corrected by amendment to its articles or by other corporate action, no action may be maintained under this section unless the Attorney General has given the corporation written notice at least 30 days prior to commencement of the action of the matter or act done or omitted to be done and the corporation has failed to take appropriate action to satisfactorily correct the violation.

Comment. Section 1603 establishes a special statutory proceeding whereby the Attorney General may bring an action for the involuntary winding up and dissolution of a nonprofit corporation which has been fraudulently formed or engaged in the proscribed activities which are listed in paragraphs (1) through (5) of subdivision (a). In particular, under paragraph (2), the corporation is liable for dissolution if it violates the basic requirements of nonprofit status set forth in Section 150 including improper distributions to members as provided in Section 1006 of this code.

The right of the state to seek dissolution in the nature of quo warranto when the corporation seriously violates the basic elements of its charter or the law is not new. See People v. Dashaway Ass'n, 84 Cal. 114, 24 P. 277 (1890). Section 1603 is very similar to Section 4690 of the

Corporations Code (which previously governed nonprofit corporations pursuant to former Section 9002 of the Corporations Code). That section creates a similar statutory proceeding for involuntary dissolution although the grounds for dissolution are somewhat different. In particular, paragraphs (1) and (2) of subdivision (a) are new. Those provisions are derived in part from Section 1101 of New York's Not-for-Profit Corporation Law.

Subdivision (b) is derived from Section 4691 of the Corporations Code (General Corporation Law). It gives the corporation an opportunity to correct correctible deficiencies which might lead to dissolution by requiring the Attorney General to give the corporation 30 days' written notice prior to commencing the action of any act or omission which might subject it to dissolution under this section.

ISSUES TO BE RESOLVED:

1. If the Attorney General's action for judicial dissolution is based upon a matter which the corporation could correct, should it be given notice and an opportunity to correct its conduct prior to the institution of dissolution proceedings? (Recommendation--Yes.)
2. Should violation of the requirements of nonprofit status be a ground for judicial dissolution? (Recommendation--Yes.)

406-158

§ 1604. Service; intervention

1604. (a) Upon the filing of a verified complaint for involuntary dissolution of a corporation, a summons shall be issued and served on the corporation as in other civil actions.

(b) At any time prior to the trial of the action, any member or creditor may intervene in the action.

Comment. Subdivision (a) of Section 1604 is the same as Section 4652 of the Corporations Code (General Corporation Law). Subdivision (b) is the same as Section 4653 of the Corporations Code (General Corporation Law).

ISSUE TO BE RESOLVED:

1. Should there be a liberal right of intervention in involuntary dissolution proceedings? (Recommendation--Yes.)

406-159

§ 1605. Appointment of receiver

1605. If, after the filing of a complaint under this article, the court has reasonable grounds to believe that unless a receiver of the corporation is appointed the interests of the corporation and its members will suffer pending the hearing and determination of the complaint, upon the application of the Attorney General or any party and after notice and a hearing and the giving of security pursuant to Sections 566 and 567 of the Code of Civil Procedure, the court may appoint a receiver to take over and manage the affairs of the corporation and to preserve its property pending the hearing and determination of the complaint.

Comment. Section 1605 is substantially the same as Section 4656 of the Corporations Code (General Corporation Law).

ISSUE TO BE RESOLVED:

1. Should the court be permitted to appoint a receiver to protect the corporation during involuntary dissolution proceedings? (Recommendation--Yes.)

§ 1606. Authority of court to grant relief

1606. In any action under this article, the court may order the winding up and dissolution of the corporation or such other or partial relief as is just and equitable under the circumstances.

Comment. Section 1606 is derived from Sections 4657 and 4692 of the Corporations Code (General Corporation Law). See also Section 1609 (provisional director).

ISSUE TO BE RESOLVED:

1. After commencement of involuntary dissolution, should the court have broad authority to grant the necessary relief? (Recommendation--Yes.)

406-161

§ 1607. Supervision of the court

1607. After an order requiring the corporation to wind up and dissolve has been made, the court has jurisdiction to supervise the winding up and dissolution of the corporation and has all the authority granted under Section 1509 to make such orders and issue such injunctions as justice and equity require in connection with winding up and dissolution of the corporation including orders providing for the presentation of claims of creditors and the barring, pursuant to Section 1510, of creditors and claimants failing to make claims and present proofs as required.

Comment. Section 1607 grants the court the same authority as is granted by Section 1509 (supervision of voluntary proceedings). Section

1607 is similar in effect to Section 4654 of the Corporations Code (General Corporation Law).

ISSUE TO BE RESOLVED:

1. Should the court supervise winding up of the corporation after it orders it to dissolve? (Recommendation--Yes.)

406-162

§ 1608. Time of commencement of proceedings; effect; notice

1608. (a) Involuntary proceedings for winding up a corporation are deemed to commence when the order requiring the corporation to wind up and dissolve is entered.

(b) When an involuntary proceeding for winding up the corporation has commenced, the corporation shall cease to carry on its activities except to the extent necessary for the successful winding up of those activities or for the preservation of the value of the corporation's assets pending sale or other disposition.

(c) Unless the order for winding up has been stayed by appeal or the proceeding or the execution of the order has been enjoined, notice of the commencement of involuntary dissolution shall be given to the same persons and in the same manner as provided in Section 1507 unless the court orders otherwise.

Comment. Subdivision (a) of Section 1608 is the same in substance as Section 4660 of the Corporations Code (General Corporation Law). It establishes that involuntary proceedings commence on the date when the order for winding up is entered.

Subdivision (b) is the same as Section 1505 and also is the same as part of Section 4661 of the Corporations Code (General Corporation Law). After the commencement of proceedings, the corporation must discontinue its normal activities. However, it may continue to engage in any activity necessary to successfully complete the windup of the corporation or to protect the value of its property.

Subdivision (c) requires that, unless the court orders otherwise, the same notice prescribed by Section 1507 must be given at the commencement of involuntary windup proceedings provided that the order of dissolution has not been stayed on appeal or the proceedings or order enjoined. See Section 1507 and the Comment to that provision.

ISSUE TO BE RESOLVED:

1. Should the notice provisions for voluntary dissolution proceedings apply to the winding up of a corporation which has been ordered dissolved? (Recommendation--Yes.)

§ 1609. Provisional director

1609. In case of a deadlock in the board of directors as set forth in subdivision (a) of Section 1602, notwithstanding any provisions of the articles or bylaws, the court may appoint a provisional director. The provisions of subdivision (b) of Section 815.5 apply to any such provisional director so appointed.

Comment. Section 1609 authorizes the court to appoint a provisional director to remove a deadlock on the board. It is substantially the same as Section 4655 of the Corporations Code (General Corporation Law). See also Section 1606 (court's power to order partial remedies).

§ 1610. Applicability of voluntary dissolution provisions

1610. Subject to the provisions of this article, the provisions of Article 1 (commencing with Section 1501), governing voluntary dissolution, apply to a corporation dissolved under this chapter except that the requirements of Sections 1503 and 1506 do not apply.

Comment. Section 1610 makes clear that the final windup of a corporation dissolved pursuant to an involuntary dissolution proceeding is governed by the same provisions as a corporation undergoing voluntary dissolution except as specifically provided otherwise by this code.

Analysis

Once dissolution of a corporation has commenced, the final windup should be conducted in basically the same fashion whether or not the corporation is dissolving voluntarily or pursuant to a court order except that involuntary dissolution should always be supervised to some degree by the court. This latter requirement is established by Section 1607. New York's Not-for-Profit Corporation Law follows this general approach.¹

ISSUE TO BE RESOLVED:

1. Except as specifically provided in this article, should the procedures for windup of a corporation ordered dissolved be the same as those governing windup during voluntary dissolution? (Recommendation--Yes.)

1. See N.Y. Not-for-Profit Corporation Law § 1115.

§ 1611. Discontinuance

1611. An action for the dissolution of a corporation may be discontinued at any stage when it is established that the cause for dissolution did not exist or no longer exists. In that event, the court shall dismiss the action and direct any receiver to redeliver to the corporation all the remaining property.

Comment. Section 1611 is derived from Section 1114 of New York's Not-for-Profit Corporation Law. It establishes clearly the power of the court to discontinue and dismiss an involuntary dissolution proceeding under this article when the cause for dissolution did not exist or no longer exists.

CHAPTER 9. FOREIGN CORPORATIONS

Article 1. General Provisions§ 1701. "Conducting intrastate activities"

1701. (a) For the purpose of this chapter, "conducting intrastate activities" means entering into repeated and successive transactions of corporate business or activities in this state as distinguished from conducting interstate or foreign commerce.

(b) Without excluding other acts which may not constitute conducting intrastate activities in this state, a foreign corporation is not conducting intrastate activities for the purpose of this chapter by reason of doing in this state any one or more of the following acts:

(1) Maintaining or defending any action or proceeding whether judicial, administrative, arbitratve, or otherwise, or effecting settlement thereof or the settlement of claims or disputes.

(2) Holding meetings of its directors or its members.

(3) Maintaining bank accounts.

(4) Creating evidences of debt, mortgages, or liens on real or personal property.

(5) Securing or collecting debts due to it or enforcing any rights in property securing debts due to it.

(6) Granting funds.

(7) Distributing information to its members.

(8) Conducting an isolated transaction completed within a period of 30 days and not in the course of a number of repeated transactions of a like nature.

(c) The specification in subdivision (b) does not establish a standard for activities which may subject a foreign corporation to service of process under this code or any other statute of this state.

Comment. Section 1701 is derived from Section 1301 of New York's Not-for-Profit Corporation Law and Section 63 of the ABA-ALI Model Non-Profit Corporation Act. Under the former law, the provisions of the Corporations Code regulating foreign corporations applied to nonprofit foreign corporations. See Corp. Code § 6201. The Corporations Code requires foreign corporations which "transact intrastate business" to perform certain acts (e.g., obtain a certificate of qualification pursuant to Section 6403 of the Corporations Code). However, no previous case interpreted the term "transact intrastate business" in the nonprofit context. It was unclear, for example, whether "business" included widespread solicitation of members or only commercial activities. The change in terminology from "transacting intrastate business" to "conducting intrastate activities" is designed to remove any uncertainty concerning this matter. State regulation extends to all corporations with substantial connections with this state, commercial or otherwise. Foreign corporations enjoy no privilege not accorded to corporations incorporated in California.

Paragraphs (1) through (3) of subdivision (b) provide a nonexclusive list of specific activities which do not constitute conducting intrastate activities in this state. These provisions are derived from Section 63 of the ABA-ALI Model Non-Profit Corporation Act and are meant to aid the courts in their interpretation of this section.

Subdivision (c) makes clear that the guidelines set forth in subdivision (b) do not establish a standard for service of process. See Code Civ. Proc. § 410.10.

ISSUES TO BE RESOLVED:

1. Should the Corporations Code terminology be changed for nonprofit corporations from "transacting intrastate business" to "conducting intrastate activities"? (Recommendation--Yes.)

2. Should this code specify a nonexclusive list of activities which do not constitute "conducting intrastate activities"? (Recommendation--Yes.)

§ 1702. Application of other provisions

1702. Except as otherwise provided by statute, the provisions of this code do not apply to foreign corporations.

Comment. Section 1702 expressly continues the policy of the prior law which was to make the Corporations Code provisions (themselves made applicable to nonprofit corporations pursuant to former Section 9002 of the Corporations Code) applicable only to domestic corporations unless foreign corporations were included by specific reference in the particular provision. See Corp. Code § 106 (definition of "corporation"). It should be noted by way of example that Section 775 (action to procure a judgment in the right of the corporation) and a large part of Chapter 5 (Corporate Records and Reports) apply to foreign corporations.

ISSUE TO BE RESOLVED:

1. Should foreign corporations which conduct intrastate activities in this state be required as a general rule to comply with the various provisions of this code regulating domestic corporations? (Recommendation--No.)

406-169

§ 1703. Liability of directors and officers

1703. (a) Except as otherwise provided by statute, a director or officer of a foreign corporation conducting intrastate activities is liable for any violation of his official duty to the corporation (including any illegal distribution of the corporate assets) according to the laws of the place or state of incorporation, whether committed or done in this state or elsewhere, and such liability may be enforced in the courts of this state.

(b) A director or officer of a foreign corporation which conducts a substantial part of its principal activities in this state or owns the greater part of its property in this state or has more than one-half of its members in this state is subject to the same duties, restrictions, penalties, and liabilities as are imposed by the laws of this state upon a director or officer of a domestic corporation of like character.

Comment. Section 1703 is derived from the modern nonprofit codes which also subject closely connected foreign corporations to many of the regulations governing domestic corporations. See Pa. Corporation Not-for-profit Code § 8145; N.Y. Not-for-Profit Corporation Law § 1321. The former law governing foreign nonprofit corporations--Sections 6601 and 6804 of the Corporations Code--makes the directors or officers of a foreign corporation subject to the laws of the place of incorporation except in a few limited cases expressly listed in Section 6804, e.g., violation of Section 3019 (knowingly making false report). Subdivision (a) of Section 1703 follows this approach concerning foreign corporations which are not so closely connected with this state as to meet the requirements of subdivision (b). Directors and officers of the corporations described in subdivision (b) are subject to the laws of this state to the same extent as directors or officers of domestic corporations of like character.

Analysis

An important issue is the extent to which California should seek to regulate the internal affairs of foreign corporations conducting affairs in this state. Present law provides very little regulation of the affairs of these corporations. Except for a few limited exceptions generally unrelated to nonprofit corporations (such as the illegal issuance of shares), foreign corporations are governed only by the law of the state or place of incorporation¹ although that law may be enforced in this state.²

1. Corp. Code §§ 6601, 6804.

2. Corp. Code § 6601.

Many of the new nonprofit corporation codes take a broader view and subject closely connected foreign corporations to more in-state regulation. For example, under New York's Not-for-Profit Corporation Law, directors of membership corporations which have more than one-third of their members residing in New York are subject to the special liability provisions governing directors of domestic corporations.³

In general, it seems advisable not to permit a corporation which conducts most of its affairs in California to escape the protective features of this code by out-of-state incorporation. On the other hand, foreign corporations which conduct only a small portion of their activities in this state should not be burdened with having to comply with the particular rules of each state in which it conducts its affairs. Section 1703 attempts to strike a balance between these two considerations.

ISSUES TO BE RESOLVED:

1. Should the liability of directors of foreign corporations which conduct intrastate activities be governed by the laws of the place of incorporation? (Recommendation--Yes.)

2. Should there be an exception to the rule that the liability of directors of foreign corporations is governed by the laws of the place of incorporation in the case of a foreign corporation which conducts a substantial part of its activities in this state or has more than one-half of its members residing in this state? (Recommendation--Yes.)

406-171

§ 1704. Misleading or deceptive corporate name

1704. (a) No foreign corporation may conduct intrastate activities if it has a name which is likely to mislead the public or which is the same as, or resembles so closely as to tend to be deceptive, any of the following:

3. N.Y. Not-for-Profit Corporation Law §§ 1318, 1321.

(1) The name of a domestic profit or nonprofit corporation or established association.

(2) The name of a foreign profit or nonprofit corporation which is qualified to transact intrastate business or conduct intrastate activities in this state.

(3) A name which is under reservation for another corporation pursuant to Section 402.

(b) No foreign corporation may qualify to conduct intrastate activities by complying with the provisions of Article 2 (commencing with Section 1751) if it has a name in violation of subdivision (a).

(c) The Secretary of State shall not file a copy of any document by which any name in violation of subdivision (a) is adopted.

(d) Subdivisions (a), (b), and (c) do not apply in either of the following cases:

(1) The foreign corporation has obtained an order from a court of competent jurisdiction permanently restraining the other corporation from doing business in this state or from conducting its activities in this state under the conflicting name and has filed with the Secretary of State a copy of the order of the court, duly certified by the clerk of the court.

(2) The Secretary of State finds, upon proof by affidavit or otherwise as he may determine, that the intrastate activities to be conducted in this state by the foreign corporation are not the same as or similar to the business or activities being conducted by the corporation (or to be conducted by the proposed corporation for which a name is under reservation) with whose name it may conflict and that the public is not likely

to be deceived and the foreign corporation agrees that it will add to its corporate name some distinguishing word or words acceptable to the Secretary of State and that it will use (and the corporation does in fact use) the corporate name with such addition in all of its dealings with the Secretary of State and in the conduct of its affairs in this state.

(e) The Attorney General or any interested party may bring an action to enjoin the use of a name in violation of this section.

Comment. Section 1704 is derived largely from Section 6404 of the Corporations Code (foreign business corporations). The scope of the section has been extended to protect a domestic established association. This codifies prior law. Cf. Law v. Crist, 41 Cal. App.2d 862, 107 P.2d 953 (1941). Subdivision (d) is new and is comparable to subdivision (b) of Section 401 (corporate name of domestic corporation).

ISSUES TO BE RESOLVED:

See Section 401.

§ 1705. Articles as evidence

1705. (a) In any action or proceeding, civil or criminal, in any court of this state, a copy of the articles or other incorporation papers of a foreign corporation purporting to be duly certified by the Secretary of State or other competent official of the state or place under the laws of which the corporation purports to be incorporated, or the original of any such instrument, or a copy of such certified copy duly certified, is

admissible in evidence by all courts, and is prima facie evidence of the incorporation, existence, and powers of the corporation.

(b) Certified copies of the instruments referred to in subdivision (a) may be filed in the county clerk's office in the county where the foreign corporation held or holds real property and, when so filed, are conclusive evidence of the incorporation and powers of the corporation in favor of any bona fide purchaser or encumbrancer of such property for value whether or not the corporation has qualified to conduct intrastate activities.

Comment. Section 1705 is the same in substance as Corporations Code Section 6600 (foreign business corporations).

§ 1706. Judicial notice of official acts

1706. In any action or proceeding, the court takes judicial notice, in the same manner that it takes judicial notice of the matters listed in Section 452 of the Evidence Code, of the official acts affecting corporations of the legislative, executive, and judicial departments of the state or place under the laws of which the corporation purports to be incorporated.

Comment. Section 1706 is the same as Section 6602 of the Corporations Code (foreign business corporations).

Article 2. Qualification to Conduct Intrastate Activities

§ 1751. Qualification of foreign corporations

1751. (a) A foreign corporation shall not conduct intrastate activities in this state until it has obtained a certificate of qualification from the Secretary of State.

(b) A foreign corporation which has obtained a certificate of qualification may conduct in this state any activities which may be conducted lawfully in this state by a domestic corporation, to the extent that it is authorized to conduct such activities in the jurisdiction of its incorporation, but no other activities.

Comment. Subdivision (a) of Section 1751 requires foreign nonprofit corporations to qualify before conducting intrastate activities in a manner which is parallel to the first part of Section 6403 of the Corporations Code (foreign business corporations). See Section 1701 (defining "conducting intrastate affairs").

Subdivision (b) is derived from subdivision (a) of Section 1301 of New York's Not-for-Profit Corporation Law. There was no comparable provision under the former law.

ISSUE TO BE RESOLVED:

1. Should nonprofit corporations be required to qualify by obtaining a certificate of qualification before it conducts its activities in this state? (Recommendation--Yes.)

§ 1752. Certificate of qualification

1752. (a) To obtain a certificate of qualification, the corporation shall file with the Secretary of State on a form prescribed by him a statement and designation in its corporate name, signed by its chief officer or any two subordinate officers, which shall set forth all of the following:

- (1) Its name and the state or country of its incorporation.
- (2) The location and address of its main office.
- (3) The location and address of its principal office within this state.
- (4) The specific activities it proposes to conduct in this state.
- (5) The name of an agent upon whom process directed to the corporation may be served within this state. The agent may be a natural person residing within the state in which case his complete business or residence address shall be set forth, or it may be a domestic corporation which has filed the certificate provided for in Section _____ of the Code of Civil Procedure or a foreign corporation which has filed the certificate provided for in Section _____ of the Code of Civil Procedure. If a corporate agent be designated, the statement shall set forth the state or place under the laws of which such agent was incorporated and the name of the city, town, or village wherein it has the office at which the corporation designating it as such agent may be served, as set forth in the certificate filed by such corporate agent pursuant to Sections _____, _____ of the Code of Civil Procedure.
- (6) Its irrevocable consent to service of process directed to it upon the agent designated and to service of process on the Secretary of State

if the agent so designated or the agent's successor is no longer authorized to act or cannot be found at the address given.

(b) Annexed to such statement and designation shall be a certificate by the public officer of the state or country having custody of the original articles or certificate of incorporation or of the act creating such corporation, or by a public officer authorized by the laws of such state or country to make such certificate, to the effect that such corporation is an existing corporation in good standing in the state or country of its incorporation.

Comment. Section 1753 sets forth the requirements for a certificate of qualification which is substantially the same as the certificate required by Section 6403 of the Corporations Code of foreign business corporations. The statutory references in Section 1752 for designation of an agent for service of process are to the Code of Civil Procedure provisions which govern this matter pursuant to Chapter 10 (Service of Process).

Note. The staff plans to draft a new chapter in the Code of Civil Procedure which will cover designation by a foreign corporation of an agent for service of process.

§ 1753. Filing statement and designation; issuance of certificate of qualification

1753. Upon payment of the fees required by law, the Secretary of State shall file the statement and designation prescribed in Section 1752 and shall issue to the corporation a certificate of qualification stating

the date of filing of such statement and designation and that the corporation is qualified to conduct intrastate activities in this state, subject, however, to any licensing requirements otherwise imposed by this state.

Comment. Section 1753 is substantially the same as Section 6403.1 of the Corporations Code (foreign business corporations).

§ 1754. Existing qualified corporations

1754. Every corporation to which this code applies which, at the time this code becomes operative, has qualified to transact intrastate business in this state shall have authority to conduct intrastate activities in this state.

Comment. Section 1754 is similar to Section 6403.2 of the Corporations Code and assures that the enactment of this code will not affect foreign nonprofit corporations which are qualified to "transact intrastate business" in this state prior to the operative date of this code.

§ 1755. Filing amended statement and designation required; when certain changes occur

1755. (a) If any foreign corporation qualified to conduct intrastate activities changes its name, the location or address of its main office,

the location or address of its principal office in this state, the specific activities to be conducted in this state, its agent for the service of process, or if the stated address of any natural person designated as agent for the service of process is changed, or the city, town, or village wherein any designated corporate agent may be served is changed, it shall file with the Secretary of State on a form prescribed by him an amended statement and designation setting forth the change or changes made. In the case of a change of name, the amended statement and designation shall set forth the name relinquished as well as the new name assumed and there shall be annexed to the amended statement and designation a certificate of the public officer having custody of the original corporation documents in the state or place of incorporation to the effect that such change of name was made in accordance with the laws of the state or place of incorporation.

(b) If the change includes a change of name, or a change affecting a fictitious name pursuant to paragraph (2) of subdivision (d) of Section 1704, upon the filing of the amended statement and designation, the Secretary of State shall issue a new certificate of qualification.

(c) If the corporation originally was qualified to transact intrastate business in California prior to the operative date of this code and if a specific activity has not been set forth in an amended statement and designation filed on or subsequent to that date, then such information shall be set forth in the amended statement and designation being filed.

Comment. Section 1755 is very similar to Section 6403.3 of the Corporations Code (foreign business corporation). It requires under stated conditions, such as a change in the corporate name, that an amended statement and designation be filed with the Secretary of State.

§ 1756. Certificate of surrender of authority

1756. A foreign corporation which has qualified to conduct intrastate activities in this state may surrender its right to engage in such activities within this state by filing in the office of the Secretary of State a certificate of surrender of authority signed and acknowledged by its chief officer or any two subordinate officers setting forth all of the following:

(a) The name of the corporation as shown on the records of the Secretary of State and the state or place of incorporation.

(b) That it revokes its designation of agent for the service of process.

(c) That it surrenders its authority to conduct intrastate activities in this state.

(d) That it consents that process against it in any action upon any liability or obligation incurred within this state prior to the filing of the certificate may be served upon the Secretary of State.

(e) A post office address to which the Secretary of State may mail a copy of any process against the corporation that is served upon him, which address may be changed from time to time by filing a certificate entitled "certificate of change of address of surrendered foreign corporation" signed and acknowledged by an officer of the corporation. If the name of the corporation has been changed since the filing of its certificate of surrender of authority, the certificate of change of address shall set forth such new name as well as the name appearing on the certificate of surrender of authority.

Comment. Section 1756 is substantially the same as Section 6700 of the Corporations Code (foreign business corporations).

§ 1757. Effect of surrender on pending actions; revocation of appointment of designated agent

1757. The surrender of right to conduct intrastate activities in this state does not affect any action pending at the time. Mere retirement from conducting intrastate activities in this state without filing a certificate of surrender of authority does not revoke the appointment of any agent for the service of process within this state.

Comment. Section 1757 is substantially the same as Section 6701 of the Corporations Code (foreign business corporations).

406-181

§ 1758. Attorney General's action to annul or enjoin the certificate of qualification

1758. The Attorney General may bring an action to restrain a foreign corporation from conducting intrastate activities in this state, or to annul its certificate of qualification to conduct intrastate activities in this state, if the foreign corporation contrary to law has done or omitted any act within this state which if done or omitted by a domestic corporation would be cause for its dissolution under Section 1603.

Comment. Section 1758 is derived from Sections 112 and 1303 of New York's Not-for-Profit Corporation Law. This provision is designed to discourage a foreign corporation from engaging in activities which are fraudulent or which seriously offend against any provision of this code or the laws of this state. See the Comment to Section 1603.

ISSUES TO BE RESOLVED:

1. Should the Attorney General be given a statutory action to annul or enjoin the certificate of qualification of a foreign corporation which conducts its activities in an unlawful manner? (Recommendation--Yes.)
2. Should the grounds for this action be coextensive with those for judicial dissolution of a domestic corporation? (Recommendation--Yes.)

406-182

Article 3. Unauthorized Conducting of Intrastate Activities§ 1775. Penalty for unauthorized conducting of intrastate activities

1775. (a) Any foreign corporation which conducts intrastate activities in this state which does not hold a valid certificate of qualification from the Secretary of State and is not exempt from the requirement of holding such a certificate by Section 1754 is guilty of a misdemeanor, punishable by both of the following:

(1) A fine of not less than five hundred dollars (\$500) nor more than one thousand dollars (\$1,000).

(2) A penalty of twenty dollars (\$20) for each day that such unauthorized activity is conducted, which penalty shall be assessed according to the number of days it is found that the corporation has been willfully conducting intrastate activities without proper authorization.

(b) Prosecution under this section may be brought by the Attorney General or by any district attorney in any court of competent jurisdiction. If brought by the latter, one-half of the fine collected shall be paid to the treasurer of the county in which the conviction was had, and one-half

to the State Treasurer. If brought by the Attorney General, the entire amount of fine collected shall be paid to the State Treasurer to the credit of the General Fund of the state.

Comment. Section 1775 is derived from Sections 6408 and 6800 of the Corporations Code.

ISSUE TO BE RESOLVED:

1. Should there be both a fine and \$20 per day penalty for unauthorized conducting of intrastate activities? (Recommendation--Yes.)

406-183

§ 1776. Consent to jurisdiction; service on Secretary of State

1776. (a) A foreign corporation which conducts intrastate activities in this state without holding a valid certificate of qualification from the Secretary of State, unless it is exempt from holding such a certificate pursuant to Section 1754, shall be deemed to consent to the jurisdiction of the courts of California in any civil action arising in this state wherein such corporation is named a party defendant and shall be deemed to have designated the Secretary of State as the agent upon whom process directed to the corporation may be served within this state.

(b) Service on a corporation pursuant to this section may be made by personal delivery to the Secretary of State, or to an assistant or deputy secretary of state, of one copy of the process, together with a written statement signed by the party to the action seeking such service, or by his attorney, setting forth an address to which such process shall be sent

by the Secretary of State. Upon receipt of the process and his fee therefor, the Secretary of State shall forthwith forward the copy of the process, together with a statement indicating the date upon which the process was served upon the Secretary of State, by registered or certified mail, charges prepaid, with request for return receipt, to the corporation at the address specified in the written statement delivered by the party. The corporation shall appear within 30 days after delivery of the process to the Secretary of State. The Secretary of State shall keep a record of all such process served upon him and shall record therein the time of service and his action in respect thereto. The certificate of the Secretary of State, under his official seal, certifying to the receipt of the process and the forwarding of such process to the corporation, is competent and prima facie evidence of the matters stated therein.

Comment. Section 1776 is substantially the same as the consent to jurisdiction provisions of Section 6408 of the Corporations Code (foreign business corporations).

406-184

§ 1777. Disability to maintain action upon intrastate activity;
civil penalty

1777. A foreign corporation subject to the provisions of Article 2 (commencing with Section 1751) which conducts intrastate activities in this state without complying therewith shall not maintain any action or proceeding upon any intrastate activity so conducted in any court of this state,

commenced prior to compliance with Article 2 until it has complied with the provisions thereof, and has:

(a) Paid to the Secretary of State a penalty of two hundred and fifty dollars (\$250) in addition to the fees due for filing the statement and designation required by Section 1752; and

(b) Filed with the clerk of the court in which the action is pending receipts showing the payment of said fees and penalty and all franchise taxes and any other taxes on business or property in this state that should have been paid for the period during which it conducted intrastate activities.

Comment. Section 1777 is substantially the same as Section 6801 of the Corporations Code (foreign business corporations).

ISSUE TO BE RESOLVED:

1. Should there be a disability to maintain any action on unauthorized activity until the corporation has properly qualified? (Recommendation--Yes.)

§ 1778. Acting as agent for unauthorized corporation; criminal penalty

1778. Any person who conducts intrastate activities in this state on behalf of a foreign corporation which is not authorized to conduct such activity in this state, knowing that it is not so authorized, is guilty of a misdemeanor punishable by fine of not less than twenty-five dollars (\$25) nor more than three hundred dollars (\$300).

Comment. Section 1778 is substantially the same as Section 6803 of the Corporations Code (foreign business corporations).

CHAPTER 10. SERVICE OF PROCESS

Note. The staff plans to draft a new chapter in the Code of Civil Procedure to cover service of process and designation of an agent for service of process. This chapter will include both business and nonprofit corporations, domestic and foreign. Chapter 10 will incorporate by reference the new provisions in the Code of Civil Procedure.

CHAPTER 11. SUPERVISION BY ATTORNEY GENERAL

§ 1901. Power of supervision

1901. A corporation is subject at all times to examination by the Attorney General, pursuant to Section 1902 or otherwise, to ascertain the condition of its affairs and to what extent, if at all, it fails to comply with the trusts it has assumed, departs from the general purposes for which it was formed, or violates the provisions of this code or any other law of this state.

Comment. Section 1901 creates for the Attorney General a broad power of supervision over the affairs of domestic nonprofit corporations. Under previous law, this power to examine the corporation's affairs extended only to charitable corporations pursuant to former Section 10207 of the Corporations Code (Corporations for Charitable or Eleemosynary Purposes) or to nonprofit corporations which held property subject to a public or charitable trust pursuant to former Section 9505 of the Corporations Code (General Nonprofit Corporation Law). This change in the law is warranted because the special rights and privileges granted to all nonprofit corporations by this code and other laws--including tax exemptions and the right to represent themselves to the public as a nonprofit corporation--mandate close supervision of nonprofit corporations to protect the public interest.

The power of supervision granted by this section includes the power to examine the corporate records and books and also the power to require corporations to answer written interrogatories pursuant to Section 1902.

ISSUE TO BE RESOLVED:

1. Should the Attorney General have a broad power of supervision over the affairs of all nonprofit corporations? (Recommendation--Yes.)

§ 1902. Interrogatories by Attorney General

1902. The Attorney General may propound to any corporation, domestic or foreign, and to any officer or director, such interrogatories as may be reasonably necessary and proper to enable him to ascertain whether the corporation has complied with all the provisions of this code applicable to the corporation. All interrogatories shall be answered within 30 days after receipt or within the additional time fixed by the Attorney General. The answers to interrogatories shall be full and complete and shall be in writing and under oath. If the interrogatories are directed to an individual, they shall be answered by him and, if directed to a corporation, they shall be answered by the chief officer of the corporation or any subordinate officer charged with this duty by the board.

Comment. Section 1902 is derived from Section 87 of the ABA-ALI Model Non-Profit Corporation Act which permits similar interrogatories to be posed by the Secretary of State to be certified to the Attorney General if answers thereto disclose a violation of the law. Section 1902 is designed to insure that the Attorney General has access to the information which is necessary to enforce the provisions of this code.

ISSUE TO BE RESOLVED:

1. Should the Attorney General possess a special power to propound interrogatories to a nonprofit corporation? (Recommendation--Yes.)

§ 1903. Action by Attorney General

1903. (a) The Attorney General shall institute, in the name of this state, the proceedings necessary to correct noncompliance with the provisions of this code or other applicable statutes.

(b) The Attorney General may bring an action to enforce any right given by this code to a member, director, officer, or to the corporation. In such an action, the Attorney General shall have the same status as a member, director, officer, or the corporation.

Comment. Subdivision (a) of Section 1903 supplements the specific enforcement powers of the Attorney General under various provisions of this code, e.g., Sections 808 (power to procure a judgment removing a director for cause), 1312 (power to enjoin a fraudulent merger of consolidation), 1602 (power to seek judicial dissolution of a corporation), 1758 (power to annul certificate of qualification). For a similar provision under the prior law, see former Section 9505 of the Corporations Code.

Subdivision (b) is new. It is derived from Section 112(a)(8) of New York's Not-for-Profit Corporation Law. This provision permits state enforcement of the duties imposed by this code (e.g., the duties of directors set forth in Section 817).

ISSUES TO BE RESOLVED:

1. Should the Attorney General be delegated the primary duty to enforce the duties imposed by this code? (Recommendation--Yes.)
2. Should the Attorney General be permitted to enforce rights given by this code to members, officers, directors, or the corporation? (Recommendation--Yes.)