#77 11/15/76

Memorandum 76-102

Subject: Study 77 - Nonprofit Corporations (Assembly Select Committee on Revision of the Nonprofit Corporations Code)

The Commission has previously expressed an interest in reviewing the work of the Assembly Select Committee on Revision of the Nonprofit Corporations Code. Professor Hone, draftsman for the Select Committee, has agreed to make the attached materials available for the Commisssion. We have also requested that he send the Commission copies of any other materials produced by the Select Committee.

Respectfully submitted,

Nathaniel Sterling
Assistant Executive Secretary

California Legislature

Assembly Select Committee on Revision of the Nonprofit Corporations Code

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JOHN T. KNOX
CHAIRMAN

September 2, 1976

TO: All Members of the State Bar Committee on Corporations

As you know, the Assembly Select Committee is in the process of writing a new nonprofit corporations code. The new code will draw heavily upon the work done by Harold Marsh and you on the new corporations code. For this reason your aid and counsel would be most appreciated.

At the same time, a nonprofit law necessarily presents many issues which do not arise in business corporations. Yet very little has been written that is helpful in such matters, or which addresses the basic questions of why nonprofits exist, what function they serve, and what abuses of them arise. Thus, while the Select Committee is reviewing current laws, including the recent New York revision, the proposed Canadian Code, and the Law Revision Commission's draft, there is additional need for a conceptual underpinning for the new code.

As a result the Select Committee is proceeding in three areas. First, it is drafting noncontroversial provisions. Most of these are simply adaptations of the new corporations law, and we hope to present these to you at your next meeting. Secondly, it is trying to develop the necessary conceptual underpinning. We have enclosed a draft, labelled "Introduction to Drafting a Nonprofit Corporations Code", which begins this effort. While it is academic in tone, we believe it is essential to develop this basic understanding in order to deal with, or even recognize, the major policy questions that will arise.

Thirdly, we are developing a list of important basic questions and issues. While these issues relate to the overall concept of nonprofit corporations, they deal with more particular aspects and problems. "A Sample of Particular Legislative Issues" which is enclosed presents some of these issues. We would appreciate your reflecting on them so that we can obtain your imput at the meeting of the 13th.

We hope to follow the procedures so successfully used in drafting the new corporations code and in the Corporate Securities Law of 1968. We believe that by working closely with the State Bar Committee on Corporations we will be able to develop a work product similar in quality to that of those laws.

Mike Hone

Ira M. Ellman

September 7, 1976

[DRAFT: NOT FOR PUBLIC DISTRIBUTION]

PART ONE

Introduction to Drafting a Nonprofit Corporations Code*

A. Preface

Drafting a code such as this involves several basic objects. First is the codifying of common understandings, so that those involved in a nonprofit corporation may rely upon the law either to enforce their reasonable expectations, or to require advance warnings when there are departures from such expectations. Second is the identification of those areas in which overriding social policies require particular rules regardless of whether expectations are defeated. These policies can result from an overriding interest of the public or a need to protect the legitimate interests of members, directors, the corporation or third parties dealing with the corporation such as creditors, debtors, tort claimants, contributors, employers and competitors. Third is facilitating the operation of the corporations governed by the code, a task particularly important in this code because of the frequency with which nonprofit organizations are run by people with little business experience and without the financial means to obtain the services of attorneys.

These three objects, although interrelated, may be difficult or impossible to satisfy simultaneously throughout the entire code. Nonetheless, an evaluation of proposed pro-

*Part of the approach employed here was inspired by an unpublished paper by Henry Hansmann, "An Economic Rationale for Non-Profit Institutions" (September, 1974). The authors wish to express their appreciation to Jerry Witherspoon and Richard Buxbaum, of the Boalt Hall School of Law at Berkeley, the former for bringing this paper to our attention, and both for providing many of their own insights.

visions in terms of these objects should lead to a more thoughtful consideration of underlying policy questions. At the same time, we must remember that as a corporations code only, the statute cannot deal with or solve every problem which may involve nonprofit corporations. Thus, while we may wish as a matter of policy to ensure that nonprofit corporations do not have an unjustified advantage over profit making competitors, we cannot deal with one major area -- taxation -- that may be quite relevant to this concern.

It would be helpful, if not necessary, before making policy decisions about particular portions of the code, to develop a conceptual overview of the nature of nonprofit corporations -- the public interests served by allowing them and the interests and expectations of the various private parties involved with them. Although this conception will not be perfect at the outset, it will be refined as we confront the particular issues that arise in drafting a code, and as we talk to individuals experienced in their operation.

Unfortunately, the legal literature is not helpful. While business corporations have been the subject of numerous books and articles, there is no similar record of interest in nonprofit corporations. The problem is exacerbated by the tremendous variety of organizations that use the nonprofit corporate form: churches, retail outlets, fraternal organizations, consulting companies, hospitals, automobile clubs, charities. Profit making corporations may join together in creating a jointly controlled nonprofit corporation to serve their common purpose, as with

Mastercharge or a trade association. Some nonprofits exist side by side with business corporations, providing the same services to the same public, as with hospitals, consulting companies or tennis clubs; others combine charitable purposes with the carrying on of a business for profit, such as a church which runs a profit making mortuary business; and others appear to perform functions entirely different than any performed by business corporations, such as charities. It seems unlikely that the same rules should apply to all of these organizations, but we clearly do not wish to rely solely upon an intuitive feeling that charities are different from consulting companies in drafting a code. This introduction will therefore attempt to explore the nature of the various kinds of nonprofit organizations subject to this code, to gain a better understanding of how they are different as well as how they are the same.

B. The Current Code

The classic response of nonprofit codes in general and the California code in particular to the bewildering array of nonprofit corporations has been permissiveness, presumably designed to accomodate all comers: nonprofit corporations are supposed to have members, yet they may avoid having members if they wish; members are ordinarily thought of as participating equally in the endeavor, but in fact not only are classes of membership allowed, but unequal voting rights within classes; while the code appears to allow only "incidental" profit making activities, profit making may in fact be carried on as a principal purpose. Cumulative voting is optional; staggered terms of

directors are permitted. Thus the California code makes little attempt to codify common understandings, or adopt social policies but exalts instead the goal of facilitation by leaving largely to those drafting the corporate instruments the choice of the rules they think appropriate to their organization. Some distinctions are made between charitable corporations and others, but virtually none in the fundamental area of internal governance that is the principal business of the code. No attempt is made to define "charitable." The bulk of the code is imported, by reference, from the business corporations code, although practicing attorneys and the courts are left with the task of determining precisely which portions of the business corporations code in fact apply. In sum, the code reflects virtually no sense of policy and a great deal of disarray.

When questions do arise, solutions are attempted on an ad hoc basis, with the result that the code contains many special provisions affecting only this or that particular kind of nonprofit corporation, ordinarily identified by its purpose: a chamber of commerce here, group optometric services there, societies for the prevention of cruelty to animals somewhere else. These provisions are often obsolete appendages from the date of their birth, since they usually may be avoided by forming the corporation under other provisions of the general nonprofit law. Indeed, the provisions of the current code specifically applying to the formation of charitable nonprofit corporations fall in this category, as most charitables are apparently formed under the General Nonprofit Corporation Law instead.

C. What are Nonprofits?

Despite the difficulties, there does remain one fundamental characteristic shared by all nonprofit corporations which distinguishes them from business corporations: there is no class of individuals analogous to shareholders to whom distributions may be made during the corporation's life. It is important to remember that this is different from saying that nonprofit corporations do not run businesses for a profit; the fact is that a great many of them do, whether as one of a number of activities or as the principal activity.* The profits generated by such a business may go to other activities conducted by the corporation; may be accumulated for later use as a source of capital; may be invested; may find their way into the pockets of the employees of the organization in the form of compensation; or finally, may be given indirectly to the membership of the corporation in the form of reduced membership fees or the provision of goods or services at a discount. But whatever the result, it is always important in looking at these entities to remember that while there are nonprofit corporations, there are almost no nonprofit people.

Nonetheless, a variety of important distinctions between

*The accuracy of this statement necessarily turns upon the definition of "profit", which may not be as easily defined as its common usage suggests. Obviously, if profit is defined as a surplus which is distributed to the owners in the form of dividends, then by definition no nonprofit conducts a profit making business. Yet it is clear that a nonprofit corporation which principally runs a retail department store selling goods at a markup, or a consulting company principally selling the professional time of its employees, is in some ordinary understanding of the term operating principally at or for a "profit" -- even though there is no surplus distributed to shareholders. A nonprofit corporation, such as a church or university, which also owns a conventional business, is a familiar example of the nonprofit operating a profit making business as one of a number of activities.

nonprofit corporations and business corporations flow from this fundamental characteristic of nonprofits. Some relate to the economic or social functions fulfilled by nonprofit corporations and an analysis of these distinctions will be helpful in developing a sense of why we have nonprofit corporations, and what useful functions they serve which the code ought to facilitate. Others relate to the nature of the interests which those persons involved in nonprofits have at stake in regard to them, and this group provides the necessary underpinning for any rules of internal governance. We are obviously interested in both areas, and for the purpose of discussion they may be conveniently separated, although they are in fact intertwined and ordinarily present themselves in particular combinations in any single nonprofit.

But before proceeding along this line, we must first briefly develop a way of categorizing nonprofits so that we may talk about the ways in which they differ from each other. They may be separated into groups along two basic parameters: financing and control. Considering financing first, it is clear that all nonprofits are limited in their access to capital as compared to business corporations; in essence, they have no source of initial capital, although one segment of them -- those favored with a 501(c)(3) tax status -- have access to funds in the form of donations, a source unique among corporations. Others may receive substantial donations even without 501(c)(3) status, such as political lobbying groups. Those which rely primarily upon donations as their source of funds may be called donative nonprofits. Others, such as the AAA or a tennis club, will

rely principally upon fees or the sale of goods and services, and these may be called fee nonprofits. Many entities, of course, fall in between these two poles, such as the nonprofit college relying upon both donations and tuition.

The second parameter is control, by which we mean the formal power to elect the corporation's directors. For business corporations, such initial control usually lies with those providing the equity or venture capital, but in nonprofits there may be no such group, although there may be analogous distributions of risk and control in some cases. Looking first at our fee nonprofits, we can see that they fall into one of two groups: customer controlled, and employee controlled. An organization such as the AAA or a trade association is founded for the private benefit of its customers, who ordinarily provide by their fees or assessments the funds it requires to operate. In some, such as many tennis clubs or country clubs, there is even a capital contribution required for membership, in the form of a high initiation fee. These customers also constitute the corporation's membership. These are therefore customer controlled fee nonprofits, and they may occasionally look like consumer cooperatives, although they are formally different in that they may not make patronage refunds to their members, since this would constitute a prohibited dividend.

The employee controlled fee nonprofit, on the other hand, is one alternative to the professional partnership, and is illustrated by consulting companies controlled by their employees, and, perhaps, nonprofit hospitals controlled by their doctors. Like the partnership, they effectively provide income for their

member-employees (partners). The employees may themselves contribute initial capital to the organization, or, as may be more likely, the government contributes the capital in the form of grants, research contracts, or the like. As in a partnership, the member-employees may have their labor "at risk" -- this is, they may find that they have invested professional time in an organization which is ultimately unable to provide them with a reliable income. The risks might be smaller than those which may be encountered in the partnership, however, as, at least in a general partnership, each partner is liable for all partnership debts. But unlike a partnership, the nonprofit may not distribute a share of its "profits" to the members, which means, of course, that members are not required to account for their distributive share of profits or losses on their tax returns. The corporation may well distribute bonuses to its employees, however, which may come to the same thing.

Donative nonprofits present a different puzzle, since they are generally not organized for the private gain of the founders, nor with their investment of time, effort or money in the sense of investment for an economic return. Although we will explore the internal governance implications of this later, in the memorandum on Issue Two, we can now classify them into two groups: donor controlled, and management controlled. The donor controlled nonprofits, such as KQED or some art museums, vest the power to elect directors in one group of its donors. The management controlled nonprofit, on the other hand, vests control in the directors themselves, under code provisions which allow a nonprofit to designate its directors as its only

members. The directors, under such an arrangement, are a self perpetuating board, exercising power as members in the morning to elect directors for the board meeting in the afternoon.

We must add one final observation to this discussion: management controlled donative nonprofits are not the only organizations utilizing the self perpetuating board in which the directors comprise the entire membership. This structure is available under the General Nonprofit Law to all nonprofit corporations, and other types make use of it. In some cases this may reflect no more than the small number of members, as in an employee controlled fee nonprofit with only three founding member-employees, or a trade association with only five member-customers. In other cases this choice of organization is used even though the class of employees or customers is larger, and others whose interests are arguably identical to the member-directors are effectively excluded from a voice in management. Whether this is an abuse and if so amenable to correction by a code revision is examined in Part Two. For now, however, we may merely observe that there are differences between the use of the self perpetuating board by donative and by fee nonprofits which have implications for code drafting.

D. What functions are performed by nonprofits?

1. Donatives

With our sketchy taxonomy behind us, we can consider first what functions are performed for society by the donative nonprofits. The charity is probably the one that most immediately comes to mind when the term nonprofit corporation is used. They provide an intermediary between the donor

and the recipient of the charity. This essential function is necessary for two reasons. The first is a product of the tax code: it provides a tax-exempt entity to which donations may be given. There is a separate economic function fulfilled as well, however. While an individual with a charitable impulse may be able on his own to help a needy family down the block, he is not equipped to arrange on his own for the feeding of starving Biafrans, and he may not wish to personally take on the burden of arranging for the care of those closer to home. He thus relies upon an intermediary who will accept his donation along with the donations of others to carry out this function. Even apart from the tax consideration, he is likely to prefer the nonprofit organization for this function on the assumption that it is more likely to use his donation for its intended purpose than for the private gain of the entity or individuals associated with it, since the donative nonprofit may not distribute gains to shareholders in any event.

Charity is usually defined by economists as the subsidizing of another person's consumption. But there is another function carried on by donative nonprofits which do not fall within this narrow category, although the organizations involved are equally charitable for the purposes of the tax code. This function is the production of certain "goods", including intangible ones such as knowledge, which the ordinary profit making body may fail to produce because the opportunity for private gain is too remote, even though the public would benefit from their production. The Cancer Society or the Heart Fund are examples. The kind of biological research funded by such organizations

may be paralleled by the private sector, where the possibility of reaping profits by use of the knowledge gained is present. But the potential of such profits is often remote, particularly where the research will result not in a marketable and perhaps patentable good, such as a drug or medical device, but in a piece of knowledge which will fall in the public domain. Obviously much research has both possibilities, but some research may be more likely to produce immediate possibilities of gain. Little profit may be reaped immediately by discovery of the structure of the DNA molecule, despite its undoubted significance. Moreover, because of a tradition that such knowledge should ultimately be made generally available by way of publication, rather than kept as a "trade secret," there is no effective way to market the knowledge itself -- that is, to charge for its consumption. Nor is knowledge "consumed," in the sense that use of it by the first person prevents use of it by another. Something with such attributes is called a "public good" by economists.* Public goods such as the knowledge resulting from research may be incidentially produced by a profit making entity, but its choice of the research to be carried out will be governed by profit making considerations -- the possibility that the research will yield a private good, such as a patentable drug, which may be marketed. The public may wish to ensure that other research without this immediate profit making potential is also conducted.

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*The term "public good" may be somewhat confusing, as most people think of a "good" in the conventional sense of a tangible item of economic value. But as this is the standard label used by economists, we have made no attempt to change it.

A nonprofit form may be crucial in this endeavor. A group of people could individually hire the services of physicians, biologists, etc., to carry on some research task, but the difficulties with such an arrangement are enormous. If the contributors wish to insure that the funds are used for their intended purpose, they each would have to have a separate private contract with those providing the research services, and they could enforce their bargain only by suing upon each of these individual contracts. It is far simpler to create a nonprofit intermediary to hire the researchers and receive donations from those who wish to contribute. The intermediary thereupon takes upon itself the task of ensuring that the funds are expended for their intended purposes and assumes administrative responsibilities; the contributors rely upon the nonprofit character of this intermediary as assurance that the funds will not be diverted to private gain.

There are other such public good functions carried out by nonprofits. The university is probably the leading example of the research-producing nonprofit, and that research function is one reason why tuition rarely pays the full cost of running it. The balance is derived from donations, either private or governmental, to support this "public good." The American Civil Liberties Union or a public interest lobbying group such as Common Cause also provides public goods, although the public may disagree as to whether it is really benefitted. In both cases there are profit making entities incidentally providing the same product -- the lawyer with a paying client who raises a First Amendment claim on his behalf, or the corpora-

tion whose private interest suggests support of a "reform" measure -- but as with research, the nonprofit group can fill the gaps left by the profit making entity. The most familiar example of this is public television. Television is obviously a public good, at least until we have a pay TV system, but it is incidentally provided by the private sector which sees a profit making opportunity in financing it. But the kind of television produced by the private sector is limited, and public television, produced by donative nonprofits, fills some of those gaps.

In summary then, donative nonprofits, by virtue of their nonprofit character, offer two advantages over business corporations for fulfilling their intermediary function. First, they provide an entity eligible for tax exempt status to which donations can be made. The policing of this function is more properly a subject of the tax laws rather than a question of concern for a corporations code. Second, however, they offer an administratively convenient intermediary function and their nonprofit status provides assurance that funds contributed to them will be used for the donor's intended purpose rather than for private gain. Whether the nonprofit status of these organizations in fact really offers this second advantage is another matter which we should address. But for now we may conclude that it is this apparent advantage of nonprofits which in part accounts for the public preference for them. They thus offer a means to a donative goal that would not otherwise be available in corporate form, although the charitable trust or unincorporated association would often provide a noncorporate alternative.

2. Fee Nonprofits

The fee nonprofits provide an entirely different function: rather than filling a role which cannot be filled by business corporations, the fee nonprofits often exist side by side with business corporations with whom they compete. We thus have both profit and nonprofit hospitals, schools, tennis clubs, automobile clubs and department stores. Clearly the nonprofit status of these institutions influences customer preference. People often believe, whether justified or not, that a nonprofit nursing home, school, hospital, or childcare center is likely to be superior to a profit making one. They might feel the same way about a nonprofit corporation producing automobiles, if nonprofit corporations had the capital available to them to enter into such an area. Sometimes this customer preference is relatively abstract, hardly more than a notion based upon the label "nonprofit," which conveys the sense that the organization is more likely to give the customer a "good deal," whether by way of price or quality of service, or that the organization is socially worthwhile and deserves support. That notion may or may not be realistic; it may appear, for example, to have some validity in the case of nursing homes, but not in the case of certain nonprofit hospitals. (See, e.g., Lowry Hospital Association v. Commissioner, 66 T.C. --, #80, C.C.H. ¶7571, 8/12/76.)

A fee nonprofit which is customer controlled offers more direct tangible benefits to its customers, however. These benefits may be economic or may result from the ability of the

customers to directly control the policies and practices of the organization. For example, parents may prefer enrolling their children in a daycare center controlled by member-parents because of their ability to control the policy and practices of the entity. This is a possibility not ordinarily available in a profit making institution. The same advantage may be present in tennis clubs or country clubs or various social organizations. An employee or management controlled nonprofit does not offer this advantage.

At the same time, however, one joining a nonprofit tennis club, for example, may find that there is a high initiation fee which is, in effect, a capital contribution. Payment of this fee makes the member-customer reluctant to abandon his regular patronage of the organization. He would not feel similarly about a profit making tennis club which merely charged periodic fees based on actual use. By joining a tennis club with a high initiation fee, the member has sacrificed some mobility -- the ease with which he might take his business elsewhere -- for a vote in the management of the entity. This is particularly true if the initiation fee is not refunded upon the member leaving the organization.

The promoter, on the other hand, has given up control over the organization to the member-customers in exchange for their assuming the risk. That is, in a profit making tennis club, the promoter puts up the risk capital, either alone or in combination with others who share in the ownership, and he takes the risk that he may not be able to obtain the customers

necessary to run the operation in a profitable manner. With the nonprofit form, however, the customers themselves may put up the capital and provide an assured patronage to the promoter; in exchange, the promoter has given up effective control over the entity to the customers. In this context then, the nonprofit form provides an alternative method for a group of individuals to distribute control and at least initial risk when banding together to form some joint enterprise.

E. Identifying the Interests of Participants

This last discussion brings us to our second area of concern: the interests at stake by those who are involved in a nonprofit corporation, principally those serving on the governing board, and those who are members of the corporation. In the case of donative nonprofit corporations, the interests of contributors are also important to consider.

The simplest case is the customer-controlled fee nonprofit corporation, such as the tennis club we have just discussed. As far as the members are concerned, it is clear that the endeavor has been organized principally for their private mutual benefit and with their capital, and they have the same concerns -- and should have the same rights -- as the shareholders of a business corporation. The "profit" they expect to get is provision of some good or service rather than cash, but it remains the case that their interest in obtaining a "return" of their investment exceeds any interest of others that may be involved, and no public interest is in jeopardy here. The same argument applies to trade or professional

associations which cater to those with particular business interests as opposed to recreational interests. These are still customer-controlled fee nonprofits. It is in this area that we may most comfortably draw upon the familiar principles of business corporation law and assume that the members represent no more than their own personal self-interest, and the directors' major obligation is to the members.

The other extreme is the management controlled donative nonprofit corporation, which would have no group of members distinct from those serving on the board of directors. In such a situation, where the board and the members are one, it is apparent that the board represents no private interest other than its own. Yet there are other interests which deserve protection in such an entity. First of all, there is the interest of those who contribute to the organization; although they have no formal method of control over it under corporation law, they may be able to exercise influence by conditioning their contributions on tacit understandings as to the direction of the entity's activities, conditioning future contributions on such an understanding, or even creating a formal trust instrument by which to enforce their views. The recipients of the services or goods purchased by the organization also have an interest, although it is not one which has historically been recognized in the law. Finally, the public has an interest. This is in part justified on the grounds that these organizations are the recipients of favorable tax treatment vital to their existence, but the

rationale is broader than that. Those in control are answerable to no private body, and profess to engage in the endeavor solely for public purposes rather than from self-interest. They solicit donations on that basis. The public therefore has an interest in insuring that such solicitations are done in good faith and that the expenditures of the corporation are consistent with its representations in the course of solicitations. This public interest exceeds any private interest that may be present in these organizations.

More troublesome are the remaining categories of nonprofit corporations. The donor-controlled donative nonprofits such as KQED or an art museum, which vest formal control in one group of their contributors, fall in this class. Individual contributors become members; others, such as corporations or foundations, may not. The contributor-members expect the directors to represent their views, and are or may be in a position to enforce that expectation. Yet at the same time other members of the public, as well as non-member contributors, may expect the board to represent a broader public interest as well, and the board may view its own role with this broader perspective -- particularly insofar as it desires to maintain an amicable relationship with non-member contributors whose continued financial support may be crucial to the organization's future. It is not surprising that such an arrangement would lead to serious internal disputes, as evidenced by the recent battle within KQED.

The employee controlled fee nonprofit also presents unique problems. We have already discussed the motivations and interests involved in the customer controlled fee nonprofit, such as the tennis club or daycare center, and their rationale seems rather straightforward. Yet there are fee nonprofits controlled by a portion of their employees, such as certain research-consulting groups which provide employment for their members, as well as others who may be hired. They are labor intensive businesses, which allow them to move forward with little capital demands, and the small amount of financing required comes from their customers, often various government entities. But control is vested in the employees, or some group of them, and the motivation may be primarily profit making, such as the generation of business to support desirable jobs for the members who are high paid professionals. They are similar to a professional partnership using a nonprofit corporate form. The members have interests in the enterprise similar to those of partners in a law firm, and the directors are their representatives -- if they are not the same people altogether.* The customers -- usually various government agencies -- have no formal voice in the internal governance and need none; like customers of any profit making entity, if they cannot satisfy their interests by contractual provisions, they can take their business elsewhere.

One might reasonably ask why the promoters of these

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*Of course, for the reasons mentioned on pages 7-8, professional partnerships are different than employee controlled fee nonprofits.

organizations chose the nonprofit corporate form. It is unlikely that there is hidden tax advantage. It may be that the customers, or at least some of them, buy the corporation's services in the form of grants, and that by law or regulations such grants can only be "given" to a nonprofit entity. There may be other factors involved, peculiar to each case, of which we are not aware. In any event, it would appear that there is no interest involved in these organizations which requires protection in the internal governance of these organizations other than the interest of its member-employees, represented on the board of directors.

[DRAFT: NOT FOR PUBLIC DISTRIBUTION]

PART TWO

A Sample of Particular Legislative Issues

Issue One: Should any limits be placed upon the right of a nonstock organization to conduct a profit making business?

This question breaks down into two parts: first, should nonstock corporations be prohibited from engaging in profit making activities as their principal or sole activity (see page 5 of Part One); second, should nonstock corporations be allowed to engage in profit making and nonprofit making activities at the same time?

A. Profit making as a sole activity.

Some states under the "functional" approach allow nonstock corporations to be formed for only limited purposes, and any activities outside of these allowable purposes are prohibited. Particular profit making activities may be prohibited. Other states follow the "economic" approach, which proscribes the distribution of dividends or profits to the members except on dissolution and otherwise allows the nonstock corporation to engage in all lawful activities. California employs an economic approach. See Corporations Code §9200; Note, Permissible Purposes for Nonprofit Corporations, 51 Colum.L.Rev. 889 (1951).

As we have seen from Part One, the nonstock form can flexibly and effectively satisfy a variety of different needs. Where it exists in competition with profit making entities, it may fulfill a different role and may provide a useful or desirable alternative. In any event, there appears to be little if any evidence that nonstock corporations have

been abused in any way which could be cured by a restriction upon the purposes for which they may be formed. Our tentative conclusion, therefore, is that a change in California law to limit the purposes for which nonstock corporations may be formed, in an effort to prevent them from entering certain areas in competition with profit making businesses, is likely to inhibit the formation of potentially useful alternatives to the business corporation without any offsetting gains. It would also be inconsistent with the approach of the new corporations law which severely limits the ultra vires doctrine. We would therefore recommend that a new nonprofit code continue the current California approach, followed in a majority of states, which allows such corporations to be formed for any purpose so long as there are no distributions to members except on dissolution.

If the Committee chooses to follow this recommendation, it is then important to keep in mind that the rules we write will frequently govern entities which resemble business corporations in some important respects. This has two results. First, the Committee should consider adopting a different title or label for such corporations, as the name "nonprofit" is likely to be misleading. This is not only for the benefit of business competitors of a "nonprofit" corporation, but for the benefit of its customers who may be attracted to it by virtue of unwarranted assumptions about its goals and the economics of its operation. We have adopted the word "nonstock" as a substitute for "nonprofit." This may not be the word or concept which we

ultimately choose, but is an improvement over the misleading concept of "nonprofit corporations." Of course, charitable nonstock corporations should be allowed to say they are "charitable corporations."

Second, as a result of the wide range of activities which are and will continue to be allowed nonstock corporations, the interests of various parties who may become involved with them are often but not always similar to the interests of those involved in profit making corporations. The interests of creditors and tort claimants are almost the same. The interests of members and directors are different than those of shareholders, and business corporation directors, but present many parallel problems. Rules we develop with regard to such people should therefore take the similarities and differences into account.

B. Profit making and nonprofit making activities at the same time.

Conceptually the second issue could be resolved differently. Thus it is possible to decide that a nonstock corporation cannot run profit and nonprofit activities at the same time, even though we have concluded to otherwise allow profit generating activities by nonstock corporations. Section 9200 of the current code states that "carrying on business at a profit...incident to the main purpose of the corporation... [is] not forbidden to nonprofit corporations..." The phrase "incident to" has been interpreted by the courts to allow nonstock corporations to carry on profit making business as a principal or co-equal activity with a nonprofit or charitable activity. In Groman v. Sinai Temple, 20 Cal.Ap.3d 614, 99

Cal.Rptr. 603 (1971), the Sinai Temple in Los Angeles purchased a portion of Forest Lawn Cemetary Association, including eighty-two acres of cemetary property as well as undeveloped land and a fully equipped mortuary. The capacity of the acquired business greatly exceeded the needs of the congregation. Therefore the synagogue sought business from the entire Jewish community through advertising and other solicitation. It was successful, and by 1968 realized substantial profits by conducting more than 20% of all of the Jewish funerals in Los Angeles County. The case arose when a business competitor challenged the operation of its funeral business as beyond the allowable scope of its activities under its articles and Section 9200 of the Corporation Code. These arguments were rejected by the court which concluded that the Legislature was concerned principally with improper distributions of profits and did not intend to limit the profit making activities of nonstock corporations. The court therefore found that so long as there were no distributions in violation of the nonprofit law the synagogue could carry on its profit making enterprise as one of its substantial activities.

At one time the conduct of a profit making business by a nonstock organization might have provided it with a tax advantage over its business competitors, but tax reforms which have placed the unrelated business income of nonstock corporations on the same footing as for-profit corporations largely eliminated this issue. Furthermore, analysis of the potential issues in corporations engaging in mixed profit and nonprofit activities appear to resolve themselves along lines similar to the basic question of whether a nonstock corporation should be formed for

the sole purpose of conducting a business for profit. That is to say, the only serious problems that could arise are those resulting from the misleading name applied to the organization when it conducts such a profit making business, as well as the necessity of protecting those dealing with the nonstock corporation.

Indeed, it might be beneficial to allow a charitable corporation to conduct a profit making enterprise. This would allow it to generate funds to further its charitable purposes. Individuals might even deal with the profit making activities of a charitable corporation because of a desire to support the charitable purposes of the organization. In the case of charitable corporations, moreover, the nonprofit law has traditionally barred distribution of the assets to members even upon dissolution, a rule which we should retain. As a result, such a profit making business will inure principally to the benefit of the charitable purposes for which the entity has been formed and is therefore more likely to be to the public's benefit than to its detriment. However, we should bear in mind these profit making activities while drafting the code, so that the interests of various persons connected with or dealing with such a charity will be protected.

For non-charitable corporations, which will distribute surplus to its members upon dissolution, ownership of a substantial profit making business could conceivably present more problems. But these problems can be solved by protecting the rights of members, creditors and claimants rather than by prohibiting such profit making activities.

Issue Two: Should all or some nonstock corporations be required to have members?

Current California law resolves this question by sleight of hand. The entire code is written upon the assumption that nonprofit corporations have members, but that assumption is entirely undermined by §9603, which provides that where a nonprofit corporation fails to provide for members, the directors shall be the members.* It appears that §9603 was initially intended as a savings clause for the benefit of corporations formed with no group of persons initially designated as members, or which subsequently find themselves without members for some reason. It has in fact been used, however, as a method by which one may form a memberless nonprofit corporation with a self-perpetuating board of directors, who elect themselves periodically by taking off their director hats and putting on their member hats. Such a use of this section has received judicial approval, and the articles of a California nonprofit corporation may provide that it shall have no members, other than its directors. Brown v. Memorial National Home Foundation, 162 Cal.App.2d 513, 521, 329 P.2d 118, 75 A.L.R.2d 427 (1958).

This is an unsatisfactory state of affairs; to the

*"Where neither the articles nor by-laws of a nonprofit corporation provide for members thereof as such, and in any case in which any nonprofit corporation has, in fact, no members other than the persons constituting its board of directors, the persons for the time being constituting its governing body or board are, for the purpose of any statutory provision or rule of law relating to nonprofit corporations, the members of the corporation and shall exercise all the rights and powers of members thereof."

extent the new code allows memberless* nonstock corporations, it should do so expressly and not by such indirection. The question the Committee must decide, however, is whether any restrictions should be placed upon the formation of memberless nonstock corporations.

Neither the literature on this subject, nor recent code revisions provide much aid. The model nonprofit code ignores the issue. The recent New York revision requires all but charitable corporations to have members. New York Not-For-Profit Corporation Law, §601(a). Unfortunately, we have found little legislative history describing its source.

An initial examination reveals that donative nonprofits frequently use the memberless nonprofit form. Such groups are virtually exclusively charitable within the meaning which that term has to both the layman and the tax attorney. Here there is no group of private individuals with an interest easily fitted into the mold of membership, since the organizations purport to serve a public function -- charity and the providing of public goods -- rather than a private interest of some identifiable group. For these groups, then, governmental supervision, traditionally vested in the Attorney General on behalf of the public interest, has served as the principal safeguard. The Attorney General, at least in theory, ensures that the funds

*The term "memberless" is technically wrong, since the directors become members automatically under the law. But it is a convenient term to describe these corporations, in which the directors have no constituency other than themselves, and are in effect self perpetuating.

are not diverted to private gain, either during the life of the corporation or upon dissolution. The Attorney General does not, of course, involve himself in questions of policy; he does not, for example, review the decisions of the Cancer Society as to which research to fund. This is left to the internal governance structure of the entities. Potential contributors who disagree with those choices may simply refrain from contributing; there is otherwise little control over the decisions of the directors of memberless donative nonprofits. But neither is there a private interest which necessarily requires such control in the form of membership rights. We may thus tentatively conclude that whatever rule is adopted should allow the continued use of the memberless nonprofit corporate form for those charitable corporations which choose it.

We now move on to the fee nonprofits, many of which do have members and all of which have classes of people with private interests that the membership concept should protect. Some do have, however, either self-perpetuating boards, or classes of membership, and these structures may at times frustrate the reasonable expectations of membership rights which private parties may have. Unfortunately, reflection reveals that practical difficulties of draftsmanship and a reluctance to intrude into the internal affairs of private organizations may prevent any attempt to mandate the beneficial aspects of membership. An example will help explain the problem.

People joining a non-donative nonprofit corporation may do so, as explained in Part One, in order to obtain a vote

in the management, and in doing so may sometimes reduce their mobility -- the ease with which they can take their business elsewhere -- as when a large nonrefundable initiation fee is paid to join. Yet they may find upon joining the organization that in fact they have no effective vote. Thus, one may join a tennis club only to discover that there are a small group of people who possess all of the true membership rights. This may occur where a nonstock corporation employs the term "member" loosely, so that one is led to believe that he is purchasing a membership entitling him to vote for directors when in fact he has no such right. Alternatively one may discover the organization has classes of membership such that one small group constitutes the only class with effective control over the organization. The individual in such a situation has surely had his reasonable expectations frustrated and might well expect that the law would protect his interests as a "member." Similar abuses may occur in organizations of artists or in trade or professional associations.

Correction, however, presents tremendous difficulties of draftsmanship. One may first note that any statutory language which merely required membership, without more, could easily be defeated, since there is nothing to prevent a self perpetuating board of directors from fashioning membership requirements which would effectively exclude all but themselves. This is particularly true where the requirements were applied by a "friendly" membership committee vested with authority to pass upon applications. But in any event, the potential for abuse arises not because

the organization is without members; in fact it does have members. The problem is that the only members, or the only members of the controlling class, constitute only a small portion of those who reasonably expect to have a protected membership interest.

A statutory solution, therefore, would require language which effectively identified those people who reasonably expect membership rights and require the organization to confer such rights upon that entire class. The identification of such a class of people by statutory language appears to be virtually impossible, as the criteria would vary with each type of organization. The task is further complicated since we often wish to preserve the flexibility of most nonstock organizations -- social clubs, tennis clubs, or even trade associations -- to control their membership for a variety of apparently valid reasons -- at least where there is no racial, sexual or religious discrimination. In a tennis club, for example, the directors might want to allow junior tennis players to use the facilities without paying dues or a membership fee. A trade association may desire to apportion its fees in an unequal manner, and use a class structure so that voting rights reflect the varying contributions. A group of parents forming a childcare center may wish to do the same. A social club may simply choose to restrict membership to those with whom the current members desire to associate. Thus a solution which required an organization to admit everyone to equal membership rights would make little sense. In a pluralistic society it is usually undesirable to

mandate the class of people who must be members of private organizations.

A small but potentially helpful step would be to restrict use of the term "member" to situations in which true membership rights were being offered. Enforcement could be vested in the Attorney General, who would be empowered to seek judicial orders enjoining violations. One might even provide for some form of private relief -- such as affording such persons actual membership rights -- where the violations were wilful and with an intent to mislead, and where such a result would not be unfair to those already exercising membership rights.

Moreover, it may be that there are certain particular types of nonstock corporations the nature of which makes a drafting solution both possible and desirable, as where the class of persons who reasonably expect to have membership rights are easily identifiable and definable by statute, and where there is evidence that frustration of those expectations is in fact occurring. The possibility should be constantly considered as the new code is drafted, even though imposing a membership requirement should be approached with caution.

Issue Three: To what extent should a member's interest in retaining his membership be protected by statutory rules setting forth a minimum amount of procedural due process in termination or exclusion?

This is a question peculiar to the nonstock form which does not arise in a business corporation, in which there is usually no qualification for ownership of shares other than the necessary money in hand with which to buy them. In nonstock corporations, on the other hand, a different tradition has been prevalent. Social clubs, often unincorporated, usually pass upon applications for admission to membership, and are accustomed to terminating memberships as well. This is carried over to various forms of nonstock corporations such as tennis clubs, church groups, or professional or trade associations. Depending upon the nature of the nonstock corporation, the expelled member may or may not have some substantial financial or property interest at stake. In the customer controlled fee corporation, he may have made a substantial contribution to capital in the form of an initiation fee which is forfeited; in the employee controlled fee nonstock he may have an even more substantial contribution to capital, and his entire livelihood may be tied to his connection with the organization since it may provide him with employment. In both cases, his right to share in the proceeds upon dissolution is also at issue, and although this frequently will be speculative, it may not always be so remote a loss. These are examples of organizations in which the member has an interest similar to that of shareholders but is subjected to a

potential for expulsion to which shareholders are not ordinarily exposed.

In a professional or trade association, which is ordinarily organized as a customer controlled fee corporation, the member's interests may extend far beyond his financial investment in his membership; his ability to carry on his profession or his trade may well be impaired by virtue of the expulsion. This membership may thus be of tremendous financial significance although of a kind different from that ordinarily associated with the ownership of shares in a business corporation. Finally, we have other forms of nonstock corporations in which the membership interest is principally one of social standing: the social club or church membership. Here courts have historically found more difficulty in developing a doctrinal basis for intervention upon the member's behalf against arbitrary expulsion, because of equity's traditionally exclusive concern with property rights. But strong arguments may be made that injuries to reputation and social standing resulting from arbitrary expulsion merit some form of equitable relief. See the classic article on the subject by Chafee, The Internal Affairs of Associations Not for Profit, 43 Harv.L.Rev. 993 (1930).

The California cases have clearly established that where the member has some arguable property interest associated with the membership, such as those associated with membership in a professional association, minimal due process standards must be followed by the association in terminating a member-

ship. Pinsker v. Pacific Coast Society of Orthodontists, 1 Cal.3d 160, 165-166 (1969); Ascherman v. San Francisco Medical Society, 39 Cal.Ap.3d 623, 647-50.

Where religious organizations are involved, however, the doctrine has traditionally been more confused because of the accepted rule that courts do not ordinarily insert themselves into the internal disputes of religious organizations. The source of this rule, however, is the reluctance of the court to be placed in a position in which it is asked to make decisions turning upon resolution of doctrinal disputes within the church; indeed, a court acting in such circumstances is likely to run afoul of the First Amendment. But one can distinguish between the grounds for an expulsion, which may be related to a doctrinal dispute, and the procedures under which it is carried out, which often have no doctrinal content. Thus, where the court is asked merely to insure that these procedures were not arbitrary, or that the body followed its own rules, there may be no constitutional bar to judicial review. Such review, in effect imposing minimal procedural due process standards upon an expulsion, is precisely what courts have ordinarily done in all nonstock corporations. The general rule is that the body is required to adhere to its own bylaws or other governing instruments in expelling a member, and that one may not be expelled without notice and a reasonable opportunity to defend against the charges made. Cason v. Glass Bottle Blowers Association, 37 Cal.2d 134, 142-146 (1951) (unincorporated labor union); Taboada v. Sociedad Espanola de Beneficencia Mutua, 191 Cal. 187,

191, 215 P. 673, 27 A.L.R. 1508 (1923). In Erickson v. Gospel Foundation of California, 43 Cal.2d 581, 275 P.2d 474 (1954), the court, while expressing some reluctance to impose upon religious societies the same rules applied in other nonstock organizations, in fact did so. In Erickson the corporation in question had only three members, who also served as its board of directors, and the plaintiff brought the action to upset his expulsion from membership. The court sustained the expulsion only upon finding that the organization's bylaws had been followed and that the plaintiff had been given reasonable notice and an opportunity to be heard. A similar result was arrived at in Owen v. Board of Directors of the Rosicrucian Fellowship, 173 Cal.Ap.2d 112 (1959).

Thus, although the statutes currently require only that "membership may be terminated in a manner provided in the articles or bylaws," Corporations Code §9608, the courts have in fact developed additional standards of minimal due process to protect members against arbitrary expulsion. Because of the interests which such members ordinarily have at stake, this judicial doctrine is probably sound. The question for the Committee is whether an attempt should be made to codify it. The purpose of such a codification would be to give the rules more certainty, both in insuring their continued application and in providing practitioners or laymen involved with a clear statement of the guidelines or minimal guidelines they must follow in terminating a membership. The argument against codification of these rules would be the desire to preserve judicial flexibility, at least for a while, so that the doctrine

may be further refined in light of continuing experience with such problems as they arise.

Issue Four: Should the code provide for some administrative mechanism, as an alternative to the judicial forum, by which internal disputes may be settled?

A number of people with whom we have talked have suggested such a procedure, and William Holden of the Secretary of State's office has already given some thought to the matter and has recommended the creation of such a forum. There are a number of reasons why the creation of such an administrative mechanism may be particularly helpful in the nonstock corporation area. First, it appears that nonstock corporations frequently operate in an informal manner which results in great confusion if disputes arise. This informality may result from placing responsibilities for running the nonstock corporation in people who have little business experience, or in people who, whether with business experience or not, participate in a corporation only part time and on a donative basis. Records are frequently lost or not kept properly. Moreover, there is frequently so little at stake financially that the cost of retaining lawyers is prohibitive.

Some administrative office, which could resolve such disputes in an informal manner, following the model of a small claims court, could provide a relatively inexpensive and speedy means by which such disputes could be settled and would thus offer an attractive solution to many problems.

Assuming that the Committee agrees that the creation of such a mechanism is desirable, there are many questions to resolve regarding its structure. One would first need to decide

where such a mechanism would be placed in the governmental structure. One could give jurisdiction to the current small claims court, or in some administrative body like the Secretary of State's office, the Attorney General's office, the Department of Corporations, or the Department of Consumer Affairs. There are a variety of reasons to support any of these choices.

One important factor to consider would be the function which this administrative mechanism would fulfill. There are a number of basic questions to decide: 1. Should resort to such a forum be optional or should one party to a dispute in a nonstock corporation be able to require that any dispute be brought to such a forum before commencing judicial action? 2. Assuming that a dispute is brought to such a forum, would its decision be advisory or would it be binding if no appeal were taken? 3. Assuming that its decision were advisory only, should its findings at least be admissible as evidence in a subsequent judicial proceeding? 4. Should there be some limit placed upon the kinds of disputes which could be brought to such a forum; for example, should the administrative body have power to decide questions of liability or breach of fiduciary duties or should it be limited to disputes regarding elections of directors or determinations of whether particular individuals are members of the corporation or its governing board?

There appear to be a number of reasons to prefer an administrative body which issued advisory rulings only on questions voluntarily brought to it by the parties. First of

all, the creation of such a body would be an innovation that would of necessity be somewhat experimental at its inception, and it may be prudent, at least at the outset, not to vest it with mandatory jurisdiction or the power of binding decisions. One could still provide, however, that any findings of the body would be admissible as evidence in a subsequent judicial proceeding. Second, any attempt to give an administrative body the power to make binding determinations would create practical difficulties since it would be necessary to obtain a court order in order to enforce such determination. Finally, there are probably many nonstock corporations in which the financial stakes are sufficiently high so that the parties would prefer to proceed immediately to a judicial forum. Nonetheless, it might still be possible, if the Committee preferred a body with greater powers, to provide that while the administrative body would be empowered to make binding decisions, any appeal would be to the Superior Court which could exercise de novo review. One could further provide that the initial step of going through the administrative procedure could be bypassed upon stipulation of the parties.

Issue Five: Do we need a judicial procedure by which nonstock corporations may be authorized to hold meetings of their membership or their directors, or conduct mail ballots, in some manner which would otherwise violate the corporation's bylaws or articles or the requirements of the nonstock corporations code?

The need for such a provision arises from the same factors which suggest the informal dispute settling mechanism discussed as Issue Four above. Because of the informal manner in which the affairs of many nonstock corporations are conducted, they often find themselves uncertain of who their members are, or unable to raise a quorum because they continue to list as members large numbers of persons who have long since ceased being active in the corporation and whose present addresses may be unknown. Difficulties often arise because of an inability to locate a current version of the organization's bylaws so that the body cannot be certain it is proceeding properly. An organization in such a position may fail to hold required elections for its board of directors and even may be uncertain of the membership of its governing board. Such difficulties sometimes arise in the context of a corporation whose purposes have long since been fulfilled and which ought to be dissolved but is unable to dissolve itself because of difficulties such as these. It is frequently the case that the only remaining persons with any interest in the body agree completely upon the course of action that ought to be followed but are unable to follow that course of action in compliance with the necessary rules.

A judicial procedure to deal with this problem would likely be of great help. It could be drafted along the following lines:

> (a) If for any reason it is impractical or impossible for any nonstock corporation to call or conduct a meeting of its members or directors, or otherwise obtain their consent, in the manner prescribed by its articles or bylaws, or this division, then the superior court in the county of its principal place of business upon petition of a director, a member, or the Attorney General, may order that such a meeting be called or that a mail ballot or other form of obtaining the consent of members or directors be authorized, in such a manner as the court finds fair and equitable under the circumstances.
>
> (b) The court shall, in an order issued pursuant to this section, provide for the best available, practical method of giving notice to all parties who would be entitled to notice of a meeting or mail ballot held pursuant to the articles and bylaws, whether or not the method results in actual notice to every such person, or conforms to the notice requirements that would otherwise apply.
>
> (c) The order issued pursuant to this section may dispense with the quorum requirements that would otherwise apply, and with any other requirement that would otherwise be imposed by the articles, bylaws, or this division, and may limit the subject matter of the meeting or matters which the written consents may authorize.
>
> (d) Wherever practical any order issued pursuant to this section shall limit the subject matter of the meetings or other forms of consent authorized to items, including amendments to the articles or bylaws, the resolution of which will or may enable the corporation to continue managing its affairs without further resort to this section; provided, however, that an order under this section may also authorize the obtaining of whatever consents and approvals are necessary for the dissolution, merger, consolidation or reorganization of the nonstock corporation.
>
> (e) Any meeting or other method of obtaining the consent of members or directors held or conducted pursuant to an order issued under this section, and which complies with all the provisions of such order, is for all purposes a valid meeting or mail ballot, as the case may be, and shall have the same force and effect as if the meeting or written consent complied with every requirement imposed by the articles, bylaws, and this division.

We are interested in obtaining the Committee's views on the general concept of such a provision as well as the specific statutory language suggested.