#77.220 5/26/76

Memorandum 76-64

Subject: Study 77.220 - Nonprofit Corporations (Crimes and Penalties)

Chapter 22 (Sections 2200-2260) of the new General Corporation Law collects in one place the provisions relating to crimes and penalties imposed upon corporations and their officers, directors, and agents; these provisions are presently scattered throughout the General Corporation Law. With a single exception, these sections have been carried over virtually verbatim to the new law. These sections are now applicable to nonprofit corporations by virtue of Section 9002 as no specific provisions for such crimes or penalties are contained in the existing General Nonprofit Corporation Law.

The staff draft concerning crimes and penalties does not follow the pattern of the new General Corporation Law with respect to the sections imposing penalties (Sections 2200-2204 of the new General Corporation Law). In the staff draft, the penalty sections (as distinguished from the crimes sections) have been placed in the chapters in which the underlying duties are found: Sections 6513 and 6514 (attached to this memorandum) and 14610, 14871, 14872, and 14884 (in redrafted Division 4). The staff believes that the penalty provisions should be in close proximity to the substantive sections imposing obligations and to the sections containing relevant damage and enforcement provisions. This placement corresponds generally to the location of such sections in the existing General Corporation Law.

An obvious disadvantage of this change is the resulting dissimilarity between the arrangement of provisions of the code relating to business and nonprofit corporations. However, this consideration is outweighed by the greater clarity and ease of use inherent in maintaining a close proximity among the sections establishing a duty, setting forth liability for damages, providing enforcement

procedures, and imposing penalties for nonperformance. If the Commission disagrees with this recommendation, these sections may be inserted in Chapter 22 of the new General Nonprofit Corporation Law as Sections 7200-7204.

The attached draft does continue the policy of the new General Corporation Law in collecting together all of the sections imposing criminal sanctions although these provisions are also found in various parts of existing Division 1 of the code. These sections have been assembled as Chapter 10 of Division 4 (Provisions Applicable to Corporations Generally). There are two reasons for this arrangement:

(1) The crime sections relate less often than the penalty provisions to the violation of specific substantive sections, thus making it difficult to place a crime section in close proximity to the section or sections imposing related duties or obligations;

(2) The material in these sections is applicable to all corporations and the inclusion of these sections in Division 4 would permit repeal of the comparable sections of the new General Corporation Law.

At its April meeting, the Commission directed the staff to review the sections of the new General Corporation Law relating to crimes to determine whether these sections are superfluous in light of the contents of the Penal Code. The staff has done this, and a discussion of the relationship of each of these sections to the Penal Code is contained in the following analysis of individual sections.

In general, the staff found that it was rarely able to conclude that all of the criminal behavior delineated in a Corporations Code section was clearly proscribed in one or more Penal Code sections. While we did find that Corporations Code crimes were often charged in conjunction with Penal

Code violations, some such cases specifically distinguished the charges and upheld conviction on one and not the other. See, e.g., People v. Blau, 140 Cal. App.2d 193 (1956). The review was made more difficult by the lack of reported cases involving the Corporations Code crimes, which left some uncertainty as to the scope of some of these sections.

In these circumstances, the staff recommends that the crimes sections be continued as set forth in the attached draft.

Analysis of Individual Sections

Penalties

§ 6513. Failure to keep records or submit financial statements

Section 2200 is a duplicate of existing Section 3015. Section 6513 (attached to this memorandum) continues the substance of these sections; it has been rewritten for clarity.

No reported cases have arisen under Section 3015 which would clarify whether the direction in subdivision (c) that the penalty be paid "to the shareholder . . . damaged by the neglect, failure, or refusal" might be construed to require actual damages as a prerequisite to the imposition of the penalty. The use of the word "penalty" and the provision in existing Section 3017 (carried forward in Section 2202 and draft Section 6514) that the penalty is "in addition to any action . . . for damages" militate against such a construction. See Pourroy v. Gardner, 122 Cal. App. 521, 528 (1932) (distinguishing a penalty from a "liability imposed by law," with only the latter requiring actual damages).

At its April meeting, the Commission raised the question of whether this section should provide for prosecution by the District Attorney or Attorney

General and payment of the penalty to the county or state. This scheme is used in Section 2203 and draft Section 14871 (penalty for unauthorized transaction of intrastate business by foreign corporation). Public enforcement of the foreign corporation responsibilities is more appropriate than utilization of such resources under Section 6513; the statutes requiring qualification of foreign corporations are for the benefit of the general public dealing with these bodies while the usual beneficiaries of the record-keeping requirements of Chapter 15 are only the individual members. The staff therefore recommends that the penalty of Section 6513 remain payable to injured members in order to encourage private enforcement of the record-keeping duties.

Note. Section 2201 of the new General Corporation Law, continuing existing Section 3016, imposes a maximum $500 penalty (payable to each aggrieved shareholder) on any corporate officer with the duty to execute stock transfers who fails to perform; the penalty is also applicable to directors or other officers causing such failure. Section 3016 is applicable to nonprofit corporations by virtue of Section 9002 although there are no reported cases involving nonprofit corporations.

It is the general policy of the existing General Nonprofit Corporation Law (Sections 9402, 9600-9611) to allow nonprofit corporations virtually complete freedom in determining membership rights, including matters relating to the transfer and issuance of membership certificates; this plan is continued in this draft (see Sections 5262, 5400-5410). In light of this policy and the infrequency of situations in which memberships will be investment securities whose delay in transfer will cause any injury, the staff has not included in this draft such a section imposing penalties for the neglect or failure to transfer a membership.

§ 6514. Penalty cumulative; remission of penalty

Section 6514 (attached to this memorandum) is the same in substance

as existing Section 3017 which has been placed in Chapter 22 (Section 2202) of the new General Corporation Law.

§ 14610. Procedure upon failure to file statement

Section 14610 (in redrafted Division 4) requires the Secretary of State to mail a notice of delinquency to any nonprofit corporation which fails to file the required statement identifying its directors, officers, and the like, and then to certify the name of such corporation to the Franchise Tax Board upon its failure to file within 60 days of the notice. The Board then assesses a $250 penalty on the corporation.

At its April meeting, the Commission directed the staff to discuss with the office of the Secretary of State the desirability and probable cost of these provisions. We raised both issues with Bill Holden, who was the represenative of the Secretary of State on the drafting committee for the new General Corporation Law. He indicated that the penalty provision had been created because the committee felt that the existing sanction (suspension of corporation powers) for the failure to file was too drastic. The amount of the penalty was selected arbitrarily.

Mr. Holden did not see the cost of running this penalty system as excessive. Corporate names and characteristics are now in the computer memory used by his office for the purpose of sending out statement forms required by Section 3301 (annually to both business and nonprofit corporations). Some cost will be involved in preparing a new program to comply with new Section 2204 (a monthly computer scan to determine which corporations should receive annual statement forms, delinquency notices, or certification to the Franchise Tax Board). He did not know the amount involved in this start-up or the continuing expenses of implementing the system, but it did seem apparent that

little additional cost to the Secretary of State would result from including nonprofit corporations in the system.

§ 14871. Penalty for unauthorized transaction of intrastate business

Section 14871 (in redrafted Division 4) is the same in substance as a portion of Section 2203 of the new General Corporation Law and a portion of former Section 6408.

§ 14872. Disability to maintain action upon intrastate business

Section 14872 (in redrafted Division 4) is the same in substance as Section 2203(c) of the new General Corporation Law and former Section 6801.

§ 14884. Service on unqualified corporation transacting intrastate business

One aspect of Section 2203 of the new General Corporation Law presents a problem. The problem and the staff resolution of the problem is discussed below.

The new General Corporation Law did not resolve one inconsistency that existed under the prior law. Section 2203 of the new law includes the following:

> Any foreign corporation which transacts intrastate business and which does not hold a valid certificate from the Secretary of State . . . , by transacting unauthorized intrastate business, 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.

The above provision is taken from former Corporations Code Section 6408 but omits the portion of Section 6408 which provided that the plaintiff who served the Secretary of State under the section had to provide "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" and requiring that the Secretary of State send a notice of service and copy of the process to the corporation at the address specified in the written statement. We do not know whether the omission of the written-statement requirement was intentional or inadvertent, but there is nothing in Section 2203 to indicate what the Secretary of State does with the process served on the Secretary of State pursuant to Section 2203.

Section 2114, which also continues prior law, provides in part:

> (a) A foreign corporation which has transacted intrastate business and has thereafter withdrawn from business in this state may be served with process in the manner provided in this chapter in any action brought in this state arising out of such business, whether or not it has ever complied with the requirements of this chapter.

The "chapter" referred to includes the requirement that a foreign corporation shall obtain a certificate of qualification from the Secretary of State before engaging in intrastate business in California. Service of process "in the manner provided in this chapter" adopts the general service provisions relating to foreign corporations which require reasonable diligence to serve a corporate officer and the obtaining of a court order authorizing service on the Secretary of State, such court order to indicate the address to which the Secretary of State is to send the notice of service and the copy of the process. Sections 2203 and 2114 overlap insofar as they relate to a corporation which does intrastate business in California without a certificate of qualification. Section 2114 has a gap, however, because it does not cover the corporation that is still doing intrastate business in California. This gap is covered by Section 2203.

The staff has drafted a section to supersede the quoted portion of Section 2203--Section 14684 which is contained in redrafted Division 4. The provision relating to consent to jurisdiction in California has been omitted; Code of Civil Procedure Section 410.10 permits California courts to exercise

jurisdiction "on any basis not inconsistent with the Constitution of this state or of the United States." The Judicial Council Comment to Section 410.10 points out the broad basis of jurisdiction over foreign corporations. We have not reproduced the Comment here, but it is set out at pages 477-483 of West's Annotated California Codes. It is much broader than merely doing business in California. The staff has eliminated the inconsistency between Sections 2203 and 2114 by providing in new Section 14884 a rule that is consistent with Section 2214 (codified as Section 14885 in Division 4). Although there is some overlap in the coverage of new Sections 14884 and 14885, this causes no difficulty since the service of process rule is the same under both sections.

Crimes

§ 1490o. Fraudulent issuance of memberships

Except for the addition of "memberships" to "shares," this section is the same as new Section 2251 and existing Section 1308. There are no reported cases involving prosecution under Section 1308.

While it is possible that Penal Code Sections 182(4)(conspiracy to defraud person of property), 484 (theft, including the fraudulent appropriation of another's property), and 503 (embezzlement) might in combination cover the range of offenses contained in Section 1490o, there are too many questions without answers for certainty. For instance, when is an existing shareholder's property "appropriated" by a later unlawful issue of shares; did such a shareholder "entrust" property to the corporate officer which was then appropriated (embezzled); does the act of "consenting" to the invalid issuance of memberships constitute false pretenses, fraudulent representations, or false reports of "mercantile character"?

Section 25541 of the Corporations Code makes criminal the willful use of a fraudulent scheme or willfully fraudulent conduct "in connection with the offer, purchase, or sale of any security." As the Draftsmen's Commentary indicates, this language is taken from SEC Rule 10b-5 under the Securities Exchange Act of 1934. Existing 10b-5 case law generally requires that the plaintiff be either a buyer or seller of securities. 2 A. Bromberg, Securities Law: Fraud, Sec. 8.8, at 221-223 (1975). This restricts the reach of Section 25541, denying it the same coverage of creditors and existing shareholders provided in Section 1490o.

§ 1490q. Fictitious or fraudulent subscriptions

Section 1490q is the same in substance as Section 2252 and existing Section 1309. There are no reported cases involving prosecution under Section 1309.

Forgery is defined as the signing of the name of another or of a fictitious person, with intent to defraud and without authority, on certain legal instruments,

including a "contract for money or other property." Penal Code § 470. The difference between this definition and the crime set forth in Section 14901 is that forgery requires actual intent to defraud--a significant distinction.

§ 14902. Fraudulent payment or distribution

Section 14902 is the same in substance as new Section 2253 and existing Section 1511 except that those sections cover only "stock corporations." Arguably, this language currently exempts directors of most nonprofit corporations from the coverage of Section 1511. There is no reason, however, why members or creditors of nonprofit corporations should not have the same protection offered by the criminal penalty imposed upon directors as shareholders and creditors of business corporations. There are no reported cases involving criminal prosecution under Section 1511.

To the extent that the forbidder payment or distribution operated to injure a stock or membership purchaser or subscriber, Section 25541 of the Corporations Code would apply to this offense; this would not be the case with regard to existing shareholders, members, or creditors. Any attempt to bring such activity within such Penal Code provisions as theft (Section 484) or fraudulent removal or concealment of property (Sections 154-155) meets the difficulty that the activity proscribed by those sections is actually that of the corporation rather than the individual.

§ 14903. False report or statement; refusal to keep book or post notice

Section 14903 is the same in substance as new Section 2254 and existing Section 3019. There are no reported cases involving criminal prosecutions under Section 3019 (although a handful of pre-1925 cases under a predecessor statute do exist).

Where any of the acts prohibited by this section result in the purchase or sale of securities, Section 25541 of the Corporations Code is adequate

protection. If the false reports or lack of posting or notice results in the transfer of funds or property by a defrauded party, the crime of theft (Section 484) or conspiracy to defraud a person of property (Section 182(4)) under the Penal Code is probably involved. In other instances of activity described by Section 14903 (such as the use of false reports to exaggerate the value of the corporation, its stock, or its property which does not cause anyone to give up property or otherwise act to his detriment), no other criminal statutes are applicable.

§ 14904. Fraudulent records

Section 14904 is the same in substance as new Section 2255 and existing Section 3020. The reported cases indicate that offenses under Section 3020 are generally charged in conjunction with theft and conspiracy counts.

The crime described in subdivision (a) constitutes theft or embezzlement under Penal Code Section 484, depending upon whether the corporation or a third party is the victim. There is no Penal Code analogue to subdivision (b).

§ 14905. Exhibition of false records to public officer

Section 14905 is substantially the same as new Section 2256 and existing Section 3021. Reported prosecutions under Section 3021 have all involved bank officers.

The behavior described in this section may constitute forgery (Penal Code § 470), perjury (Penal Code § 118) if evidence or testimony under oath is involved, or the recording of false documents in a public office (Penal Code § 115). If the false documents or books are utilized in connection with the sale of securities, Section 25541 of the Corporations Code will apply. However, there exists a residue of activity within the scope of Section 2256 which is not covered by these Penal Code and Corporate Securities Act sections.

§ 14906. Unauthorized use of names

Section 14906 is the same in substance as new Section 2257 and existing Section 3022. There are no reported cases of prosecutions under Section 3022.

To the extent that Section 14906 behavior involves actually signing another's name, the crime of forgery has been committed (Penal Code § 470). Forgery may also be involved if the third party's name is "inserted" into a document which contains some other signatures as an "alteration" of a signed instrument. The use of such a fraudulent document to obtain property from another constitutes a form of theft (Penal Code § 484). If the document involved is used to cause the sale of stock of the corporation, a violation of Section 25541 of the Corporations Code will also have occurred. There remains within the scope of Section 14906 and outside the coverage of other criminal sections the unauthorized use of an individual's name in a document relating to an existing or not-yet-formed corporation which does not lead to the purchase or sale of securities or any other transfer of property.

Respectfully submitted,

Peter A. Whitman
Staff Attorney

EXHIBIT I

406/178

§ 6513
Staff Draft May 1976

§ 6513. Failure to keep records or submit financial statements

6513. (a) A nonprofit corporation is subject to penalty as provided in subdivision (b) if it neglects, fails, or refuses to do any of the following:

(1) Keep or cause to be kept or maintained the record of members or books of account required by this division to be kept or maintained.

(2) Prepare or cause to be prepared or submitted the financial statements required by this division to be prepared or submitted.

(b) The penalty shall be twenty-five dollars ($25) for each day that the failure or refusal continues, beginning 30 days after receipt of written request that the duty be performed from one entitled to make the request, up to a maximum of one thousand five hundred dollars ($1,500).

(c) The penalty shall be paid to the member or members jointly making the request for performance of the duty and damaged by the neglect, failure, or refusal if suit therefor is commenced within 90 days after the written request is made; but the maximum daily penalty because of failure to comply with any number of separate requests made on any one day or for the same act shall be two hundred fifty dollars ($250).

Comment. Section 6513 is the same in substance as Section 2200 and former Section 3015. The language of Section 2200 has been modified to substitute "members" for "shareholders."

Cross-Reference:

Sections 6510 (required books and records), 6511 (form of records; where kept), 6520-6525 (annual report), 6526 (members' right to obtain fiscal information), and 14903 (false report or statement; refusal to keep book or post notice).

§ 6514. Penalty cumulative; remission of penalty

6514. (a) The penalty prescribed by Section 6513 is in addition to any remedy by injunction or action for damages or by writ of mandate for the nonperformance of acts and duties enjoined by law upon the nonprofit corporation or its directors or officers.

(b) The court in which an action for the penalty is brought may reduce, remit, or suspend the penalty on such terms and conditions as it may deem reasonable when it is made to appear that the neglect, failure, or refusal was inadvertent or excusable.

Comment. Section 6514 is the same in substance as Section 2202 and former Section 3017.