

Memorandum 76-10

Subject: Study 77.200 - Nonprofit Corporations (Winding Up and Dissolution--
Distribution of Assets)

BACKGROUND

A nonprofit corporation is precluded from making periodic dividend distributions. Nonetheless, it may accumulate assets and on dissolution, after satisfying all obligations, distribute the remaining assets to members. Corporations Code Section 9200 provides that "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 memorandum discusses the law regulating distributions to members on dissolution and the important limitations on disposition of assets of charitable corporations. The staff recommends generally continuance of existing law with a few minor changes. Draft sections are attached.

EXISTING LAW

General Scheme of the Law

As a general rule, California law, like that of other jurisdictions, permits a nonprofit corporation to dissolve and distribute assets to members just as business corporations do. See Section 9800:

9800. A nonprofit corporation may dispose of all or substantially all of its assets, or may be wound up or dissolved, or both, in the same manner and with the same effect as a stock corporation, under the General Corporation Law, subject to the provisions of Section 9801.

However, Section 9801 limits the right of a nonprofit corporation to distribute its assets to members where the corporation holds its assets on any trust, or is organized for a charitable purpose or purposes:

If the corporation holds its assets on trust, or is organized for a charitable purpose or purposes, the assets shall be disposed of in such manner as may be directed by decree of the superior

court of the county in which the corporation has its principal office, upon petition therefor by the Attorney General or any person concerned in the liquidation, in proceedings to which the Attorney General is a party.

While the statute subjects disposal of such assets to court supervision, it provides no express standards for disposal. The appellate courts have announced that the doctrine of cy pres applies in such situations. See, e.g., In re Veterans' Industries, Inc., 8 Cal. App.3d 902, 88 Cal. Rptr. 303 (1970):

A proceeding under section 9801 like the one presented here calls for an application of the equitable doctrine of cy pres. A charitable corporation is being wound up and dissolved and its assets held upon a charitable trust are to be transferred to another corporation, organization, society, or trust so that the original trust purposes can be carried out if that is possible. [8 Cal. App.3d at 917-918 (footnote omitted).]

Corporations sole are governed by a special provision, similar to those governing charitable corporations, which precludes distribution of assets to members. Section 10015 provides:

10015. After the debts and obligations of the corporation are paid or adequately provided for, any assets remaining shall be transferred to the religious organization governed by the corporation sole, or to trustees in its behalf, or disposed of as may be decreed by the superior court of the county in which the dissolved corporation had its principal office upon petition therefor by the Attorney General or any person connected with the organization.

Definition of Charitable Corporation

The nonprofit corporation law, permitting distribution of assets to members unless held on trust or for charitable purposes, presents real problems of interpretation. The policy of the law is to protect the public interest and reliance, particularly where tax exemptions, donations, or other publicly conferred benefits have been involved. However, a nonprofit corporation may have mixed purposes; it may not be easy to characterize it as either public or private in nature. This has been a continuing source of litigation:

Abalian v. Townsend Social Center, 112 Cal. App.2d 441, 246 P.2d 965 (1952) involved an attempted distribution of assets amounting to \$30,000 among 200 remaining members. The court held that it was "a nonprofit corporation for the benefit of members. There is nothing to indicate that the situation at hand involves anything in the nature of a public trust."

In re Los Angeles County Pioneer Society, 40 Cal.2d 852, 257 P.2d 1 (1953) involved an attempted distribution of \$100,000 in assets among 50 remaining members. The court held that the assets of the corporation were a public trust and that "it has abused and abandoned its trust." A vigorous dissent stated "It seems quite apparent that Pioneer was a nonprofit organization existing for the private benefit of its members who should, upon dissolution, receive a distributive share of the assets held by Pioneer."

Lynch v. Spilman, 67 Cal.2d 251, 62 Cal. Rptr. 12, 431 P.2d 636 (1967) involved the attempted distribution of assets worth \$300,000 among the remaining 5 members of the nonprofit corporation. The court held that the case presented a triable issue of fact whether the corporate assets were held upon a charitable trust.

In the view of the Charitable Trust Division of the Attorney General's office, there are very few nonprofit corporations that are purely membership corporations and, hence, that may freely dispose of assets on dissolution. As soon as an organization goes beyond service to its particular members--which must also be a fairly limited class--it becomes charitable in the eyes of the Attorney General. A large organization with a vague purpose or purposes is a charity. Under this same line of reasoning, the Charitable Trust Division views a nonprofit clinic of doctors as a charity within its jurisdiction.

Application of Cy Pres Doctrine

Once it has been determined that a nonprofit corporation may not distribute assets to its members, the question remains to whom it may distribute them. Generally, the courts have taken a very restrictive view in applying the cy pres doctrine:

By definition, in applying cy pres the court should order a distribution which will carry out the original trust purposes as nearly as possible. It will not do to make a distribution to a charity whose purposes are generally similar if there is another charity whose purposes are identical, absent other factors which would frustrate the original charitable purpose. [In re Veterans' Industries, Inc., 8 Cal. App.3d 902, 918-919, 88 Cal. Rptr. 303 (1970).]

See also Metropolitan Baptist Church of Richmond, Inc. v. Younger, 48 Cal. App.3d 850, 121 Cal. Rptr. 899 (1975).

DISCUSSION

The existing California law embodies roughly the following policy: A corporation organized primarily for the benefit of its own members may endow the members with a property interest in the corporation, while a corporation organized to serve the public interest or that has invited public reliance may not do so. This is a fairly common policy in the law. It can be found, for example, in the tax laws and the corporate security regulations relating to nonprofit corporations.

Tax laws

Both Internal Revenue Code Section 501(c)(3) and Revenue and Taxation Code Section 23701d require that a nonprofit corporation be organized exclusively for purposes which do not include distribution to members on dissolution in order to receive an income tax exemption. Treasury Regulation Section 1.501(c)(3)-1(b)(4) provides that an organization does not qualify for an exemption "if its articles or the law of the state in which it was created provide that its assets would, upon dissolution, be distributed to its members or shareholders." Likewise, Revenue and Taxation Code Section 23701d requires that corporate assets must be irrevocably dedicated to exempt purposes:

Assets shall be deemed irrevocably dedicated to exempt purposes if the articles of organization provide that upon dissolution

the assets will be distributed to an organization which is exempt under this section or Section 501(c)(3) of the Internal Revenue Code or to the federal government, or to a state or local government for public purposes; or by a provision in the articles of organization, satisfactory to the Franchise Tax Board, that the property will be distributed in trust for exempt purposes; or by establishing that the assets are irrevocably dedicated to exempt purposes by operation of law.

Corporate Securities Law of 1968

Similarly, the Corporate Securities Law of 1968 provides that memberships in nonprofit corporations are "securities." Corp. Code § 25019. The rationale for this provision is that issuance of memberships confers a proprietary right on the holder. "A proprietary right may be defined as a right to the ownership of assets or earnings of an organization or the right to control of such organization." California Corp. Comm'r, Release, 15-C (May 15, 1970).

The Corporate Securities Law also exempts memberships of certain nonprofit corporations from the qualification requirements where the corporations are not organized for pecuniary profit and no part of their net earnings inures to the benefit of members. Corp. Code § 25100(j). Whether a nonprofit corporation is organized for pecuniary profit depends in part on whether its members may share in its assets on dissolution. The Commissioner of Corporations has stated that the mere right to participate in the assets does not necessarily remove the exempt status of a nonprofit corporation:

A nonprofit corporation is not organized for pecuniary profit, unless it appears that at the time of its formation, the organizers intended to confer profits upon the members by increasing the assets or the value of the assets of the corporation and distributing the increment to the members in a liquidation. In the absence of evidence to this effect, a nonprofit corporation is not disqualified from the exemption by reason of the fact that its articles or bylaws grant distributive rights to members upon liquidation either expressly or by being silent as to such rights. [Release 15-C.]

Staff Critique

The staff believes that, generally speaking, the existing law regulating distributions to members on dissolution is sound. A purely private corporation should be able to dispose of its assets as it sees fit, subject to tax and corporate securities regulations, provided the rights and interests of members are not violated. Since the nonprofit corporation law incorporates the provisions and procedures of the business corporation law on this point, the investment of members should be adequately protected. In this connection, the staff believes that the statute should make clear that the distributive rights of members are equal unless the articles expressly provide otherwise.

The staff has toyed with the idea of removing the corporate securities law exemption from any nonprofit corporation which permits the distribution of assets to members on dissolution; the staff believes that such an approach, however, would impose unnecessary expenses with little corresponding benefit except in a very few cases.

While the staff is not convinced that the "charitable trust or purposes" test of existing law is adequate, the staff recommends against any change or attempts at further codification. There is now a substantial body of case law interpreting that language which should be preserved. Each situation must be reviewed on its facts under that law with the Attorney General representing the public interest. The staff does, however, suggest that the Attorney General be notified of the impending dissolution of any nonprofit corporation. This corresponds with a suggestion the Attorney General has previously made to the Commission. It will enable the Attorney General to assure proper disposition of assets held by charitable corporations. In this connection, the staff recommends that the cy pres requirement be made explicit by statute.

The provisions for disposition of assets of a corporation sole, the staff recommends be left untouched for the time being. Later in the study, we will determine whether to continue the corporation sole provisions as a unit or to integrate them with the General Nonprofit Corporation Law.

Respectfully submitted,

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§ 5241. Permitted contents of articles

5241. The articles of incorporation may set forth any desired provision for the regulation of the affairs of the nonprofit corporation in a manner not in conflict with law, including any restrictions authorized by Chapter 9 (commencing with Section 5910) upon the power to amend the articles of incorporation.

Comment. Section 5241 continues former Section 9303. For a comparable provision, see Section 204(d) (General Corporation Law).

Section 5241 is broadly drawn to allow, for example, any provision which is required or permitted to be stated in the bylaws. See, e.g., (former Sections 9301 and 9302--permissible provisions in articles or bylaws).

The pattern of the General Nonprofit Corporation Law is to specify rules regulating the affairs of nonprofit corporations absent contrary provisions in the articles or bylaws. It should be noted, however, that some of these rules may be varied only in the articles. See, e.g., Section 7032 (general rule of distribution of assets equally among members may be varied in articles). Moreover, some of these rules may not be varied at all. See, e.g., Section 5236 (distributions to members prohibited).

CHAPTER 20. GENERAL PROVISIONS RELATING TO DISSOLUTION

Article 1. Winding Up§ 7011. Notice to Attorney General

7011. Upon commencement of involuntary or voluntary proceedings for winding up a nonprofit corporation, the board shall give written notice thereof to the Attorney General. The notice shall contain such information as is specified in rules established by the Attorney General.

Comment. Section 7011 is new. It is designed to facilitate performance of the Attorney General's supervisory duties over assets held on trust or by a charitable corporation. See Section 7034 (disposition of assets held on trust or by charitable corporation).

Involuntary proceedings are commenced when the court order for winding up is entered. Section [1805]. Voluntary proceedings are commenced upon adoption of the resolution of members or directors electing to wind up or upon the filing of a written consent of members thereto. Section [1903].

Note. The staff has not yet drafted provisions relating to commencement of dissolution proceedings.

Article 3. Distribution of Assets

§ 7030. When distribution may be made

7030. (a) After determining that all the known debts and liabilities of a nonprofit corporation in the process of winding up have been paid or adequately provided for, the board shall distribute all the remaining corporate assets in the manner provided in this article.

(b) If the winding up is by court proceeding or subject to court supervision, the distribution shall not be made until after the expiration of any period for the presentation of claims which has been prescribed by order of the court.

Comment. Subdivision (a) of Section 7030 continues the portion of the first paragraph of former Section 9801 that related to payment or adequate provision for debts and obligations of the nonprofit corporation. For a comparable provision, see Section 2004 (General Corporation Law). Payment of a debt or liability has been adequately provided for if the conditions of Section 7031 are satisfied.

Subdivision (b) is comparable to the second sentence of Section 2004 (General Corporation Law).

Distribution of assets of a nonprofit corporation on dissolution may be made only after the requirements of Section 7030 are satisfied. Distribution of assets generally is provided for in Section 7032 (distribution among members or in accordance with articles). There are special rules for assets held on condition requiring return (Section 7033), assets held on trust or by a charitable corporation (Section 7034), and assets held by a subordinate body (Section 20005).

Note. The staff has not yet reviewed the need for subdivision (b).

§ 7031. Adequate provision for payment of debts and liabilities

7031. (a) The payment of a debt or liability, whether the whereabouts of the creditor is known or unknown, has been adequately provided for if the payment has been provided for by either of the following means:

(a) Payment thereof has been assumed or guaranteed in good faith by one or more financially responsible persons or by the United States government or any agency thereof, and the provision (including the financial responsibility of such persons) was determined in good faith and with reasonable care by the board to be adequate at the time of any distribution of the assets by the board pursuant to this article.

(2) The amount of the debt or liability has been deposited as provided in Section 7036.

(b) This section does not prescribe the exclusive means of making adequate provision for debts and liabilities.

Comment. Section 7031 continues provisions applicable to nonprofit corporations by former Section 5001 through former Section 9800. It is comparable to Section 2005 (General Corporation Law). "Financially responsible persons" includes financially responsible corporations. See Section 18 ("person" includes "corporation").

§ 7032. Distribution among members or in accordance with articles

7032. Unless otherwise provided in this article:

(a) Assets held by a nonprofit corporation shall be distributed among the members in accordance with their respective rights therein or in such other manner as may be provided in the articles.

(b) Absent a provision in the articles for distribution of assets on dissolution or winding up, assets held by a nonprofit corporation shall be distributed among the members equally.

Comment. Section 7032 supersedes a portion of former Section 9801. Section 7032 governs distribution of the remaining assets of a nonprofit corporation on dissolution unless the assets fall within the terms of Section 7033 (return of assets held on condition), 7034 (disposition of assets held on trust or by charitable corporation), or 20005 (delivery of assets held by subordinate body).

Subdivision (a) continues without change the substance of that portion of the first paragraph of former Section 9801 that related to distribution of assets to members or as otherwise provided in the articles. For a comparable provision, see Section 2004 (General Corporation Law)(distribution of remaining corporate assets among shareholders according to their respective rights and preferences).

Subdivision (b) is new. The articles may, but need not, make provision for distribution of assets on dissolution. See Section 5241 (permitted contents of articles).

It should be noted that, if assets of a nonprofit corporation are distributable to members on dissolution, the nonprofit corporation will not qualify for income tax exemption under Revenue and Taxation Code Section 23701d or Internal Revenue Code Section 501(c)(3). Moreover, the memberships will be "securities" within the meaning of the Corporate Securities Law of 1968 and may not be exempt from the qualification requirements of that law. See Sections 25019 and 25100(j); see also California Corporations Commissioner, Release 15-C (May 15, 1970).

§ 7033. Return of assets held on condition

7033. Assets held by a nonprofit corporation upon condition requiring return, transfer, or conveyance, which condition occurs by reason of the dissolution, shall be returned, transferred, or conveyed in accordance with such requirements.

Comment. Section 7033 is new. It is comparable to Section 46 of the ALI-ABA Model Nonprofit Corporation Act. Section 7033 is consistent with the common law in California. See In re Los Angeles County Pioneer Society, 40 Cal.2d 852, 866, 257 P.2d 1, 9 (1953), cert. denied, 346 U.S. 883 (1953).

§ 7034. Disposition of assets held on trust or by charitable corporation

7034. (a) Assets held by a nonprofit corporation on trust or by a nonprofit corporation organized for charitable purposes shall be distributed to one or more nonprofit corporations in conformity with the doctrine of cy pres.

(b) Upon petition therefor by the Attorney General or any person concerned in the dissolution, the disposition required in subdivision (a) shall be made by decree of the superior court of the county in which the nonprofit corporation has its principal office in proceedings to which the Attorney General is a party.

Comment. Section 7034 continues the substance of the second paragraph of former Section 9801. The disposition of assets provided in Section 7034 applies only where the assets are not held on condition requiring return. See Section 7033.

Subdivision (a) applies both to assets received on express trust and to assets received by a charitable corporation whether or not on trust. A nonprofit corporation organized exclusively for charitable purposes holds its assets in trust for the purposes enumerated in its articles of incorporation even though they were not otherwise expressly earmarked for charitable trust purposes when acquired by the corporation. See, e.g., Pacific Home v. County of Los Angeles, 41 Cal.2d 844, 257 P.2d 1 (1953). Whether a nonprofit corporation is deemed to be a charitable corporation for the purposes of subdivision (a) is a question of fact to be determined by reference not only to its articles of incorporation but also to the manner of conducting its activities. See, e.g., Lynch v. Spilman, 67 Cal.2d 251, 62 Cal. Rptr. 12, 431 P.2d 636 (1967); In re Los Angeles County Pioneer Society, 40 Cal.2d 852, 257 P.2d 1, cert. denied, 346 U.S. 888 (1953). Charitable purposes are not defined by statute but left to judicial development.

Subdivision (a) also makes clear that the doctrine of cy pres is to be applied to dispositions governed by Section 7034. Former Section 9801 was silent as to this point, but case law required application of the cy pres doctrine. See, e.g., In re Veterans' Industries, Inc., 3 Cal. App.3d 902, 88 Cal. Rptr. 303 (1970); Metropolitan Baptist Church of Richmond, Inc. v. Younger, 48 Cal. App.3d 850, 121 Cal. Rptr. 899 (1975).

Subdivision (b) requires a court decree of distribution under Section 7034 only upon petition therefor by the Attorney General or an interested party. The Attorney General receives notice of the corporate dissolution pursuant to Section 7011 and may intervene pursuant to subdivision (b). It should be noted that, while the Attorney General may consent to a proposed distribution by a nonprofit corporation or recommend others for consideration by the court, neither such consents nor recommendations by the Attorney General are binding upon the court upon whom the ultimate responsibility for the proper application of cy pres rests. In re Veterans' Industries, Inc., supra.

Note. The question whether foreign nonprofit corporations or organizations should be permitted to receive assets under this section is reserved for future consideration in connection with foreign nonprofit corporations generally.

The question whether provisions governing corporations sole should be integrated with this section is deferred.

§ 7035. Manner of distribution among members

7035. (a) Unless the articles otherwise provide, distribution of assets among members may be made either in money or in property or securities and either in installments from time to time or as a whole, if this can be done fairly and ratably and in conformity with the rights of the members.

(b) Distribution of assets among members shall be made as soon as reasonably consistent with the beneficial liquidation of corporate assets.

Comment. Section 7035 continues provisions applicable to nonprofit corporations by former Sections 5002 and 5003 through former Section 2800. It is comparable to Section 2006 (General Corporation Law). Section 7035 applies only to distributions among members where there are no contrary requirements in the articles. Where the articles provide otherwise, or require some other disposition of assets, or where some other disposition of the assets is required by the provisions of this article, the distribution is not made pursuant to Section 7035 but is made in such manner as may be appropriate under the circumstances of the case.

§ 7036. Deposit of distribution to members

7036. (a) If any members or creditors are unknown or fail to accept their payment or distribution or their whereabouts cannot be ascertained after diligent inquiry, or the existence or amount of a claim of a creditor or member is contingent, contested, or not determined, or if the ownership of any membership is in dispute, the nonprofit corporation may deposit any such payment or distribution or the maximum amount of such claim with the State Treasurer or with a bank or trust company in this state in trust for the benefit of those lawfully entitled thereto. Such payment or distribution shall be paid over by the depositary to the lawful owners, their representatives, or assigns upon satisfactory proof of title.

(b) For the purpose of providing for the transmittal, receipt, accounting for, claiming, management, and investment of all distributions deposited in the State Treasury under the provisions of subdivision (a), such distribution shall be deemed to be paid or delivered for deposit in the State Treasury under the provisions of Chapter 7 (commencing with Section 1500) of Title 10 of Part 3 of the Code of Civil Procedure and may be recovered in the manner prescribed therein.

Comment. Section 7036 is comparable to Section 2008 (General Corporation Law). Subdivision (a) continues provisions applicable to nonprofit corporations by former Sections 5009 and 5010 through former Section 9800. Subdivision (b) continues provisions applicable to nonprofit corporations by former Section 5011 through former Section 9800.

§ 7037. Recovery of improper distribution to members

7037. (a) Whenever in the process of winding up a nonprofit corporation any distribution of assets has been made, otherwise than under an order of court, without prior payment or adequate provision for payment of any of the debts and liabilities of the nonprofit corporation, any amount so improperly distributed to any member may be recovered by the nonprofit corporation. Any of such members may be joined as defendants in the same action or brought in on the motion of any other defendant.

(b) Suit may be brought in the name of the nonprofit corporation to enforce the liability under subdivision (a) against any or all members receiving the distribution by any one or more creditors of the nonprofit corporation, whether or not they have reduced their claims to judgment.

(c) Members who satisfy any liability under this section shall have the right of ratable contribution from other members similarly liable. Any member who has been compelled to return to the nonprofit corporation more than the member's ratable share of the amount needed to pay the debts and liabilities of the nonprofit corporation may require that the nonprofit corporation recover from any or all of the other members such proportion of the amounts received by them upon the improper distribution as to give contribution to those held liable under this section and make the distribution of assets fair and ratable, according to the respective rights of the members, after payment or adequate provision for payment of all the debts and liabilities of the nonprofit corporation.

(d) As used in this section, "process of winding up" includes proceedings under Chapters 18 and 19 and also any other distribution of assets to members made in contemplation of termination or abandonment of the corporate activities.

Comment. Section 7037 continues provisions applicable to nonprofit corporations by former Section 5012 through former Section 9800. Section 7037 is comparable to Section 2009 (General Corporation Law). Although a nonprofit corporation may make distributions to persons or groups other than members (see Sections 7032-7034), Section 7037 is limited to recovery of distributions made to members. The directors may be liable for improper distributions to members or other distributees pursuant to Section [316]. For the obligation to pay or adequately provide for debts and liabilities, prior to distribution, see Section 7030. Adequate provision for debts and liabilities is defined in Section 7031.

Note. The staff has not yet drafted provisions relating to the liability of directors.

APPENDIXCorporations Code § 9303 (repealed)

9303. The articles of incorporation may state any desired provision for the regulation of the affairs of the corporation in a manner not in conflict with law, including any restrictions authorized by Article 2, Chapter 1, Part 8, Division 1, Title 1 of this code upon the power to amend the articles of incorporation.

Comment. Former Section 9303 is continued in Section 5241.

CHAPTER 6. WINDING UP AND DISSOLUTION

Corporations Code § 9800 (repealed)

9800. A nonprofit corporation may dispose of all or substantially all of its assets, or may be wound up or dissolved, or both, in the same manner and with the same effect as a stock corporation, under the General Corporation Law, subject to the provisions of Section 9801.

Comment. Section 9800 is superseded by Chapters 10 (commencing with Section 6010)(sales of assets), 18 (commencing with Section 6810)(involuntary dissolution), 19 (commencing with Section 6910)(voluntary dissolution), and 20 (commencing with Section 7010)(general provisions relating to dissolution) of Division 2.

Corporations Code § 9801 (repealed)

9801. Upon the dissolution or winding up of a nonprofit corporation, after paying or adequately providing for the debts and obligations of the corporation, the directors or persons in charge of the liquidation shall divide any remaining assets among the members in accordance with their respective rights therein, or dispose of them in such other manner as may be provided in the articles, unless the corporation holds its assets on any trust or is organized for a charitable purpose or purposes.

If the corporation holds its assets on trust, or is organized for a charitable purpose or purposes, the assets shall be disposed of in such manner as may be directed by decree of the superior court of the county in which the corporation has its principal office, upon petition therefor by the Attorney General or any person concerned in the liquidation, in proceedings to which the Attorney General is a party.

This section does not apply where the charter of an incorporated subordinate body is surrendered to, taken away, or revoked by the head or national body.

Comment. The portion of the first paragraph of former Section 9801 that related to payment or adequate provision for debts and obligations is continued in Section 7030. The portion of the first paragraph that related to distribution of assets to members or as otherwise provided in the articles is continued in Section 7032.

The second paragraph of former Section 9801 is continued in Section 7034. The last paragraph of former Section 9801 is continued in Section 20005.

Corporations Code § 9802 (repealed)

9802. Whenever the charter of a subordinate body incorporated pursuant to this part is surrendered to, taken away, or revoked by the head or national body granting it, the subordinate body shall dissolve. The subordinate body shall pay its debts and obligations or make adequate provision therefor. The subordinate body may collect obligations owed to it and may sell property which is not designed for the exclusive use of the organization. The subordinate body shall then deliver any remaining property or obligations owed to it and any remaining proceeds of the sale of property to the head or national body, to be disposed of in accordance with the laws of the head or national body.

Comment. Former Section 9802 is continued in Section 20005.