#77.400 11/19/76

Memorandum 76-111

Subject: Study 77.400 - Nonprofit Corporations (Comments Concerning Division 2--Nonprofit Corporation Law)

Attached as Exhibit 1 (pink) is a copy of a letter received commenting on the Commission's tentative recommendation relating to nonprofit corporations. The points raised in the letter are analyzed below in the order in which they are made in the letter.

Proposed New Division 4

The commentator is opposed to creation of a new Division 4 and suggests as one alternative to "incorporate in one section in the Nonprofit Corporation Law a reference by number to all the sections in the General Corporation Law which have general application." The Commission has previously determined to adopt a procedure somewhat like that proposed.

Nonprofit Cooperative Corporations

The commentator notes that nonprofit cooperative corporations formed under former Title 22 of Part 4 of Division 1 of the Civil Code will, by virtue of 1976 legislation, on January 1, 1977, be governed by the General Nonprofit Corporation Law rather than by the General Corporation Law. (At present, they are governed by the General Corporation Law.) The commentator suggests that, upon enactment of a new Nonprofit Corporation Law, such cooperatives be governed by the new law rather than waiting for amendment of the general cooperative statutes. "They far more resemble a nonprofit corporation than a cooperative corporation, and have not been governed by a specialized law for several decades. They should be governed by the Nonprofit Corporation Law when it is adopted."

The staff does not believe we can or should attempt to apply the new nonprofit corporation law to cooperatives without a study. Moreover, it is a substantial task just to take care of the corporations covered by the nonprofit corporation law without adding more. If the persons involved with cooperatives believe the nonprofit corporation law can or should be made applicable to cooperatives, they should sponsor legislation to do so.

Financial Limitations Upon Reacquisition of Subvention Certificates

The commentator accurately points out that, while Section 5550 and following place limitations on payouts to members to acquire memberships or subvention certificates, Section 5520 permits nonmembers to hold subvention certificates, thereby enabling the avoidance of Section 5550. The staff believes this hole should be filled by limiting Section 5550 to membership certificates and adding to the subvention provisions the following provision:

> A nonprofit corporation may not redeem a subvention certificate if the redemption would not satisfy the requirements of Section 5552.
>
> Comment. This section incorporates the requirement of Section 5552 (purchase or redemption of memberships) that a nonprofit corporation may not make a payment that would cause it to be unable to meet its liabilities (except those whose payment is otherwise adequately provided for) as they mature.

The effect of this provision would be to impose a general solvency standard of the type normally applicable to debt payments for all subvention redemptions, on the theory that subventions are somewhat akin to debt.

Redemption of Subvention Certificates Upon the Call of the Holder

The commentator objects to the standard of Section 5525 that a subvention certificate may be redeemed at the option of the holder only upon an affirmative showing that the financial condition of the nonprofit corporation will permit the payment to be made "without impairment of its operations or injury to its creditors." He suggests that this is an impossibly vague standard, that the general solvency limitations on payments are adequate, and that the nonprofit corporation can protect itself by making clear in any subvention certificates that are redeemable by the holder what prerequisites there are to call by the holder.

The staff is sympathetic to this point of view and suggests that the Commission replace the standard of Section 5525 with a reference to the general provisions of Section 5551 (there must be a fund balance of revenues over expenditures and assets must exceed liabilities by 1-1/4); the Comment would note the ability of the nonprofit corporation to place additional limitations on call of the subvention certificate for its own protection.

Temporal Application of the Financial Limitations on Distributions

The commentator makes the point that we have failed to make clear the time as of which the solvency requirements of Section 5550 et seq. must be satisfied in the manner of Section 166 of the new business corporation law. This gap in the statute should be filled. The staff suggests the addition of the following provision:

§ 5550.5. Time of payment

5550.5. (a) For the purposes of this article, the time of a payment to members is the date cash or property is transferred by the nonprofit corporation, whether or not pursuant to a contract of an earlier date.

(b) A promissory note of a nonprofit corporation, other than a negotiable debt security (as defined in subdivision (1) of Section 8102 of the Commercial Code), shall not be deemed cash or property for the purposes of subdivision (a).

Comment. Section 5550.5 is comparable to a portion of Section 166 (General Corporation Law). Under subdivision (b), a negotiable debt instrument is treated as cash or property for purposes of subdivision (a) so that the limitations of this article apply at the time of the issuance of the instrument and not at the time of payments pursuant thereto. A promissory note (other than a negotiable debt instrument) is not considered cash or property and need not satisfy the requirements of this article at the time of issuance; however, any payments thereunder would, by virtue of subdivision (a), be required to satisfy this article at the time they are made.

Challenges to Mergers or Consolidations

The commentator objects to Section 6160, which permits a challenge to the validity of a merger or consolidation up to 60 days after the transaction, on the ground that this could cripple the operations of the corporations for years. The commentator suggests either or both of the following as solutions to the problem thus created:

(1) Require notice 20 days prior to the consummation of a merger or consolidation, within which time the member could seek injunctive relief.

(2) Restore dissenters' rights to enable dissatisfied members to get out of an undesirable merger or consolidation.

The staff believes there is merit to these suggestions, particularly the concept of requiring an action to be brought prior to the merger or consolidation (with adequate prior notice to members), and urges the Commission to give serious consideration to this proposal.

Proxy Form--Abstentions

Section 5732(a) requires a proxy form to provide for approval, disapproval, or abstention. The commentator points out that abstention creates two problems:

(1) In the case of a meeting, the abstention is a vote "represented at the meeting" and, since a majority of the votes represented at the meeting is necessary for approval of an action, the abstention is in effect a negative vote.

(2) In the case of a mail ballot, the abstention may or may not be construed as being a "vote cast." Approval of an action requires a majority of the votes cast, provided the number cast equals or exceeds a quorum. If the abstention is a vote cast, it contributes to a quorum but is in effect a negative vote for majority purposes; if the abstention is not a vote cast, it is not in effect a negative vote, but it does not contribute to a quorum either. (This last point the Commission has previously determined to clarify by providing that an abstention counts for quorum purposes.)

The solution offered by the commentator is to eliminate the abstention feature from the proxy form. The staff does not believe this is an adequate solution to the problem posed--it may decrease the number of abstentions received in an election but does not tell what to do when an abstention is received. Moreover, as the commentator acknowledges, the Legislature feels strongly about this matter, and the staff believes it is best to follow the rather clear recent legislative decision on this point.

The staff believes the problem can be better resolved by making clear that an abstention does count for quorum purposes (as the Commission has previously determined to do) and by revising the vote requirements so that an abstention is not counted for purposes of determining whether there is a majority approving the action. This could be done by amendment of Section 5713(a) to provide the following vote for approval of actions:

> (1) If the approval is at a meeting of members duly held at which a quorum is present, be approved ~~by a majority of the~~ if the votes represented at the meeting and entitled to be cast on the action are cast in a greater number for approval than for disapproval of the action .

(2) If the approval is by mail or any reasonable means provided in the bylaws, be approved ~~by a majority of the~~ if the votes cast on the action are cast in a greater number for approval than for disapproval of the action , provided the number of votes cast (including abstentions) equals or exceeds the number required for a quorum of a meeting of members.

A similar problem arises, of course, with regard to action by directors (Section 5317). The Commission should determine whether the policy embodied in the draft above is sound and, if so, whether it should be extended to abstentions on the board of directors. The staff believes that board action is of a sufficiently different character, that abstentions really are believed to be "no" votes, and, hence, no change in the law is necessary.

Proxy Form--Withholding

Section 5732(b) relates to withholding votes in an election of directors. The commentator correctly points out a misstatement in the preliminary part of the recommendation--the provision does not require a "withhold" box on the form. This misstatement will be corrected.

The commentator also points out an ambiguity in the drafting of Section 5732(b)--it could be construed to mean that a person may vote for directors or withhold his votes for directors but may not withhold his votes as to specified directors. This ambiguity could be resolved by the following amendment:

(b) In an election of directors, a proxy in which the nominees for election are set forth and which is marked "withhold," or otherwise marked in a manner indicating that the authority to vote for ~~directors~~ a director is withheld, shall not be voted either for or against the election of a the director.

Professional Corporations

Also attached to this memorandum as Exhibit 2 (yellow) is a suggestion to permit incorporation of professional nonprofit corporations. The Commission should read this letter to determine whether it wishes to take any action on the suggestion.

Respectfully submitted,

Nathaniel Sterling
Assistant Executive Secretary

Memorandum 76-111

EXHIBIT 1

GORDON GRAY (1877-1967)
W. P. CARY (1882-1943)
FRANK A. FRYE (1904-1970)
JOHN M. CRANSTON
JAMES W. ARCHER
FRANK KOCRITZ
STERLING HUTCHESON
THOMAS C. ACKERMAN, JR.
EUGENE L. FREELAND
R. REAVES ELLEDGE, JR.
KARL ZOBELL
JOSIAH L. NEEPER
FREDERICK P. CROWELL
RICHARD ALEXANDER BURT
RUDI M. BREWSTER
ROBERT AMES
THEODORE J. CRANSTON
JAMES R. SMITH
ROBERT D. COPELAND
DAVID E. MONAHAN
TIMOTHY V. McFARLAND
PETER G. AYLWARD
RALPH M. PRAY, III
T. KNOX BELL
TERRY D. ROSS
DAVID B. GEERDES
JAMES F. STIVEN
LANCE C. SCHAEFFER
WILLIAM E. BEAMER
BROWNING E. MAREAN
ROBERT W. BELL, JR.

GRAY, CARY, AMES & FRYE
ATTORNEYS AT LAW
2100 UNION BANK BUILDING
SAN DIEGO, CALIFORNIA 92101
TELEPHONE [714] 238-1661

NORMAN D. PEEL
DIRK T. METZGER
WILLIAM E. BOGGS
GARY J. SPRADLING
JAMES K. STERRETT, II
KENNETH O. COVENEY
PAUL I. MEYER
JAY D. HANSON
WILLIAM N. KAMMER
DANIEL T. BRODERICK, III
RICHARD A. PAUL
CHRISTOPHER C. CALKINS
CHRISTOPHER B. NEILS
VICTOR A. VILAPLANA
DENNIS A. SCHOVILLE
SHIRLEY L. KOVAR
LEO P. SULLIVAN
BRIAN L. FORBES
J. TERENCE O'MALLEY
DAVID L. MULLIKEN
JEFFREY M. SHOHET
WILLIAM McCURINE, JR.
NANCY E. HOLLAND
KATHARINE N. ROSENBERRY
DIANE R. FIELDS

OF COUNSEL
WALTER AMES
JOSEPHINE IRVING

November 11, 1976

California Law Revision Committee
Stanford Law School
Stanford, California 94305

Re: Tentative Recommendation Relating to Nonprofit Corporation Law

Gentlemen:

I have had an opportunity to briefly review the Tentative Recommedation and Proposed Legislation with respect to the proposed Nonprofit Corporation Law, and desire in this letter to make several comments with the hope that they will be considered in future drafts.

First, let me say that I agree wholeheartedly with the policy guidelines used for the drafting effort. Those policies seem to be in large part followed consistently throughout the Proposed Legislation.

My comments consist of two suggestions with regard to the format and application of the proposed Nonprofit Corporation Law, and some more specific thoughts with respect to corporate finance matters, certain voting and proxy considerations, and mergers and consolidations.

A. Proposed New Division 4 of Title 1. It is proposed that a new division or general application be adopted incorporating certain provisions of the new General Corporation Law that could apply to all corporations, profit or nonprofit. I believe that such a division would create confusion and simply set a trap

for the unwary. In addition, it seems to run counter to the Commission's arguments for a totally independent body of law for nonprofit corporations. Instead of creating a new division, I suggest that those provisions be set forth in both the new General Corporation Law and the Nonprofit Corporation Law. This would make both laws totally independent and all inclusive. Another alternative would be to incorporate in one section in the Nonprofit Corporation Law a reference by number to all the sections in the General Corporation Law which have general application. Either one of these methods would make it far easier for practitioners to efficiently advise their clients.

B. Nonprofit Cooperative Corporations. It was upon our suggestion made to the drafting committee for the new General Corporation Law that AB 2849 provided that nonprofit cooperative corporations be governed by the General Nonprofit Corporation Law, rather than by the General Corporation law. (See our letter and the committee's response enclosed herewith.) The Tentative Recommendation's brief discussion of nonprofit cooperative corporations notes important reasons for the suggestion. Those corporations are forbidden from issuing shares and making distributions in the form of dividends to members. (See Tentative Recommendation at page 66.) These two features make nonprofit cooperative corporations more akin to the typical nonprofit corporation, rather than the typical business or profit-oriented corporation.

I see no reason why they should continue to be governed by the old General Nonprofit Corporation Law, rather than by the proposed Nonprofit Corporation Law after it is adopted. The Tentative Recommendation gives no reasons for this recommendation, but only suggests a general study of all cooperative corporations be undertaken. Instead, I think that a brief review of Title 22 of Part 4 of Division 1 of the Civil Code will show that such a study is not needed in the case of nonprofit cooperative corporation. They far more resemble a nonprofit corporation than a cooperative corporation, and have not been governed by a specialized law for several decades. They should be governed by the Nonprofit Corporation Law when it is adopted.

C. Financial Limitations Upon Reacquisition of Subvention Certificates. It appears from the comment to section 5525 that it is contemplated that the financial limitations of Chapter 5 would apply to reacquisitions of all subvention certificates, but the language of the various sections does not make this clear. Section 5551 states that a nonprofit corporation may not make a payment to members unless its requirements are met, and so does

section 5552. However, section 5520 permits subventions to be received from nonmembers and section 5550 states that provisions of Article 5 of Chapter 5, which include sections 5551 and 5552, apply to the reacquisition of subvention certificates. In reviewing Chapter 5, I was surprised at the failure of the Proposed Legislation to contain a definitional provision (similar to section 166 of the General Corporation Law) for reacquisition of memberships and subvention certificates. Besides rectifying the obvious gap with respect to nonmember subvention certificate holders, such a definitional provision would simplify and unify the language of sections 5550, 5551 and 5552.

D. Redemption of Subvention Certificates Upon the Call of the Holder. Proposed section 5525 states that the board may authorize subvention certificates which can be redeemed at the call of the holder "upon an affirmative showing that the financial condition of the nonprofit corporation will permit the required payment to be made without impairment of its operations or injury to its creditors. I suggest that such a showing is far too slippery and vague. The burden upon the subvention holder is simply too great, and the board of directors are given no guidance as to when to accept such an "affirmative showing," short of a court declaration. Instead, I suggest that Chapter 5's limitations on distributions and any provisions of the subvention contract will provide ample protection. The subvention contract will probably specify additional conditions upon which a call by the holder can be made. I suggest that a nonprofit corporation will take the steps it deems necessary to protect itself from the call of a subvention agreement in its subvention contract.

E. Temporal Application of the Financial Limitations on Distributions. The Proposed Legislation also omits any specification as to when a payment, purchase or redemption is deemed to take place and when the financial limitations of Article 5 of Chapter 5 must be met. These temporal considerations have particular importance when payment for a purchase or redemption is effected in installments. In such a case, the question arises whether the financial limitations must be met in the entire amount of the reacquisition price at the outset, or in the amount of each installment when it is made, or all such cases. See generally Herwitz, Installment Repurchase of Stock: Surplus Limitations, 79 Harv.L.Rev. 303 (1965). I suggest that a definitional section provide that the time of any distribution by purchase or redemption of memberships or subvention certificates shall be the date cash or property is transferred by the nonprofit

corporation, whether or not pursuant to a contract of an earlier date; provided, that where an evidence of indebtedness in negotiable form is issued, the time of the distribution is the date when the corporation issues such evidence of indebtedness.

This would permit a negotiable promissory note to be issued by the nonprofit corporation only when the entire redemption or purchase price can pass the financial tests at the outset. This avoids the troublesome question of who prevails when a holder in due course attempts to enforce the negotiable instrument after the nonprofit corporation has suffered reversals and installment payments cannot meet the financial limitations. The corollary is that once the financial tests are met at the outset, the holder of the negotiable instrument is no longer subordinated to general creditors, but stands on a parity with them. Since the repurchase or redemption could have legally been accomplished by one cash or property payment, creditors cannot later complain that they were prejudiced. Requiring each installment to meet the distribution test would discourage members and subvention certificate holders from entering into installment agreements, possibly to the detriment of financial health of nonprofit corporations and their creditors.

On the other hand, when the corporation cannot initially meet the financial limitations to the full extent of the purchase or redemption price, there is no reason to prohibit future installment payments, provided each installment meets the tests when made and the corporation's installment obligation is not evidenced by a negotiable instrument. The selling member or subventure certificate holder takes the risk that the future income of the nonprofit corporation will be insufficient to fund the corporation's obligations and remains subordinate to general creditors in that event. Since the obligation is not in negotiable form, any successor to the member or subvention certificate holder should not have disappointed expectations.

Section 166 of the new General Corporation Law sets forth slightly different rules for determining the time of distributions. To the extent those rules differ from those proposed here, they are unfortunate and are criticized in the article Tom Ackerman and I recently published, California's New Approach to Dividends and Reacquisitions of Shares, 23 UCLA L. Rev. 1052 at 1087-1090 (1976).

F. Challenges to Mergers or Consolidations. The provisions of section 6160 of the Proposed Legislation providing for an after-the-fact challenge to a merger or consolidation on the

basis that such a combination is manifestly unfair to the property rights of members inject far too much uncertainty into such transactions. A lawsuit filed as late as 60 days after such a combination could effectively disable the constituent nonprofit corporations until a final judgment is made, and that could take several years. Until such a judgment is rendered, the respective boards would be simply unable to take any important steps and would be severely limited in day-to-day operations. Obviously, unanimity of opinion between the respective boards would be required to do anything, and even then matters approved by a consensus might be aborted because of the practical problems of "unscrambling the eggs" should the court ultimately rule that the combination must be undone.

I suggest that prior notice, say 20 days, to all members is a far better solution to this problem. If they want to sue, it is far better that they do it before consummation when injunctive relief would not require an "unscrambling."

In the event that it is not felt that prior notice alone is enough, I tentatively suggest that as a possible alternative the Commission reconsider its decision to abolish dissenters' rights. As with business corporations, combination contracts could condition combinations upon the exercise of dissenters' rights by less than a specified number of members, such number being set by the boards of directors after analysis of the financial condition of the constituent corporations. In this way dissenters would not unduly jeopardize the financial health of the corporations, and would be provided with a well established means to avoid being forced into a new or different entity.

F. Proxy Form - Absentions. Section 5732 unfortunately continues the mistaken notion of section 604 of the new General Corporation Law that an abstention is something different than a vote against a matter. As you know, section 604 was made a part of the new General Corporation Law over the ardent objections of the drafting committee upon the insistence of one state legislator. As professor Harold Marsh has stated, that legislator's failure to understand the voting processes required could lead to a "tyranny of the disinterested." Section 5713(a)(1) states that a majority of the votes "represented at the meeting and entitled to be cast on the action" is required to effect the approval of the members. When a proxy is marked "abstain" on a particular proposal, its vote is nevertheless represented at the meeting. The number of votes in favor required for approval on that matter is not reduced. Thus, an abstention operates in the same fashion as a vote against.

The problem is further compounded by section 5713(a)(2) which provides that if the membership vote is by mail (or other reasonable means) approval can be effected by a majority of the votes cast on the action, provided the number of votes cast equals or exceeds the number for a quorum at a meeting of the members. Is an abstention a vote cast? I suspect not. The elimination of the abstention provision altogether from section 5732(a) would not only make clear to members the actual effect of their vote, but also eliminate the apparent inconsistency of subsections (1) and (2) of section 5713(a), establishing different vote requirements dependent on whether or not the approval is sought at a meeting or otherwise.

G. Proxy Form - Withholding. A related problem is presented in section 5723(b) with respect to the witholding of votes for nominees for election. First, it is important to correct the discussion on page 36 of the Tentative Recommendation to the effect that a proxy for election of directors must offer a choice of abstention on the form. Section 5732(b) and its model, section 604(c) of the new General Corporation Law, do not require that a withhold box be present on a proxy solicited for the election of directors. Instead, both those sections simply provide that a proxy in which nominees for election are set forth and which is marked "withhold" shall not be voted either for or against the election of a director. Apparently, it is envisioned that a member will write, without invitation or suggestion from the proxy form, the word "withhold" on the proxy.

The problem with section 5732(b) is one of draftsmanship. One interpretation of its language could preclude the furthering of the intention of a member to withhold his vote for one of several specified nominees, but not an entire slate. In the event a member makes notation to withhold his vote for only one candidate, the language of section 5732(b) nevertheless seems to preclude the proxyholder voting for the other candidates set forth on the proxy. The section states that any proxy in which the nominees for election are set forth and which is marked "withhold" shall not be voted either for or against the election of a director. My fear is that "a" will be read to mean "any," and apply to the entire slate, not just the particular candidate which is the object of the member's notation. I suggest the section be amended to make clear that a proxy can be voted for those directors (named on a proxy form) for which the member does not desire to have his vote withheld.

Please do not hesitate to contact me with respect to clarification or further exposition of these comments. Once again, let me congratulate you on the fine effort to date.

Very truly yours,

James K. Sterrett, II
For
GRAY, CARY, AMES & FRYE

JKS/sls

February 17, 1976

Walter G. Olson, Esq.
Chairman, Committee of
Corporations of State
Bar of California
c/o Orrick, Herrington, Rowley
& Sutcliffe
Transamerica Pyramid
600 Montgomery Street
San Francisco, California 94111

Re: Trailer Legislation to AB 376
for Nonprofit Corporations

Dear Mr. Olson:

We are writing you to suggest a solution to a problem which arises in connection with the new General Corporation Law ("the New Law").

We represent a nonprofit and nonstock corporation which was originally incorporated in 1927 pursuant to Title 22 of Part 4 of Division First of the Civil Code. In 1931 Title 22 was repealed and corporations organized under it ("Title 22 corporations") were deemed to have been organized and existing under the general corporation law. Stats. 1931, Chapters 867 and 869, p. 1840.

The problem is that Title 22 corporations may have no law governing their affairs when the New Law becomes effective, because unlike the present General Corporation Law ("the Old Law"), the New Law has no independent application to nonprofit or nonstock corporations. For instance, the Old Law defines shares to include memberships (Section 115) and shareholders to include members (Section 103). In addition, specific references are made throughout for special treatment for nonstock and/or nonprofit corporations. The New Law, however, defines shares

only to mean "units into which the proprietary interests in a corporation are divided" (Section 184) and specific rules are not provided for nonstock or nonprofit corporations.

We suggest that "trailer" legislation should deem all nonstock, nonprofit corporations not now governed by a special law to be governed by the General Nonprofit Corporation Law. We believe such corporations would be better governed by a law designed for their needs.

We understand the legislature has in mind the creation of a new all-inclusive law for nonprofit corporations. Thus, nonprofit corporations, such as Title 22 corporations, now governed only by the Old Law will ultimately be governed together with the other nonprofit corporations. Our proposal would only advance these plans.

Few practical problems with respect to the internal affairs of the affected corporations would result. The General Nonprofit Corporation Law is in general far more flexible than the Old Law and will probably not create any burdens for them.

We would be happy to discuss these matters with you either by telephone or in person and to lend whatever assistance we could in the drafting of proposed legislation. In this regard, please do not hesitate to contact the undersigned or Karl ZoBell at our La Jolla office at your earliest convenience.

Very truly yours,

James K. Sterrett, II
For
GRAY, CARY, AMES & FRYE

JKS,II:kad

cc: Harold Marsh, Jr., Esq.
James R. Hutter, Esq.
Bradbury R. Clark, Esq.
Karl ZoBell, Esq.

GIBSON, DUNN & CRUTCHER
LAWYERS
333 SOUTH FLOWER STREET
LOS ANGELES, CALIFORNIA 90071
(213) 489-7000
TELEX: 67-4830
CABLE ADDRESS: GIBTRASK

April 1, 1976

James K. Sterrett, II, Esq.
Gray, Cary, Ames & Frye
2100 Union Bank Building
San Diego, CA 92101

Dear Mr. Sterrett:

Supplementing our recent telephone conversation with respect to your February 17 letter to Walter Olson, the Drafting Committee agrees with your suggestion and will recommend to the Committee on Corporations of the State Bar of California at its April 9 meeting that the following new sentence be added at the end of Section 16 of Chapter 682 (page 116) of the chaptered version of AB 376 as printed by the State printer:

> "Nonprofit cooperative corporations organized pursuant to Title 22 of Part 4 of Division First of the Civil Code prior to August 14, 1931 which have not elected to be governed by Part 2 of Division 2 of Title 1 of the Corporations Code pursuant to Section 12206, and existing as nonprofit cooperative corporations on January 1, 1977, shall be governed on and after such date by the General Nonprofit Corporation Law."

We anticipate that the full Committee will accept this recommendation and we trust that it meets your suggestion.

If you consider this recommendation unsatisfactory, please contact either Brad Clark ((213) 620-1120) or me (213) 273-6990) sometime before the April 9 meeting of the full Committee.

Sincerely,

James R. Hutter

JRH:mn
cc: Messers. Walter G. Olson; R. Bradbury Clark; Harold Marsh, Jr.; William Holden; R. Roy Finkle

Memorandum 76-111 EXHIBIT 2

UNIVERSITY OF CALIFORNIA, BERKELEY

BERKELEY • DAVIS • IRVINE • LOS ANGELES • RIVERSIDE • SAN DIEGO • SAN FRANCISCO SANTA BARBARA • SANTA CRUZ

SCHOOL OF LAW (BOALT HALL)
BERKELEY, CALIFORNIA 94720
TELEPHONE [415] 642- 1731

November 16, 1976

John H. DeMoully
Executive Secretary
California Law Revision Commission
Stanford Law School
Stanford CA 94305

Dear Mr. DeMoully:

I am enclosing to you a letter from Charles H. Jarvis of the law firm of Schramm, Raddue & Seed. This letter is self-explanatory. I had discussed with Mr. Jarvis the projects for the revision of the California Nonprofit Law. I am forwarding this letter to you with the thought that it may be of value.

Sincerely

Richard W. Jennings

Richard W. Jennings
Professor of Law, Emeritus

RWJ:prk

enc.

Schramm, Haddon & Seed
ATTORNEYS AT LAW

POST OFFICE BOX 1260
15 WEST CARRILLO STREET
Santa Barbara, California 93102
(805) 963-2044

EDW. W. SCHRAMM
HARRIS W. SEED
PAUL W. HARTLOFF, JR.
DALE E. HANST
CHAS. H. JARVIS
DOUGLAS E. SCHMIDT
JOSEPH E. NIDA
KURT H. PYLE
DOUGLAS E. FELL
JOHN W. WARNOCK
E. KEITH MARTIN
JOSEPH D. ABKIN
FREDERICK W. MONTGOMERY
HOWARD M. SIMON
DEREK A. WESTEN
WELDON U. HOWELL, JR.

OF COUNSEL
RALPH C. HADDON

WASHINGTON OFFICE
SUITE 200
1015 20TH STREET, N.W.
Washington, D.C. 20036
(202) 466-6050
RESIDENT ATTORNEY
ADMITTED IN DISTRICT OF COLUMBIA
DANIEL A. REICKER

SANTA MARIA OFFICE
SUITE 110
500 SOUTH BROADWAY
Santa Maria, Ca. 93454
(805) 922-7357

November 11, 1976

Professor Richard W. Jennings
Boalt Hall School of Law
University of California
Berkeley, California 94704

Re: California Non-Profit Law

Dear Professor Jennings:

I very much enjoyed seeing you in our brief visit before the Boalt Hall Alumni Annual Dinner at the Stanford Court. I was proud to be present to join in the recognition of your many contributions to Boalt Hall and to the Law.

Perhaps you recall our brief conversation about your participation in the work of the committee advising the California Legislature on the revision of Division 2 of the California Corporation Code regarding non-profit corporations. I am writing this letter at your suggestion to record my concern regarding an existing deficiency in the present California law regarding non-profit corporations.

As you know, historically, it was unlawful for a corporation to engage in the practice of the learned professions such as law, medicine, dentistry, etc. (See, Pacific Employers Insurance Co. v. Carpenter, 10 C.A. 2d 592, 594-596(1935) and cases cited therein.) The recent pressures asserted by members of the learned professions to obtain the benefits of corporate retirement plans and the other fringe benefits available to the corporate employee have resulted in the adoption by most states of legislation such as California's Moscone-Knox Professional Corporation Act, Part 4, Division 3 of the California Corporation Code (and related provisions of the B. & P. Code). This legislation enables a member of the designated learned professions to engage in professional practice, for profit, in corporate form.

Unfortunately, our research has disclosed no similar enabling provision in the California General Non-Profit Law expressly authorizing a non-profit corporation to render professional services through its duly licensed professional employees or associates.

Section 9201 of the present General Non-Profit Law was enacted to allow the operation of health insurance programs, such as Blue Cross, and is limited in application to a non-profit corporation whose members include, "at least one-fourth of all licentiates of the particular profession residing in California . . .". While I have no objection, on public policy grounds, to the continued existence of this statutory provision, I sincerely believe it is in the public interest for California to now adopt legislation allowing the practice of medicine (and perhaps all of the learned professions) by non-profit corporations.

Such a statute would facilitate the establishment in California of institutions similar to the Mayo Clinic, Cleveland Clinic and Oschner Clinic, to cite just a few, all of which are organized as non-profit corporations and are tax exempt under Section 501(c)(3) of the Internal Revenue Code. The contributions of these renowned institutions to the advancement of medical knowledge and care is undisputed. I am further persuaded that they could not have succeeded, as they have, had they not been non-profit, tax exempt organizations.

The combined ability of such institutions to obtain funds from charitable contributions and grants coupled with their ability to make capital acquisitions with pre-tax dollars allows them to conduct research, education and medical treatment beyond the capability of a professional person practicing in a "for profit" mode. As medical practice and research becomes ever more capital intensive, as a result of modern technology and inflation, the need for such institutions becomes ever greater.

Moreover, the ability to engage in the practice of medicine through a non-profit corporation opens the door to the creation of novel methods for the delivery of health care in new modes and organizational structures such as the HMO, the County Medical Society Foundation, and others still on the drawing boards or as yet unconceived.

Considering the increasing demand for the expansion of the availability of professional services, I submit that the flexibility of providing such service through a non-profit corporation should be expressly authorized in California's Non-Profit Corporation Law.

I have taken the liberty of enclosing a proposed form of statutory language to accomplish this purpose, together with comments thereon. I must emphasize that I do not hold out this proposed language to be any model of legislative drafting; however, it is submitted to serve as a reference for the comments thereon which I feel are important.

I am also enclosing an extra copy of this letter and the enclosure with the request that if you feel my suggestions have any merit, you will forward them to the committee now assisting the Legislature in its consideration of amending California's Non-Profit Corporation Law.

If you or any members of the Committee have any questions regarding my suggestions, or if I can be of any assistance regarding the adoption of such legislation, I would welcome the opportunity to respond.

Again, my congratulations on your most well deserved receipt of the Boalt Hall Alumni Citation Award. I have never forgotten the personal interest you took in me during law school nor your assistance in my obtaining a position in Santa Barbara.

If you are ever in Santa Barbara, I hope you will contact Harris, Paul or myself so we can get together; till then I look forward to seeing you on my next visit to Boalt Hall.

Sincerely,

Charles H. Jarvis

CHJ:p

Enc.

Proposed Statutory Provision:

A non-profit corporation may be formed[1] for the purpose of rendering professional[2] services, but only through one or more natural persons who are[3] duly licensed under the provisions of the Business and Professional Code to render the same professional services as are or will be rendered by the non-profit corporation.[4] The non-profit corporation may employ persons who are not so licensed, but such persons shall not render any professional services rendered or to be rendered by the non-profit corporation.[5] A non-profit corporation so formed may not render such professional services in this state without all currently effective licenses required by law for it to render such professional services.[6]

Comments:

1. I have not attempted to anticipate what changes the committee may recommend in the process of the formation of a non-profit corporation. It may be that some qualification should follow the word "formed" with reference to the new formation procedures. I would recommend that no distinction be drawn between a non-profit corporation whose only members are the persons who serve on its Board of Directors/Trustees as contrasted with a non-profit corporation which has one or more other classes of members.

2. I have not considered all of the professions which might be encompassed by the word "professional" and it may well be that this adjective is too broad in this context. I would have no objection to limiting the professions which could practice in the non-profit corporation mode so long as the practice of medicine and dentistry were expressly included.

3. If the proposed language is compared with the provisions of Section 13405 of the California Corporations Code, it will be noted that that code section provides, in part, ". . . a professional corporation may lawfully render professional services, but only through employees who are licensed persons." I have intentionally excluded the reference to "employees" for the reason that in the context of a non-profit corporation providing professional services, it may well be that the professionals will be employees, volunteers contributing their professional skill, or that the professionals may be employees of a separate for-profit corporation (a professional corporation) with whom the non-profit corporation contracts for their professional services. I see no reason for requiring the professional person to be an "employee" of the non-profit corporation, so long as the professional person is duly licensed as provided in the clause immediately following the footnote.

4. The portion of the first sentence following the comma has been adapted from the provisions of Section 13405 and 13401(c) of the California Corporations Code.

5. This sentence has likewise been adopted from Section 13405 of the California Corporations Code.

6. The proposed statutory provision does not require a non-profit corporation to obtain a Certificate of Registration issued by the governmental agency regulating the profession in which such corporation is or proposes to be engaged pursuant to the applicable provisions of the Business and Professions Code (which requirement is contained in Section 13404). Since the corporation is, by definition, a non-profit corporation I think it is sufficient if it complies with the provisions of the last sentence of the proposed draft. I do not think such a non-profit corporation should be required to obtain a Certificate of Registration.