#77.400 10/7/76

Memorandum 76-91

Subject: Study 77.400 - Nonprofit Corporations (Division 4--Review of Comments)

In this memorandum, we review the comments concerning Division 4 - Provisions Applicable to Corporations Generally. The text of this division is found at the beginning of Part II of the tentative recommendation. The comments are taken up in order of the sections to which they relate.

References to Division 4 in Divisions 1 and 2

Exhibit XXXXIX points out that the nonprofit law will not have all the provisions relating to nonprofit corporations. Some of the provisions will be compiled in Division 4. (And some will be found in other codes.)

The writer suggests that it might be desirable to include in Division 1 and Division 2 a code section which would say in effect that the law pertaining to the following topics is contained in Division 4 which applies to all corporations, and then list the major topics that are contained in Division 4, such as corporate name, filing of instruments, service of process, and the like. "This would lead the unsophisticated members of the general public who are attempting to operate a non-profit women's club, for example, to know that they should look to some other provision of the law concerning certain subjects."

One problem is that some of the provisions of Division 4 are limited by their terms to corporations not formed under California law. For example, the transacting intrastate provisions do not apply to domestic corporations formed under Division 2. There are other general statutes relating to nonprofit corporations, such as the Uniform Supervision of Trustees for Charitable Purposes Act, that are found in other codes. Likewise, special provisions applicable to particular types of nonprofit corporations are found in other codes. Accordingly, the suggested addition would be misleading and incomplete. See, in this connection, Section 5000(b) of the proposed draft (reference to Division 2 includes Division 4).

§ 14405. Transact intrastate business (pages 423-425)

Paragraph (9) has been added to subdivision (c) of Section 14405 which lists the activities that do not constitute transacting intrastate business:

> (9) Granting funds by a nonprofit corporation.

The question is presented whether this addition creates an inference that a similar activity by a business corporation would constitute transacting intrastate business. Rather than change paragraph (9), which comes from New York and Pennsylvania law, the staff suggests that an additional paragraph be added to subdivision (c)(taken with some revision from Section 207(e) of the Business Corporation Law) to read:

> (10) Making donations for the public welfare or for community fund, hospital, educational, scientific, civic, or other charitable purposes.

Please compare the proposed language with the language of Section 207.

§ 14450. Scope of division

Exhibit XXXXIX comments concerning this section:

> Another problem exists in your proposed Section 14450 of Part II (and perhaps the same type of language occurs elsewhere). I refer to language such as "The provisions of this division apply to every corporation, profit or nonprofit, stock or nonstock, now existing or hereafter formed unless:
>
> . . .
>
> (b) There is a special provision applicable to the corporation inconsistent with some provision of this division, in which case the special provision prevails."
>
> There is considerable difference between the saying "A general provision applies unless a special provision exists" and saying "A general provision prevails unless a special provision is inconsistent with the general provision." Inconsistency lies in the eyes of the beholder, and it is this type of language which leads to litigation and a requirement that a court determine whether inconsistency exists or not. A legislative enactment should be clear on its face and not invite litigation over its meaning.

There is some merit to the point made. However, subdivision (b) continues the prior language of former Section 119. The staff believes that there would be more risk and uncertainty created by deleting the word "inconsistent." The answer to the problem is to go through all the

special corporation statutes and eliminate any provisions that are not intended to prevail over those in Division 4 or to otherwise resolve any uncertainty. We do not believe any uncertainty exists insofar as the new General Corporation Law or the Nonprofit Corporation Law are concerned. Someone, over a period of years, will have to conform the various special corporation statutes to the new General Corporation Law and, at that time, any provisions that overlap or duplicate provisions in Division 4 can be conformed. For the time being, Division 4 retains the exact state of the prior law under the former General Corporation Law.

§§ 14462 and 14463 (not in draft - proposed to be added)

Sections 6600 and 6602 of the old General Corporation Law were provisions that specified the evidentiary effect of certain documents and provided for judicial notice of certain official acts concerning foreign corporations. The substance of these sections was not continued in the new General Corporation Law. No reason for their omission is apparent. See letter attached as Exhibit I. The staff suggests that two new sections be added to Division 4, to read as set out in Exhibit II attached.

§ 14490. Enforcement of certain statutory provisions by Attorney General

Professor Oleck (Exhibit III) is concerned about the provisions relating to crimes and enforcement. With respect to Section 14490 (and also Section 14491), he states:

> In §§ 14490 et seq. the Attorney General is given permission to (i.e., "may") get into legal actions against malefactors in nonprofit corporations. No expectation of real action is likely, except in politically advantageous or notoriously vicious situations--as long has been the reality as to attorney general work in this country. Why not make the law require action in proper cases? And why not make the Secretary of State's "Corporation Division" do the job it should do, by requiring that office to bird-dog abuses of corporate status; and the Tax Office too perhaps!

The staff believes that, in this regard, Professor Oleck's experience in other states is not necessarily relevant to California. There appears to be no support here for moving the enforcement duties from the Department of Justice to the Secretary of State. We believe it

would be undesirable to change the "may" to "shall" in Sections 14490 and 14491. The Attorney General needs some discretion on the extent to which he will act on complaints.

§ 14510. Name which tends to deceive

Expansion of scope of prohibition. The Commission has expanded the former law which merely restricted the name that a corporation could use in its articles. This was accomplished by adding "or use" in Section 14510 and other sections. Our consultant, Mr. Whitman, points out:

> The manner in which this section has been rearranged (from new § 201 and old § 310) makes it appear that a corporation is forbidden from using a name, perhaps as a fictitious name in conducting a portion of its business, in addition to the prohibition on adopting the name in its Articles. I don't think this is what the predecessors of this Section stated, nor what is proper for the Corporations Code to consider. It seems to me that what is forbidden is only the use of such a name as the formal name of the corporation, and that this Section should be restructured to make that clear.

We think there is merit to this point. There is no need to expand the scope of the section to deal with the situation where the corporation is using a fictitious business name. If another corporation claims that use of a fictitious business name by another corporation violates the right of the corporation in its corporate name, civil litigation is the remedy, and the revision of the Corporations Code provisions will not assist in the resolution of the dispute.

Use of name of national body. Exhibit XX points up a problem that exists when a corporation seeks to file articles of incorporation that have a name similar to a national organization engaged in a similar activity. The writer states:

> 14. In connection with the permissible corporate name, I think that where the organization is, or impliedly is, a chapter or subsidiary of a national body, such as fraternities or lodges or a local chapter of a heart association, cancer society, etc., that the Articles of Incorporation must be filed by a member of the national body or with the consent of the national body, and further that any use of the name is with the consent of the national body. I think there could be well meaning and unintentional efforts to file Articles which contain a name similar to a national body in order to show some similarity of purpose. A deliberate matter can be done to assist in fund raising efforts.

It would be difficult for the Secretary of State to determine whether the name is permissible under the provisions proposed by the writer. It is not a case of checking names of corporations already on file; it would require reference to other sources to determine the names of national bodies. The staff believes that there is adequate authority in the statute--Section 14512(a)("A name which is likely to mislead the public.")--to cover the situation. However, we think that an addition to Section 5212 (incorporation of subordinate body) might be desirable. We suggest that the following sentence be added at the end of subdivision (b) of that section:

> In addition to the requirements of Section 5211, there shall be attached to the articles a statement signed by an officer of the head or national body that the head or national body has instituted or created the subordinate body which is being incorporated and has consented to the incorporation of the subordinate body.

Use of name of suspended corporation. Exhibit XV is a thoughtful response which presents a problem deserving of Commission consideration:

> 14510. Present law provides that the name of a suspended corporation becomes immediately available for use by another corporation. Perhaps this should be changed. In any event, I believe the law should be amended so as to require the Secretary of State to advise a representative of a proposed corporation that while a particular name is legally available, it had been in use previously by a corporation now suspended. The Secretary of State maintains two separate name files--"active" and "inactive", (dissolved, suspended, term expired, etc). Problems can be created when a corporation which has been suspended continues to transact business under the name of the suspended corporation, and new incorporators form an entirely different corporation using that name, unknowingly. This definitely tends to mislead the public, although usually unintentionally. This situation is particularly important to nonprofit corporations where the circumstances under which many operate cause them to be suspended by the Franchise Tax Board because they fail to file information returns. Often, these returns are completed by doing nothing more than placing an "X" in one box, but the penalty for non-filing is suspension. A substantial percentage of active nonprofit organizations have been suspended for that reason; many are unaware of their status because correspondence has not reached them or because they falsely believe that a similar form filed elsewhere (with the Attorney General, for example) suffices. Although they can regain their good standing status relatively easily, they may find their corporate name taken, perhaps unknowingly, because the Secretary of State in practice checks only the "active" file in granting name availability. The

"new" corporation then experiences confusion with the "old" suspended corporation, the public may be baffled and misled, and the "old" corporation must adopt a new name.

§ 14535. Filing fees

Exhibit XV notes that one purpose of the proposed revisions is to consolidate the law and suggests that consideration be given to transferring the fee schedule to the Corporations Code. This suggestion has some appeal to the staff; however, the existing scheme is based on a theory of compiling all the fees of the Secretary of State in an article in the Government Code in the chapter relating to the Secretary of State. Other provisions concerning corporate records (microfilming, certified copies) are also compiled in the chapter in the Government Code.

§ 14582. Service on Secretary of State

Exhibit XXXXI suggests that this and other sections recognize that a declaration under penalty of perjury may be used in lieu of an affidavit. This could go in the Comment. The writer suggests that "affidavit" be defined generally to include a declaration under penalty of perjury. See discussion under Section 5180 (Memorandum 76-90).

§ 14602. Statement required of nonprofit corporation

Section 14602 provides a special rule for nonprofit corporations. Other corporations are required to file an annual statement with the Secretary of State which sets out the directors, officers, and general type of business of the corporation. The Commission decided to retain the five-year (or upon any change in officers) filing requirement for nonprofit corporations and to severely limit the information required to be included in the statement.

This section was the subject of quite a bit of comment. You will recall that the Commission's staff originally proposed that nonprofit corporations be required to file under the same time rules and to file the same information as other corporations. The Commission's consultant, Mr. Davis, in his letter containing his comments on the tentative recommendation (Exhibit XXXXVI) singles out this issue as one of the major ones on which he disagrees with the Commission's decision. He states:

I continue to respectfully disagree with the Commission on the decision that the non-profit corporation be required to file a statement of officers only once every five years. The problem with a non-profit corporation is that the officers and directors tend to change far more rapidly than they do for business corporations. Furthermore, I cannot agree that administrative duties like this are performed by volunteers without compensation and that therefore people dealing with the corporation should not have adequate information. I personally have spent hours trying to get accurate information about non-profit corporations that I represent as a legal counsel, only to find that the only information anyone has as to who the current officers are is on the last report filed with someone. In fact it is only the request for this report that generates activity which causes people to determine who the officers are, which is constructive internally as well as to third parties. It is not a serious burden, the cost is very little, and the benefit to the general public is substantial. You could even waive the filing fee if you are concerned about cost.

Exhibit XV, a generally thoughtful letter presenting a number of excellent points, states:

> Nonprofit organizations should <u>also</u> be required to disclose directors. They, too, have effects, positive and negative, on the public, and the public has a right to know who controls <u>all</u> corporations. (The "Comment" is not entirely correct. Nonprofit corporations must now file a statement every fifth year, and every time there is a change of officers.)

Exhibit LIV (Wallace Howland, who directed the exercise of Attorney General's authority over charitable trusts from 1959 to 1971) states:

> <u>The Problem:</u> § 14602 would require reporting the name and address of only one individual holding office in the corporation, viz: chief executive officer. At least two names should be required.
>
> <u>Comment:</u> In the past, the Attorney General has been put to considerable public expense in identifying and locating individuals responsible for the operations of certain types of nonprofit corporations, particularly some of those engaged in the public solicitation of funds for allegedly charitable purposes.
>
> There are numerous instances where the principal office of the corporation and the residence of its chief executive officer (president, usually) are identical. When he moves, all identification of record is lost. This situation will be aggravated in the future by reason of the operation of § 5311 in authorizing, literally, a "one-man corporation".
>
> <u>Recommendation:</u> The 5-year period between required reports should be shortened to three (3) years, at least in the case of nonprofit corporations organized for charitable purposes. Further,

the name and address of the treasurer or other chief financial officer should be required in addition to that of the chief executive officer.

Several writers indicate compliance will be easier if a form comes in the mail each year. Exhibit XIX states:

> Most homeowners associations change their officers every year, and sometimes more often. An annual filing requirement would be less burdensome upon such corporations than the provisions of Section 14602. The same would be true for small charities.

To the same effect is the comment made by James M. Cowley, a member of the Special Subcommittee on Nonprofit Corporation Law of the State Bar Committee on Taxation (Exhibit XXXXVIII):

> 8. Identification Statements. I think there is a problem with the approach of current law and Section 14602 of the Law. In practice many changes of chief executive officers are not reported because no one thinks about it. I suspect there would be far better compliance if this were simply made an annual filing requirement and the form came in the mail.

The staff continues in the belief that a uniform statute for the filing of annual statements is desirable. We believe that the annual filing provisions should extend to nonprofit corporations and that the content of the statement should conform to that required of other corporations. As to whether a fee should be imposed for the filing of the annual statement by a nonprofit corporation, that matter will be discussed later in this memorandum.

§ 14603. Designation of agent for service

Exhibit XI approves the requirement that an agent for service of process be designated in the annual statement for all corporations, characterizing it as an "excellent requirement which will facilitate communication and accessibility."

§ 14607. Renewal forms

Exhibit XV makes the following point concerning this section:

> 14607. The mailing of a form three months prior to the date due is too far in advance. Less efficient people will tend to lose it. Others will fill it out immediately, giving information current on the date of receipt, rather than current as of the date due, in cases where an election were to take place between the time the form is received and the due date. The statement does not call for

extensive information which takes time to develop, as in an income tax blank.

§ 14610. Procedure upon failure to file statement

Concerning this section, Exhibit XV comments:

14610. The penalty which Section 25936, Revenue and Taxation Code, sets forth for the failure of a corporation to file a statement of officers is $250.00, and the section states that "such penalty shall be a final assessment." This is much too severe to impose upon a nonprofit corporation. The dollar amount would be a substantial percentage of the annual income of many nonprofit organizations. Compared to other authorized and actual penalties for far more serious crimes by individuals or organizations, such a penalty is excessive. There appears to be no provision in Section 25936 whereby for good cause the assessment may be waived. There are many reasons why a nonprofit corporation would not file a statement, primarily the mechanical and educational problems involved in becoming informed of the law and obtaining a copy of the prescribed form. The experience of the Franchise Tax Board is a parallel here. Prior to 1970, nonprofit organizations at the time of incorporation were assured in writing by the FTB that they need submit no annual return unless their income exceeded $25,000. That year, the law was changed to require an annual return regardless. FTB, using the last known addresses available to it for those which previously required no reports, attempted to mail forms. Many were not received because of problems cited in comments on previous sections, such as absence of a permanent office, phone book listing, employees, etc. Many corporations were then suspended. However, those suspended may be brought into good standing by payment of a $10.00 fee and submission of the missing returns. Such a procedure and a penalty (more a processing fee for extra expense caused the state) is one more in line with the failure to file a statement of officers by a nonprofit corporation.

To the same effect is the following comment from Exhibit XIX:

The $250 penalty provided in Section 25936 of the Revenue and Taxation Code is an unnecessary burden imposed upon small charities. The penalty, as a practical matter, will fall only upon those persons who would have been charitable beneficiaries had the $250 been available for distribution.

§ 14611. Qualification of corporation as agent for service

Exhibit XI specifically approves this section.

§§ 14800-14814 generally--Conversion

One writer (Exhibit XXXXI) objects to the conversion provisions:

I do not believe that non-profit corporations should be allowed conversion into a business corporation. It is true that charitable

non-profit corporations cannot do it, but I do not think that any one of them should be allowed to do it. They should re-incorporate.

§ 14807. Rights of dissenting shareholders

The same writer (Exhibit XXXXI) objects to this section because he construes it to apply to members of a nonprofit corporation; the section is limited to rights of dissenting shareholders.

New § 14873 - proposed addition by staff

Mr. Tapper of the office of the Attorney General did not submit his written comments in time to be included in this memorandum. However, he did bring to our attention a situation that sometimes presents a problem. A foreign corporation may have its existence or its right to transact business forfeited or suspended in the state or place where it is incorporated or organized and continue to transact intrastate business in California pursuant to a certificate of qualification to do so obtained from the Secretary of State under Sections 14865-14872. There is no simple procedure provided by statute for revoking the certificate of qualification to transact intrastate business in California.

To meet the problem identified by Mr. Tapper, the staff suggests the addition of the following section to Division 4:

§ 14873. Revocation of certificate of qualification when right to transact business in state of incorporation revoked or suspended

14873. The Secretary of State shall forfeit the right of any foreign corporation to transact intrastate business upon receipt of any of the following:

(a) A certified copy of an order of a court of competent jurisdiction revoking the charter or annulling, vacating, or forfeiting its corporate existence, or forfeiting or suspending its right to transact business, in the state or place of its incorporation or organization.

(b) A certificate by an authorized public official of the state or place of incorporation of the corporation to the effect that such corporation is no longer an existing corporation in good standing in that state or place.

(c) In the case of a foreign association, a certified copy of a final judgment of a court of competent jurisdiction that such association is no longer a validly organized and existing business association under the laws of the foreign jurisdiction under which it was organized.

Comment. Section 14873 provides a new procedure for forfeiting the right of a foreign corporation to transact intrastate business in California if its corporate existence has been terminated or its right to transact business in the state of incorporation or organization has been forfeited or suspended.

If this provision is approved, we suggest that a provision based on subdivision (c) of Section 14885 be added to Section 14885 to cover forfeiture under Section 14873.

§§ 14900-14909. Crimes

Professor Oleck (Exhibit III) points out that the sections on crimes are obsolete and greatly in need of study and reform. I believe that the Commission previously took the same view but finally decided to compile the criminal provisions of the new General Corporation Law in Division 4 with only those changes needed to make the sections applicable to all corporations--changes needed to make the sections apply to membership corporations, and the like.

Perhaps the preliminary portion of the recommendation should be expanded to note the Commission's concern about the inadequacy of the criminal provisions and to state that the Commission has not undertaken to review these provisions for substance but recommends that some appropriate group undertake such a review.

Fees

Under existing law, a nonprofit corporation is not charged a fee for filing the statement of its officers and address of its office. Such a statement must be filed every five years or each time there is a change in officers. At the staff's suggestion, the Commission provided the same fee for all statements-whether filed by a profit or nonprofit corporation.

Mr. Davis, the Commission's consultant, considers the requirement of a complete annual statement for nonprofit corporations to be so important that he indicates that the fee should not be imposed if the fee requirement would result in objections to the annual filing requirement.

Three persons who commented objected to the imposition of a fee for the nonprofit corporation filing. Exhibit XV makes a very strong argument for not imposing the fee for filing the statement of officers:

It is also noted (page 72 of the background materials to Part I) that the commission's tentative recommendation is to increase the fee for the filing of a nonprofit corporation's statements of officers to $5.00. In recommending changes or no changes in this and various fees, the commission does not indicate whether or not it is in possession of information regarding the adequacy of the present fees to cover the costs of the services rendered by the Secretary of State and whether or not the legislative history indicates that the filing services are to be provided on a self-supporting basis. The Legislature took specific action about 1971 to require that statements of officers of nonprofit corporations be filed without a $3.00 fee, which had been in effect until that time. That action and that of allowing nonprofit organizations eligible to file the simplified exempt organization information return with the Franchise Tax Board (Form 199B) without fee would indicate a legislative intent to waive minor filing fees for nonprofit corporations.

Exhibit LVII also objects to this proposed change:

Fee for Filing Statement: (Gov.C. Sec. 12210)

I am strongly opposed to the deletion of the exemption of nonstock/nonprofit corporations from this fee. This conflicts with the "philosophy" (p. 9) that no change should be made in existing law unless there is a demonstrable need for change. It is stated (p. 63) that the "same fee that applies to other corporations filing a statement should apply to nonprofit corporations." But the differential concept is preserved elsewhere, and reasonably so (Gov.C. Secs. 12202, 12203.7).

Exhibit LXXI believes that the existing law, which permits the statement to be filed without fee, should be continued without change.

Respectfully submitted,

John H. DeMoully
Executive Secretary

Memorandum 76-91

EXHIBIT I

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August 16, 1976

Mr. Nathaniel Sterling
Assistant Executive Secretary
California Law Revision Commission
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Dear Mr. Sterling:

With reference to your letter of August 11th, I do not recall any specific discussion by the State Bar Committee of Sections 6600 or 6602 of the old General Corporation Law. It is possible, however, that these sections were discussed before I became a member of the Committee. I will present your questions to the full Committee at our next meeting, which is scheduled for September 13th, and will advise you of any additional information which may be developed at such meeting.

Yours very truly,

Walter G. Olson

WALTER G. OLSON

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EXHIBIT II

§ 14462. Evidence of incorporation, existence, and powers of foreign corporation

14462. (a) In any action or proceeding, civil or criminal, in any court of this state, a copy of the articles or certificate of incorporation or other incorporation papers of a foreign corporation purporting to be duly certified by the Secretary of State or other competent official of the state or place under the laws of which the corporation purports to be incorporated, or the original of any such instrument, or a copy of such certified copy duly certified, is admissible in evidence by all courts, and is prima facie evidence of the incorporation, existence, and powers of the corporation.

(b) Certified copies of the instruments described in subdivision (a) may be filed in the county clerk's office in the county where the foreign corporation held or holds real property and, when so filed, are conclusive evidence of the incorporation and powers of the corporation in favor of any bona fide purchaser or encumbrancer of such property for value, whether or not the corporation is doing business in this state.

Comment. Section 14462 is the same in substance as former Section 6600 (old General Corporation Law).

§ 14463. Judicial notice of official acts concerning foreign corporations

14463. In any action or proceeding, the court takes judicial notice, in the same manner that it takes judicial notice of the matters listed in Section 452 of the Evidence Code, of the official acts affecting corporations of the legislative, executive, and judicial departments of the state or place under the laws of which the foreign corporation purports to be incorporated.

Comment. Section 14663 is the same in substance as former Section 6602 (old General Corporation Law).