

10/9/75

Memorandum 75-57

Subject: Study 77.30 - Nonprofit Corporations (Organization--Business Activities)

BACKGROUND

Two and a half years ago, the Commission activated its nonprofit corporations study by retaining as a consultant Mr. G. Gervaise Davis III. A year and a half ago, the Commission, with the assistance of Mr. Davis, reviewed an initial staff draft of a nonprofit corporations statute produced by staff member Rand McQuinn, making preliminary policy determinations and designating areas that require further study.

Since that time, Mr. McQuinn has left the staff. The Legislature has enacted a new general corporation law to become operative January 1, 1977. And until now the staff has not had time to do further work on the nonprofit corporation study.

This is the first of many memoranda dealing with particular facets of nonprofit corporations. This memorandum presents the basic approach the staff will be taking in the drafting of the nonprofit corporation statute and examines the extent to which nonprofit corporations may engage in profit-making activity.

BASIC APPROACH

The prime reason for the Commission's nonprofit corporation study is that the existing nonprofit corporation law is incomplete. It has a few provisions specifically directed to nonprofit corporations (Corp. Code §§ 9000-10703), and for the rest incorporates by reference the business corporation law (Corp. Code §§ 100-6804). This approach leaves it uncertain what aspects of the general corporation law apply to nonprofit corporations and what aspects do not.

The problem is particularly acute with the enactment of the new general corporation law. The new law provides that nonprofit corporations are to be governed by the law in existence prior to adoption of the new statute. This

means that persons dealing with nonprofit corporations will have to look to a repealed body of law that is incorporated by reference to an uncertain extent.

The primary object of the nonprofit corporation statute will thus be to provide a single body of law that will govern nonprofit corporations. The basic approach the staff will employ in drafting the statute is to preserve existing nonprofit corporation law unless a change is clearly indicated. In those areas in which there is no specific nonprofit corporation provision, the staff plans to incorporate bodily language from the new general corporation law, unless the provision is plainly inapplicable or would be inadvisable for nonprofit corporations. For ease of use by corporate attorneys, the staff intends to follow closely the organization of the general corporation law.

## PROFIT-MAKING ACTIVITIES BY NONPROFIT CORPORATIONS

### Introduction

The extent to which nonprofit corporations should be permitted to engage in profit-making activities is one of the most troublesome problems in nonprofit corporation law. This is illustrated in the preface to the Model Non-Profit Corporation Act:

The most difficult decision of policy in drafting the Model Non-Profit Corporation Act is the determination of the purposes for which corporations may be organized under it. A majority of the Committee are of the opinion that the purposes should be limited to those which are not for pecuniary profit. We recognize, however, that even though the primary purposes are so limited, the corporation may, nevertheless, make incidental income or profit in carrying on its primary purposes. Such income or profit may not be for distribution to members, but must be devoted to the primary purposes of the corporation. A substantial minority of the Committee favors broadening the permitted purposes to any purpose not forbidden by law. [Model Non-Profit Corporation Act viii (Revised 1964).]

The remainder of this memorandum is concerned with this problem, which the Commission has requested the staff to study. Attached are draft provisions embodying the staff recommendations contained herein.

### Existing Law

About half the jurisdictions in the United States attempt to control profit-making by nonprofit corporations through limitations on the permissible purposes of incorporation. This so-called "functional" approach typically limits nonprofit corporations to the following general categories of purposes: benevolent and charitable, social, recreational, trade and professional, educational, cultural, civic, religious, and scientific. Note, Permissible Purposes for Nonprofit Corporations, 51 Colum. L. Rev. 889 (1951). However, within these jurisdictions, some profit-making activity is permitted where "incidental" to the main purpose or activity of the nonprofit corporation.

The remaining jurisdictions adopt an "economic" approach that limits the economic relationships between the nonprofit corporation and its members. These jurisdictions typically permit incorporation for any lawful purpose that does not involve profit to the members of the nonprofit corporation. The meaning of the term "profit" is not always clear, however, and some jurisdictions preclude any kind of financial advantage to the members, while others limit only the regular distribution of dividends. See Comment, Nonprofit Corporations--Definition, 17 Vand. L. Rev. 336 (1963).

### California Law

California is one of the most liberal jurisdictions in permitting profit-making activities:

9200. A nonprofit corporation may be formed by three or more persons 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. Carrying on business at a profit as an incident to the main purposes of the corporation and the distribution of assets to members on dissolution are not forbidden to nonprofit corporations, but no corporation formed or existing under this part shall distribute any gains, profits, or dividends to any of its members as such except upon dissolution or winding up.

This section, as interpreted by the cases, is as fully liberal as it seems (and perhaps more so). Until 1971, there were only dicta in several appellate cases indicating that incorporation under Section 9200 for profit-making purposes or purposes that benefited members was permissible so long as there was no direct distribution of dividends. See, e.g., Complete Service Bur. v. San Diego Med. Soc., 43 Cal.2d 201, 272 P.2d 497 (1954)(nonprofit corporation to secure medical services for members at low cost); Maloney v. American I. M. & H. Ass'n, 119 Cal. App.2d 319, 259 P.2d 503 (1953)(nonprofit corporation to render health insurance service); Laurel H. Cemetery Ass'n v. San Francisco, 81 Cal. App.2d 371, 184 P.2d 160 (1947)(nonprofit corporation making a profit on sale of property owned by it).

Then in 1971 came the first and so far the only case directly confronting the issue of whether a nonprofit corporation may engage in profit-making activities--People ex rel. Groman v. Sinai Temple, 20 Cal. App.3d 614, 99 Cal. Rptr. 603 (1971)(hearing denied). A copy of this case is attached as Exhibit I (green), and should be read with care. The case holds not only that Section 9200 permits corporations which ordinarily do not make profits to carry on incidental businesses which do, but also that Section 9200 does not preclude a nonprofit corporation from running a business for profit as one of the main purposes of the corporation. The case also holds that discounts available to the corporation members do not violate the prohibition in Section 9200 against the distribution of profits to the members.

#### Policy Considerations

Whether a nonprofit corporation should be permitted to engage in profit-making activities, or to phrase it another way, whether a corporation whose primary purpose is to engage in business should be permitted to incorporate

under the nonprofit corporation statute, depends upon who, if anyone, will be hurt by it. There are at least five identifiable groups that could be adversely affected by a nonprofit corporation engaging in business: (1) business competitors, (2) business creditors, (3) members of the nonprofit corporation, (4) other nonprofit corporations, and (5) the general public.

(1) Business competitors. That a nonprofit corporation may affect others engaged in the same business is clear; in the Sinai Temple case, for instance, the nonprofit corporation's mortuary conducted in excess of 20 percent of all the funerals conducted by Jewish funeral directors in Los Angeles County, earning substantial profits; in fact, the substance of the complaint in that case was that the nonprofit corporation was operating its cemetery as a profit-making business, competing in the market with other cemeteries.

The critical question here is whether nonprofit status per se confers an unfair competitive advantage. It seems likely that a nonprofit corporation engaged in business may to a certain extent be able to trade on its nonprofit status. The public may be more willing to purchase goods or services from a nonprofit corporation on the assumption that it is in effect helping a charity or otherwise contributing to the public good.

A nonprofit corporation may also be able to capture a share of the market from competitors by selling at lower prices. It may, for example, be an organization that is exempt from state and federal income, franchise, and excise taxes, as well as local property and business taxes and licenses. While the 1969 Tax Reform Act did put an end to the tax exemption of unrelated business income of an otherwise exempt organization, the "related" business income is tax exempt. Thus, in the Sinai Temple case, there is a good possibility that the income is "related," and hence is tax exempt.

There may be other reasons a nonprofit corporation is able to undersell competitors. It may have lower overhead due to donated services and donated property. It may be able to operate at a lower profit margin because it is capitalized by membership dues, donations, and even public funds; it does not need to make a sufficiently high profit to provide an adequate rate of return on invested capital.

(2) Business creditors. Nonprofit corporations may make contracts, borrow money, contract debts, sue and be sued, and the like, regardless whether they are engaged in business. Corp. Code § 9501. Creditors of the corporation may be placed in an unfortunate position if the corporation fails to meet its obligations, however. There are generally no requirements that a nonprofit corporation be adequately capitalized, and the directors are not personally liable for the debts of the corporation. Corp. Code § 9504. Moreover, the nonprofit corporation cannot be forced into involuntary bankruptcy. Bankruptcy Act § 4b.

There is some relief for the creditor in the fact that, if the nonprofit corporation is used as an instrumentality for private business activity by those in control, thereby concealing assets to the injury of third parties, the courts will not recognize the separate corporate entity. Wilson v. Nobell, 119 Cal. App.2d 341, 259 P.2d 720. However, the issue of whether the "alter ego" doctrine may be applied for undercapitalization of a nonprofit corporation has never been considered in California. California Nonprofit Corporations, Tort & Contract Liability § 7.18 (Cal. Cont. Ed. Bar (1969)). It would seem anomalous to disregard the corporate entity for undercapitalization where the nonprofit corporation statute precludes issuance of capital shares.

The creditor of a nonprofit corporation engaged in business faces these problems just as the creditor of a nonprofit corporation not engaged in business.

However, the problems are increased where the corporation is conducting business activities, since there will be more creditors and a greater possibility of corporate insolvency. In fact, the 1931 General Corporation Law authorized the formation of "nonstock" corporations for profit; however, the nonstock corporation for profit was an anomaly since "the only provision for establishing a capital fund (and so for statutory safeguards for creditors) is in connection with the issue of shares"; hence in 1943 the nonstock corporation provisions were repealed. Ballantine & Sterling, California Corporation Laws § 408.01(1) (4th ed. 1975).

(3) Members of the nonprofit corporation. The members of a nonprofit corporation that engages in business could be adversely affected in at least two ways.

First, the members might end up in a corporation that is engaged in activities quite remote from those they thought they were supporting when they joined the corporation. Under California law, this danger is limited since Section 9200 provides that a business may only be carried on "as an incident to the main purposes of the corporation." Otherwise, if the business itself is to be a main purpose, Section 9200 requires that the corporation be formed for that purpose; note that in the Sinai Temple case the corporation amended its articles to make the business one of the main purposes of the corporation.

Second, while the members have no direct investment in the assets of the corporation and expect no regular return, they often pay annual dues and make other investments of time and money and may be entitled to a share in the assets on dissolution, so that in a sense they have a real stake in the corporation's assets and deserve some protection. The protections afforded shareholders in a business corporation, such as voting and meeting requirements and standards of care are not present for members of nonprofit corporations.

(4) Other nonprofit corporations. If business activities are freely permitted to nonprofit corporations, nonprofit status may lose some of its public appeal. This may be to the detriment of those nonprofit corporations which in fact are not business or profit oriented, and which may no longer receive the free and unstinting support of the public.

(5) The general public. The public may be adversely affected by a nonprofit corporation engaging in business. People donate time and money to such entities in the belief that they are not tainted by an acquisitive motive. Local entities often permit them the privilege of canvassing and soliciting donations, gifts, bequests, and contributions. Nonprofit corporations are given numerous tax advantages; however, whether nonprofit corporations that engage in business activities should be afforded the same tax advantages as those that do not is more a question of taxation policy than of corporation law.

#### Discussion

Of the foregoing considerations concerning who might be affected by permitting a nonprofit corporation to engage in business activity (or permitting what is basically a business corporation to incorporate under the nonprofit corporation statute), the staff believes the only serious one is that of protection of the interests of members. To a large extent modern corporation law is concerned with protecting the investment of shareholders and assuring a fair distribution of dividends.

Permitting what is essentially a business operation under the nonprofit corporation statute enables a corporation to avoid these investor protections. Many of the required procedures of the General Corporation Law, for example, are relaxed for nonprofit corporations. Members may vote by other means than at a meeting of the members (Corp. Code § 9402); cumulative voting is optional



(Corp. Code § 9402); an annual meeting is not required (Corp. Code § 9503); unanimous consent for action without a meeting is not required. There are no means of regulating the distribution of profits, no requirement as to the maintenance of a capital fund; the nonprofit corporation may buy back, forfeit, and reduce its memberships without reference to such limitations as may be applicable to the purchase by a corporation organized for profit of its own shares or the reduction of its stated capital. Moreover, a nonprofit corporation may provide for forfeiture of valuable memberships for misconduct without payment of the value of the membership (Corp. Code §§ 9402, 9608); bylaw amendments may be made by the directors or members having voting power without approval of the class of members affected, even though the changes affect their rights, privileges, and liabilities (Corp. Code §§ 9400-9404). There are numerous other differences between business corporation law and nonprofit corporation law which essentially go to the critical distinction of the protection of the interest of the shareholder and his dividend and property rights.

However, nonprofit purposes and business purposes are not always necessarily mutually exclusive. As noted previously, a corporation having purely nonprofit motives will often find it necessary to conduct incidental business activities. Moreover, a business activity conducted by a nonprofit corporation may yield revenues which are applied solely to the basic nonprofit purposes of the corporation. In other words, it is not the conduct of a business per se that is inimical to the concept of a nonprofit corporation, but the conduct of a business with the intent to distribute the profit rather than to apply the profit to the corporation's purposes. A corporation whose purpose is to distribute profits should be governed by the general corporation law, with its protections of invested capital and its regulation of dividend distributions. A corporation whose purpose is one other than the distribution of profits should be permitted to incorporate under the more flexible provisions of the nonprofit corporation law, and to conduct a business in support of its purposes.

The staff believes that it is precisely these considerations that led to the language of present Corporations Code Section 9200--"A nonprofit corporation may be formed . . . for any lawful purposes which do not contemplate the distribution of gains, profits, or dividends to the members thereof. . . ." Note that the section permits the incorporation if it does not contemplate the distribution of profits to members. The Sinai Temple case dwells on this point:

The statute does not expressly prohibit the earning or accumulation of profits by the corporation. Instead, the statute requires that the purposes "do not contemplate the distribution of gains, profits, or dividends to the members." The use of the word "distribution" indicates that the accrual of gains is not thereby prohibited. [20 Cal. App.3d at 619.]

And again:

The introduction of the word "distribution" in the 1931 statute, in place of the phrase formerly used, is a clear indication the the Legislature was concerned not with gains or profits as such, but with their distribution to members.

The staff believes this analysis is correct. It is buttressed by the last sentence of Section 9200, which states "Carrying on business at a profit as an incident to the main purposes of the corporation . . . (is) not forbidden to nonprofit corporations, but no corporation formed or existing under this part shall distribute any gains, profits, or dividends to any of its members as : . . . such..... ."

This analysis is consistent with that of Oleck, Non-Profit Corporations, Organizations, and Associations (3d ed. 1974)[pages 10-13, emphases in original, footnotes omitted]:

A non-profit organization is one that is not used for personal financial enrichment of any of its members or managers, and no portion of the money or property of which is permitted to inure to the benefit of any private individual, except as a proper grant according to its state-approved purpose, or as salaries paid for employee-type services rendered to the organization.

Financial gain accruing to the organization from its operation, however, does not make it a profit or business organization if such gain is devoted to its maintenance or improvement. Profit means gain from a transaction or operation. More precisely, it means the excess of income over expenditure in an enterprise during a given period. In a corporation, the test of whether or not it is non-profit

is whether or not dividends or other pecuniary "divvy-up" benefits are paid to its members.

Therefore, financial gain accruing to an organization does not make it a profit or business organization if that gain is devoted to its ultimate non-profit or charitable purpose.

It is not necessary that profit be eliminated from all the activities of an organization for it to achieve non-profit status. Its practical operation often requires investment of its assets for profit. The incidental acquisition of profits does not destroy its non-profit character if its basic purpose is public benefit, and if its profits are devoted to that purpose.

It follows that non-profit status depends on what is done by an enterprise or organization with its income. If this is distributed to persons active in the enterprise, as gains on their investment of services, money, or property (i.e., as dividends), the purpose is profit. If income is employed solely to further a moral, ethical, altruistic, or cultural purpose, the enterprise qualifies for non-profit status.

#### Limitations on Distribution of Profits

If a nonprofit corporation is to be permitted to conduct a business, the nonprofit corporation statute should be so structured as to assure that any profits that accumulate are not distributed to members. There are three areas where proceeds of operations are commonly withdrawn from the corporation:

(1) through direct distribution of dividends, (2) through salaries of directors and officers, and (3) through distribution of assets on dissolution.

(1) Distributions to members. The critical feature of a nonprofit corporation is that it has no stock and, in the language of the California statute, it does not "distribute any gains, profits, or dividends to any of its members as such." Corp. Code § 9200 (emphasis added). There is a question, however, of what amounts to a distribution of gains, profits, or dividends. Most nonprofit corporations, other than charities, are formed to provide some service or benefit to their members. A nonprofit corporation which engages in a business and devotes the proceeds of the business to corporate purposes may nonetheless come close to distributing the gains to the members where services for members are the corporate purposes.

In the Sinai Temple case, for example, the question arose whether affording corporation members a discount on the price of cemetery plots was a distribution of gains, profits, or dividends to members. The court held it was not a distribution, noting that many nonprofit corporations benefit their members. "The furnishing of benefits to members, without charge or without receiving full cash value in return, is not per se the payment of a dividend, gain or profit by a corporation organized under section 9200." 20 Cal. App.3d at 614.

This is a troublesome distinction, but the staff can offer none better. Other jurisdictions generally fail to make the distinction, although the Model Act provides that a nonprofit corporation "may confer benefits upon its members in conformity with its purposes," and New York and Pennsylvania pick up this same language. See Model Non-Profit Corporation Act § 26, NY NPCL § 515(c), 15 Pa. S. § 7553(c). The staff recommends that similar language be included in the California statute.

(2) Salaries of directors and officers. One area of potential abuse of nonprofit status is withdrawal of funds through payment of excessive salaries. Other jurisdictions have made requirements that compensation for services be reasonable. New York, for example, provides that the corporation may fix the "reasonable compensation" of directors, officers, employees, and other agents, and "such compensation shall be commensurate with services performed." NY NPCL § 202(12). Ohio permits "the payment of reasonable compensation for services rendered," which "shall not be deemed pecuniary profit or distribution of earnings." Ohio Rev. Code § 1702.10(C). Likewise, the Model Act provides that, "A corporation may pay compensation in a reasonable amount to its members, directors, or officers for services rendered" and no such payment "shall be deemed to be a dividend or a distribution of income or profit." Model Non-Profit Corporation Act § 26 (1964 rev.). The staff believes the California statute should contain a similar provision.

(3) Distribution of assets to members on dissolution. One general means of withdrawal of the proceeds of corporate activity is through distribution on dissolution. California recognizes this possibility, as do most other jurisdictions--"No corporation formed or existing under this part shall distribute any gains, profits, or dividends to any of its members as such except upon dissolution or winding up." Corp. Code § 9200. As a general rule, assets of a nonprofit corporation may be distributed to members on dissolution, except where the corporation is a charitable corporation or holds its assets on trust.

Thus, a nonprofit corporation may be able to pursue a profit motive by accumulating profits and then distributing its assets on dissolution. This situation would not normally be attractive to a business oriented corporation for two reasons--the corporation would be unable to make periodic returns to its owners and the corporate duration must be limited. Nonetheless, it is conceivable that a corporation might find it desirable in some tax shelter situations, such as the so-called "collapsible" corporation (designed to convert ordinary income into capital gains), to incorporate under the nonprofit corporation statute.

There are several ways to assure that a nonprofit corporation which engages in business activity does so for motives other than the ultimate distribution of profits on dissolution. One is to require, as present California law does, that the purposes of the nonprofit corporation be indicated precisely in the articles of incorporation, and that the purposes may not contemplate the distribution of profits to members. See Corp. Code §§ 9200 and 9300(b).

Another means of limiting the potential abuse of nonprofit corporation status is to require that any corporate profits be applied to the nonprofit corporation's other lawful purposes. Thus New York provides:

Notwithstanding any other provision of this chapter or any other general law, a corporation of any type or kind to which this chapter applies shall conduct no activities for pecuniary profit or financial gain, whether or not in furtherance of its corporate purposes, except to the extent that such activity supports its other lawful activities then being conducted. [NY NPCL § 204.]

Pennsylvania provides:

A nonprofit corporation whose lawful activities involve among other things the charging of fees or prices for its services or products, shall have the right to receive such income and, in so doing, may make an incidental profit. All such incidental profits shall be applied to the maintenance and operation of lawful activities of the corporation, and in no case shall be divided or distributed in any manner whatsoever among the members, directors, or officers of the corporation. [15 Pa. S. § 7546.]

Another safeguard is to provide the membership with some control over the corporate activities. The staff believes that the minimum that should be done is to permit the members to limit the corporation's business activities in the articles.

Finally, distributions on dissolution can themselves be regulated so as to give members of nonprofit corporations the same protections that are given shareholders in business corporations. This is a matter which the staff has yet to explore, but which we will do in a subsequent memorandum.

Respectfully submitted,

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DIVISION 2. GENERAL NONPROFIT CORPORATION LAW

CHAPTER 1. GENERAL PROVISIONS AND DEFINITIONS

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Text of repealed General Nonprofit Corporation Law (green pages)

DIVISION 2. GENERAL NONPROFIT CORPORATION LAW

CHAPTER 1. GENERAL PROVISIONS AND DEFINITIONS

Article 1. General Provisions

§ 5110. Short title

5110. This division shall be known and may be cited as the General Nonprofit Corporation Law.

Comment. Section 5110 continues former Section 9000. For a comparable provision, see Section 100(a)(General Corporation Law).



Article 2. Definitions§ 5120. Application of definitions

5120. Unless the provision or context otherwise requires, these definitions govern the construction of this division.

Comment. Section 5120 is new. Comparable provisions may be found in Sections 5 (Corporations Code) and 101 (General Corporation Law). Unless otherwise provided in this division, the definitions in the general provisions of the Corporations Code are applicable. See, e.g., Sections 14-18.

§ 5125. Nonprofit corporation

5125. "Nonprofit corporation" means a corporation organized under this division or under any predecessor general or special nonprofit corporation law, or by any act of the Legislature creating a private nonprofit corporation prior to the enactment of a general nonprofit incorporation statute.

Comment. Section 5125 is new. For a comparable definition of "corporation" see Section 162 (General Corporation Law).

Note: The staff has not yet investigated the extent to which the new statute can or should be applied to preexisting nonprofit corporations.

## CHAPTER 2. ORGANIZATION AND BYLAWS

Article 1. Purposes§ 5210. Any lawful purpose other than distribution of dividends

5210. Subject to the laws and regulations applicable to the particular class of nonprofit corporation or line of activity, a nonprofit corporation may be formed for any lawful purposes which do not contemplate the distribution of gains, profits, or dividends to members.

Comment. Section 5210 continues the substance of a portion of the first sentence of former Section 9200. Section 5210 permits incorporation for such purposes as religious, charitable, social, educational, cemetery, or for rendering services, but does not limit incorporation to these purposes. The provision of former Section 9200 that the corporate purposes be ones for which individuals lawfully may associate themselves is not continued; it is unnecessary in light of the general limitation of Section 5210 that the nonprofit corporation be formed only for lawful purposes.

Under Section 5210, a nonprofit corporation may not be formed with the intent to distribute the proceeds of its operations to members, whether periodically or upon dissolution. It should be noted, however, that this restriction does not preclude a nonprofit corporation from operating a business or from making profits thereon. See Section 5235(a) (power to engage in business activity). Any profits must be applied to the lawful corporate purposes (Section 5235(b)) and may not be distributed to members, directors, or officers except to the extent permitted by Section 5237.

The introductory portion of Section 5210 recognizes that there may be limitations on the purposes for which particular types of nonprofit corporations may be formed. See, e.g., Sections \_\_\_\_ (corporations sole), \_\_\_\_ (charitable or eleemosynary corporations).

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Article 2. Formation

Article 3. Powers§ 5235. Power to engage in business activity

5235. (a) Subject to any limitation contained in the articles and to compliance with any other applicable laws, a nonprofit corporation may engage in a business activity.

(b) Any gain or profit that results from the business activity of a nonprofit corporation shall be applied to the specific and primary purposes for which the corporation is formed.

Comment. Section 5235 is new.

Subdivision (a) supersedes the portion of the second sentence of former Section 9200 which provided that "carrying on business at a profit as an incident to the main purposes of the corporation" is not forbidden. Subdivision (a) makes clear that a corporation may carry on a business for profit whether or not the business is "incident" to its main purposes. See People ex rel. Groman v. Sinai Temple, 20 Cal. App.3d 614, 99 Cal. Rptr. 603 (1971). For a comparable provision, see Section 206 (General Corporation Law). One major limitation on the business activity of nonprofit corporations is found in subdivision (b).

Subdivision (b) requires that any gains or profits of the business be applied to the main purposes of the nonprofit corporation. The main purposes are required to be stated in the articles. Section 5240. It should be noted that a nonprofit corporation may not have as a purpose the distribution of gains, profits, or dividends to members. Section 5210. Nor may a nonprofit corporation distribute any such gains, profits, or dividends to members, directors, or officers. Section 5237.

§ 5236. Shares prohibited

5236. A nonprofit corporation shall not have or issue shares as that term is defined in the General Corporation Law.

Comment. Section 5236 is new; it is based on the first sentence of Section 26 of the Model Non-Profit Corporation Act. As used in the General Corporation Law, shares are the units into which the proprietary interests in a corporation are divided. Section 184.

While a nonprofit corporation may not issue shares, it may issue memberships. See Section \_\_\_\_\_. A nonprofit corporation may not distribute gains, profits, or dividends to its members. See Section 5237.

§ 5237. Distributions to members, directors, or officers prohibited

5237. (a) A nonprofit corporation shall not distribute any gains, profits, or dividends as such to members, directors, or officers.

(b) Notwithstanding subdivision (a), a nonprofit corporation may do any of the following, none of which shall be deemed to be a distribution of gains, profits, or dividends:

(1) Pay compensation in a reasonable amount to members, directors, or officers for services rendered, subject to any limitations in the articles or bylaws.

(2) Confer benefits upon members in conformity with the specific and primary purposes for which it is formed.

(3) Make distributions to members upon dissolution or winding up to the extent permitted by this division.

Comment. Section 5213 is new; for a comparable provision, see the last portion of Section 26 of the Model Non-Profit Corporation Act.

Subdivision (a) continues a limitation formerly found in the second sentence of Section 9200, and applies the limitation to directors and officers as well as members. A nonprofit corporation may not be formed for profit-distribution purposes (Section 5210), may not issue shares (Section 5326), nor distribute profits (Section 5327(a)). While subdivision (a) continues the limitation of former law that profits, gains, or dividends may not be distributed "as such," this limitation is subject to the provisions of subdivision (a).

Subdivision (b) lists major areas of withdrawal of corporate proceeds which do not violate the prohibition of subdivision (a). Paragraph (1) is new; compensation for directors and officers may be limited or precluded in the articles or bylaws. Paragraph (2) supersedes the portion of former Section 9200 permitting the formation of a nonprofit corporation for the purpose of rendering services. It makes clear that

a nonprofit corporation may provide benefits to its members without violating the prohibition against distributions of gains, profits, or dividends as such. This codifies case law. People ex rel. Groman v. Sinai Temple, 20 Cal. App.3d 614, 99 Cal. Rptr. 603 (1971)(discount on price of cemetery land to members of nonprofit corporation is proper). Paragraph (3) continues portions of former Section 9200 permitting distributions on dissolution. For limitations on such distributions, see Sections \_\_\_\_ .



Article 4. Articles of Incorporation

§ 5240. Required contents of articles

5240. The articles of incorporation shall set forth:

(a)

(b) The specific and primary purposes for which the nonprofit corporation is formed. This requirement shall not be deemed to preclude an additional statement of general purposes or powers or to restrict the right of the nonprofit corporation to engage in any other lawful activity.

Comment. Section 5240 supersedes former Section 9300.

Subdivision (b) continues subdivision (b) of former Section 9300. Subdivision (b) makes clear that the specific and primary purposes of the nonprofit corporation must always be stated in the articles, but that the articles may also make a statement of general purposes and powers. Contrast the broad general statement of purposes provided in Section 202(b)(General Corporation Law). It should be noted that a nonprofit corporation may be formed for any lawful purposes which do not contemplate the distribution of gains, profits, or dividends to members. Section 5210. For limitations on the purposes of particular types of nonprofit corporations, see Sections \_\_\_\_\_. A nonprofit corporation may engage in business activities in support of the specific and primary purposes for which it is formed. Section 5235.

APPENDIX

Corporations Code § 9000 (repealed)

9000. This part shall be known and may be cited as the General Nonprofit Corporation Law.

Comment. Former Section 9000 is continued in Section 5100.

Corporations Code § 9200 (repealed)

9200. A nonprofit corporation may be formed by three or more persons 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. Carrying on business at a profit as an incident to the main purposes of the corporation and the distribution of assets to members on dissolution are not forbidden to nonprofit corporations, but no corporation formed or existing under this part shall distribute any gains, profits, or dividends to any of its members as such except upon dissolution or winding up.

Comment. The portion of the first sentence of former Section 9200 relating to the purposes for which a nonprofit corporation may be formed is superseded by Section 5210; the portion relating to the number of incorporators is superseded by Section \_\_\_\_ .

The portion of the second sentence of former Section 9200 permitting carrying on business at a profit is superseded by Section 5235; the portion precluding distributions to members of gains, profits, or dividends as such is continued in Section 5237(a); the portion permitting distribution of assets on dissolution or winding up is continued in Section 5237(b).

Corporations Code § 9300 (repealed)

9300. The article of incorporation shall set forth:

(a) The name of the corporation.

(b) The specific and primary purposes for which it is formed.

This requirement shall not be deemed to preclude a statement of general purposes or powers or to restrict the right of the corporation to engage in any other lawful activity.

(c) That the corporation is organized pursuant to the General Nonprofit Corporation Law or pursuant to Part 1 of Division 2 of Title 1 of the Corporations Code.

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

(e) The names and addresses of three or more persons who are to act in the capacity of directors until the selection of their successors. These persons may be given such titles as are deemed appropriate, but they shall be subject to all laws of this state relating to directors except as otherwise provided in this part. The number of persons so named constitutes the number of directors of the corporation, until changed by an amendment to the articles or, unless the articles otherwise provide, by a bylaw adopted by the members. However, the articles or, unless the articles provide otherwise, a bylaw duly 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); and in the event that 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 amendment thereof duly adopted by the members or by the board of directors. In the event the articles provide for an indefinite number of directors, 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.

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

Comment. Subdivision (b) of former Section 9300 is continued in Section 5240(b).