Study B-501 December 6, 2000

Memorandum 2000-88

Uniform Unincorporated Nonprofit Association Act: Liability Issues

The Commission is currently studying the law of unincorporated associations to determine whether the Uniform Unincorporated Nonprofit Association Act ("Uniform Act") should be adopted in California, either in whole or in part. Previous memoranda on this topic have suggested that wholesale adoption of the Uniform Act is not advisable, but that California could benefit from refinement of its existing laws regarding unincorporated associations. To that end, the Commission has directed the staff to do the following:

(1) Consolidate existing statutory law into a comprehensive Unincorporated Associations Act, reserving space for provisions that might be added later.
(2) Discuss possible rules for contract and tort liability of members and officers of an unincorporated association.
(3) Discuss possible improvements to the rules governing property ownership and management by an unincorporated association.
(4) Identify the types of governance provisions that could be applied to unincorporated associations and provide a general analysis of the issues raised by each type.

This memorandum addresses item (2). Future memoranda will address the other items.

A structural outline of this memorandum is set out below:

OUTLINE

Except as otherwise indicated, all statutory references are to the Corporations Code.

NONPROFIT ASSOCIATIONS

The analysis in this memorandum is limited to consideration of the liability of members and officers of unincorporated *nonprofit* associations. As explained in a previous memorandum, the different types of unincorporated for-profit associations (various forms of partnership, limited liability companies, etc.) are subject to their own liability rules.

COMMITTEE PROPOSAL

The Nonprofit Organizations Committee of the State Bar ("the Committee") has proposed that members of an unincorporated association should be immune from liability for contracts and torts of the association to the same extent as members of a limited liability company. That is, a member should not be liable for any debt, obligation, or liability of the association solely by reason of being a member. This would not prevent a member from expressly assuming liability or

being held liable for personal participation in tortious conduct. Nor would it preclude "alter ego" liability. Section 17101. Issues relating to application of the alter ego doctrine to an unincorporated association are discussed more fully below.

The Committee has also proposed that officers of an unincorporated association should be immune from liability for contracts and torts of the association to the same extent as officers of a limited liability company. That is, an officer should not be liable for any debt, obligation, or liability of the association "solely by reason of being [an officer] of the limited liability company." This does not prevent an officer from expressly assuming liability. Section 17158. Interestingly, Section 17158 does not acknowledge the possibility of liability for personal participation in tortious conduct. It isn't clear whether this is intentional.

The general principle in each of these proposals is that a member or officer is not liable solely as a result of membership status or office, but could be liable on other grounds. This principle makes a good starting point for discussion of the proper scope of liability.

LIABILITY BASED SOLELY ON MEMBERSHIP OR OFFICE

Under existing law, a member of a nonprofit association is not liable for a contract or tort merely as a consequence of membership status. See *Security First Nat'l Bank of Los Angeles v. Cooper*, 62 Cal. App. 2d 653, 667 (1945) ("membership, as such, imposes no personal liability for the debts of the association"); *Orser v. George*, 252 Cal. App. 2d 660, 670 (1967) ("mere membership does not make all members liable for unlawful acts of other members without their participation, knowledge or approval"). This is different from the rule in a general partnership, where each partner is jointly and severally liable for all obligations of the partnership. Section 16306(a).

The distinction between these rules arguably turns on the issue of control. In a partnership, each partner has an equal right to manage the partnership and all partners are considered to be both principals and agents of the partnership. In light of such shared control, shared liability makes sense. The linkage between control and liability is even clearer in a limited partnership, where limited partners are not liable for the obligations of the partnership unless the limited partner "takes part in the control of the business." Section 15507. The principle

that liability follows control is also evident in the law governing the joint liability of participants in a "joint enterprise" under tort law, which depends on the participants having or exercising an equal right of control over the enterprise. *Roberts v. Craig*, 124 Cal. App. 2d 202 (1954).

In a nonprofit association, membership does not necessarily translate to control. For example, an individual member may not have control over how a nonprofit association maintains its property. In *Marshall v. ILWU*, 57 Cal. 2d 781 (1962), a union member was injured in a fall in the union's parking lot. The court concluded that liability for the condition of the parking lot could not be imputed to the member, because he had neither "participated in nor authorized" maintenance of the lot. However, there will be cases where members do exercise control and liability may result. For example, in *Steuer v. Phelps*, 41 Cal. App. 3d 468 (1974), each member of a nine-member church group was directly involved in entrusting the group's car to a driver who then negligently injured someone. All of the members could be held personally liable.

In light of the variability of member control in different types of nonprofit associations, **the staff recommends** codification of the principle that liability may not be based on membership status alone. This is consistent with existing law, the Committee's proposal, and Section 6(b)-(c) of the Uniform Act. The question of when liability *should* be imposed on a member is discussed below.

Existing law does not directly address the question of whether an officer of a nonprofit association should be liable for obligations of the association solely as a consequence of office. If an officer is considered an agent of the association, then agency law dictates that the officer should not be liable for contracts of the association, or for torts of which the agent is personally innocent. See 2 B. Witkin, Summary of California Law *Agency* § 145, at 141, § 151, at 145 (9th ed. 1987). This still leaves open the possibility of liability based on authorization of a contract (where the officer is also a member) and liability for tortious conduct in which the officer is involved.

The staff recommends codification of the principle that liability may not be based on office alone. This is consistent with the existing law of agency and the Committee's proposal. The question of when liability *should* be imposed on an officer is discussed below.

The above recommendations could be implemented by adding a provision along the following lines:

> A member or officer of a nonprofit association is not personally liable for a debt, obligation, or liability of the association solely by reason of being a member or officer. Nothing in this section affects the liability of a member or officer who expressly assumes a debt, obligation, or liability of the association.
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> **Comment**. This section is new. It codifies the general rule that a member of an unincorporated nonprofit association is not personally liable for the association's debts, obligations, or liabilities solely by reason of membership. See Security First National Bank of Los Angeles v. Cooper, 62 Cal. App. 2d 653, 667 (1945) ("membership, as such, imposes no personal liability for the debts of the association"); Orser v. George, 252 Cal. App. 2d 660, 670 (1967) ("mere membership does not make all members liable for unlawful acts of other members without their participation, knowledge or approval"). This general rule has been extended to officers of an association that has officers. This is consistent with agency principles, under which an agent is not liable for obligations of a disclosed principal. See 2 B. Witkin, Summary of California Law *Agency* § 145, at 141, § 151, at 145 (9th ed. 1987).

Note that this memorandum contains a number of passages setting out proposed legislative language. These passages are drafted to address specific points in isolation. Once the Commission has decided which of the various approaches outlined in this memorandum it prefers, the staff will redraft the proposed language in a more integrated form.

CONTRACT LIABILITY: EXISTING LAW

Under existing law, a member may be liable for contractual obligations of a nonprofit association where the member has authorized or ratified the contract, either expressly or impliedly. *Cooper*, 62 Cal. App. 2d 653. However, no implication of consent or agreement to a contract may be drawn "from the fact of joining or being a member of the association, or signing its by-laws." Section 21102. Note that Section 21102 doesn't limit liability based on express authorization or ratification. Nor does it seem to limit implied authorization or ratification where the implication is drawn from facts *other* than "the fact of joining or being a member of the association, or signing its by-laws."

There is no case law interpreting the rules stated in *Cooper* and Section 21102. However, one can speculate that members could be liable under the following circumstances:

(1) The membership of an nonprofit association votes to approve execution of a particular contract. Such express prior authorization could result in liability under *Cooper*.

(2) The membership of an nonprofit association votes to authorize its officers to execute necessary contracts to achieve a particular end. This creates an agency relationship, with contracting power within the agent's actual authority. See Civ. Code §§ 2307 (creation of agency), 2316 (actual authority). The members would probably be liable for any obligation incurred by the agent, within the scope of the agent's actual authority. See Civ. Code § 2330 ("An agent represents his principal for all purposes within the scope of his actual … authority, and all the rights and liabilities which would accrue to the agent from transactions within such limit, if they had been entered into on his own account, accrue to the principal.").

(3) At a membership meeting, a member of a small nonprofit association proposes execution of a contract on behalf of the association. The other members do not object. The members may have impliedly authorized the contract. An agent's actual authority "is such as a principal intentionally confers upon the agent, or intentionally, or by want of ordinary care, allows the agent to believe himself to possess." Civ. Code § 2316.

(4) An officer of a nonprofit association informs the membership of a contract executed on their behalf. The membership votes to approve the contract, after the fact. The members have expressly ratified the contract. Express ratification could result in liability under *Cooper*.

(5) A member of a small association informs the other members that of a contract executed on behalf of the association. The other members do not object and avail themselves of the benefits of the contract. The members have ratified the contract. See Civ. Code § 2310 ("A ratification can be made …, by accepting or retaining the benefit of the act, with notice thereof.").

One factor limiting authorization and ratification is the "equal dignities" rule providing that a contract that must be in writing can only be authorized or ratified in writing. Civ. Code § 2309. For example, an agreement to lease real property for longer than one year must be in writing. Civ. Code § 1624(a)(3). Thus, authorization of an agent to execute such a contract would apparently also need to be in writing. Similarly, ratification by acceptance of benefits does not apply where written authorization would be required. Civ. Code § 2310. Thus, members apparently could not ratify a three year lease merely by accepting the benefits of the lease.

If the Commission finds that liability based on express or implied authorization or ratification of a contract is appropriate, existing law could be preserved either through silence or codification of the case law. Silence would preserve flexibility for the courts to develop the doctrine as future cases present new fact situations. Codification would provide greater certainty. Given the attempt to prepare a comprehensive statute governing unincorporated associations, codification may be preferable. The rule could be codified as follows:

> A member of a nonprofit association is personally liable for a contractual obligation of the association if the member expressly or impliedly authorizes or ratifies the contract. No inference that a member of a nonprofit association has authorized or ratified a contract may be drawn from the fact of joining or being a member of the association, or signing its by-laws.
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> **Comment**. The first sentence of this section is new. It codifies the common law rule that a member of a nonprofit association may be personally liable for a contractual obligation that the member has expressly or impliedly authorized or ratified. See Security First National Bank of Los Angeles v. Cooper, 62 Cal. App. 2d 653 (1944).
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> The second sentence continues part of the substance of former Section 21102. The language in former Section 21102 that purported to apply the section to contracts in existence prior to September 15, 1945 has not been continued.

The rationale for the change noted in the second paragraph of the Comment is discussed immediately below.

If the Commission approves the approach set out above, the staff will consider whether there are any refinements to the draft that should be made (e.g., to address whether a member must have capacity to contract before liability for a contract will be imposed). Such refinements would be discussed in a subsequent memorandum.

SPECIAL ISSUES IF EXISTING LAW PRESERVED

Retroactivity of Section 21102

As discussed, Section 21102 precludes any implication of assent to a contract based solely on joining or being a member of an association or signing its by-laws. Section 21102 appears to apply this rule retroactively: "No presumption or inference existed prior to September 15, 1945, or exists after that date…." Doubts

about the constitutionality of the retroactivity provision were raised in the Code Commission Comment to Section 22103 and in a Legislative Counsel opinion. See Wood, Report on Assembly Bill No. 356 at 5 (April 21, 1945) (on file with the Commission). These doubts seem justified. Section 10 of Article I of the U.S. Constitution provides in part: "No state shall … pass any … law impairing the obligations of contracts…." As noted in *Brown v. Ferden*, 5 Cal. 2d 226, 231 (1936), "The remedy, where it affects substantial rights, is included in the terms 'obligation of contract," and the remedy cannot be altered so as to materially impair such obligation." A statute that retroactively shields from liability some parties who would otherwise be liable under a contract, would seem to materially impair the obligations of that contract. Section 21102 precludes inferences that might result in a member of a nonprofit association being personally liable for the contract obligations of the association. Retroactive application of such a rule is probably unconstitutional.

It could be argued that the retroactivity language was intended to be declaratory of then-existing law, rather than attempting to retroactively impose a new rule. The court's analysis in *Cooper* , which was decided before enactment of Section 21102, seems to contradict such an argument. In *Cooper*, the court noted that the by-laws of the Elks lodge in question contained provisions for the operation of a club house, that the lease at issue served that purpose, and thus anyone who was a member at the time the lease was executed was deemed to have constructively assented to the lease, even if they did not expressly authorize it. In other words, the fact of membership and of signing the by-laws led to an inference of consent to the contract at question. This is exactly the inference that Section 21102 prohibits.

The staff believes that the retroactivity provision is probably unconstitutional and should not be continued.

Special Limit on Liability for Contracts Involving Real Property

In addition to the general liability rules discussed above, Section 21100 provides:

> Members of a nonprofit association are not individually or personally liable for debts or liabilities contracted or incurred by the association in the acquisition of lands or leases or the purchase, leasing, designing, planning, architectural supervision, erection, construction, repair, or furnishing of buildings or other structures, to be used for the purposes of the association.

This appears to be an absolute limit on liability for the specified types of contracts. Thus, even if a member expressly authorizes such a contract, the member is not personally liable. Apparently, the only basis for member liability on such a contract is a written assumption of liability. See Section 21101.

These sections were enacted in response to the *Cooper* case, in which the members of an Elks lodge were held liable on the lease for their clubhouse. At the time of enactment, the Legislative Counsel expressed "grave doubts" about the constitutionality of Section 21100. Regarding the distinction between the types of contracts covered by Section 21100 and all other contracts, he states (Wood, Report on Assembly Bill No. 356 4-5 (April 21, 1945) (on file with the Commission)):

> I think that the classification would make such a law contravene the Constitution of California, in that if it were considered a general law, it would not have a uniform operation … on creditors; and that it would grant to a class of citizens privileges and immunities which, upon the same terms, would not be granted to all citizens. ….
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> Those creditors who had contracts of the kinds described in the bill would have a more restricted recourse to members' property than would those creditors who sold food, an aircraft, a ship or furnishings for it, or musical instruments for a band, or who performed the services of secretaries, janitors or clergymen.
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> …
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> I have not been able to conceive of a state of facts that would show that the classification of debts and liabilities contained in the bill is founded on a natural, intrinsic or constitutional distinction which reasonably justifies different treatment from that which would be given to debts and liabilities not mentioned in it; although I freely admit that it is hypothetically possible that a court might find such a distinction. It is my opinion that grave doubt exists as to whether a court would find the proposed legislation to be constitutional as far as the classification affects it.

The Code Commission Comment to Section 21103 also expresses doubt about the constitutionality of Section 21100:

> There is some doubt as to whether [Section] 21100, may be unconstitutional as special legislation, since it makes a distinction between debts incurred in connection with real property and other debts, and so discriminates among creditors in respect to the recourse they may have for satisfaction of the debts due to them.

Of course, statutory distinctions between classes of persons are commonplace. What the California Constitution prohibits is unreasonable statutory discrimination. In *City of Pasadena v. Stimson*, 91 Cal. 238, 251-52 (1891) (emphasis added), the court stated:

> [Although] a law is general and constitutional when it applies equally to all persons embraced in a class *founded upon some natural or intrinsic or constitutional distinction*, it is not general or constitutional if it confers particular privileges, or imposes peculiar disabilities or burdensome conditions in the exercise of a common right, upon a class of persons *arbitrarily selected from the general body of those who stand in precisely the same relation to the subject of the law*.

The question then is whether there is some natural, intrinsic, or constitutional distinction justifying treating creditors whose contracts relate to real property differently from creditors whose contracts relate to some other matter. For example, what distinction can be drawn to justify limiting the rights of a person who provides *architectural* services to a nonprofit association, while not limiting the rights of a person who provides *accounting* services to the same association. If the purpose of Section 21100 is to promote nonprofit associations by insulating members from liability on contracts of the association, why not insulate members from *all* contract liability? **The staff believes** that there are doubts about whether the statute draws a reasonable (and therefore constitutional) distinction between classes of creditors, and recommends that the section not be continued in the tentative recommendation. However, a note should be added soliciting public input on whether there is a constitutional basis for the distinction justifying its preservation.

Special Limit on Liability for Medical Associations

Section 21200 provides a special liability limitation for members of an "organized medical society," which is defined as:

> Any organized medical society limiting its membership to licensed physicians and surgeons and that has as members at least 25 percent of the eligible physicians and surgeons residing in the area in which it functions (which must be at least one county).... [If] the association has less than 100 members, it shall have as members at least a majority of the eligible persons or licensees in the geographic area served by the particular association.

Section 21100 reiterates the liability exemption for contracts relating to real property. It then goes much farther, protecting its members from "debts or liabilities contracted or incurred by the association in the carrying out or performance of *any* of its purposes" that are not for pecuniary profit (emphasis added).

The general exemption from liability should probably be constitutional, as it affects all creditors equally. However, it is possible that an exemption applying only to medical associations might be considered special legislation. This seems unlikely, however. It is not difficult to conceive of a justification for treating medical associations differently from other associations, based on the magnitude of potential liabilities medical professionals face and the social importance of health care as a public service. Given that this section was amended fairly recently (1989) and was probably added on the suggestion of medical associations to address an actual problem, it would probably be best to leave the substance of the provision alone.

PROPOSED LIMIT ON CONTRACT LIABILITY

R. Bradbury Clark suggests, consistent with the Committee's proposal, that members of a nonprofit association should not be personally liable for contracts of the association if the association holds itself out to the public as a separate entity (except in alter ego cases or where a member has assumed liability). His suggestion is based on the following premises:

(1) Most members and voluntary creditors of a nonprofit association expect that a nonprofit association is a legal entity distinct from its members, and that the members are not personally liable for the association's obligations. The law should be consistent with those widely-held expectations.

(2) Most nonprofit associations *could* limit member liability by incorporating or by operating as a foreign limited liability company, but many do not, either due to expense or ignorance of the law. Members of a nonprofit association should not be penalized by imposition of stricter liability than would have applied if the members had had the knowledge and resources to incorporate.

(3) There is a general trend in the law toward recognizing nonprofit associations as separate legal entities and toward limited liability for members of nonprofit associations.

These justifications for limited member liability are discussed below.

Expectations of Parties

What are the expectations of members and creditors of an unincorporated nonprofit association? It probably varies. Sophisticated creditors, such as financial institutions, probably understand the law and require personal guarantees from individuals before extending credit to a nonprofit association. Members of large nonprofit associations probably recognize the possibility of personal liability and take steps to protect themselves (e.g., by ensuring that the association has sufficient assets to cover its obligations). The expectations of less sophisticated parties are harder to assess. There may be many members of small nonprofit associations who never contemplate personal liability for the association's obligations. On the other hand, there may be many people who are unfamiliar with the concept of limited liability and who assume that some natural person will ultimately be responsible for obligations incurred by a nonprofit association.

The question of expectations is complicated by the disclosure requirements that apply to limited liability entities. By statute, the names of such entities must include a specified phrase identifying its type. Sections 15612 ("limited partnership"), 16952 ("limited liability partnership"), 17052 ("limited liability company"). Presumably, a creditor dealing with a limited liability entity has actual notice of the entity's nature. This is probably the purpose of these disclosure requirements. A person used to dealing with such entities might reasonably infer that other types of entities, which do not identify themselves as limited liability entities, are *not* limited liability entities (as, under existing law, they are not).

Members Should Not Be Penalized for Failure to Incorporate

If the members of a nonprofit association do not incorporate, should they be "penalized" by imposition of member liability? The question raises two general policy questions: (1) If limited liability is available to unincorporated nonprofit associations, will there be an incentive not to incorporate, undermining the socially beneficial aspects of nonprofit corporation law? (2) Is it fair to apply different liability rules to unincorporated nonprofit associations and nonprofit corporations? These questions are discussed below:

Incentive to Avoid Incorporation

Nonprofit corporations are subject to a variety of statutory rules, including the following:

(1) Directors and officers are subject to standards of conduct that require good faith, reasonable care, and commitment to the best interests of the corporation. Sections 5231, 7231, 9241. Self-dealing transactions are specifically restricted. Sections 5233, 7233, 9243. Such provisions help prevent abuse of authority by management.

(2) A nonprofit corporation's affairs are subject to examination by the Attorney General. Section 5250, 7240, 9230. This helps ensure that a corporation has not deviated from its purpose or misused assets subject to a charitable trust.

(3) Distribution of assets to members (including repurchase or redemption of memberships) is either prohibited or restricted, in part to protect creditors from dissipation of the corporation's assets. Sections 5410-5420, 7411-7420, 9610.

(4) Corporations are required to maintain a variety of records, including: financial accounts, records of loans, guarantees, indemnifications, advances, etc. These records must either be provided to members annually or made available for inspection by members. Sections 6310-6338, 8310-8338, 9510-9514. These "sunshine" provisions help provide information that members and the Attorney General can use to evaluate management of the corporation.

(5) False or fraudulent action by a director or officer, in connection with issuance of memberships, distribution of assets, record-keeping, and examination by state officials, is punishable as a crime. Sections 6811-6814, 8811-8816, 9690. This helps deter such conduct.

These are socially beneficial rules, but they impose burdens and restraints on corporate management. If limited liability were available without incorporation, it seems likely that some (perhaps many) legally sophisticated organizations would choose not to incorporate, in order to avoid regulation. The Commission should be cautious about creating an unregulated limited liability entity.

Fairness of Disparate Treatment

It is unfortunate if members of a nonprofit association mistakenly believe that they enjoy limited liability, particularly if they would have incorporated had they understood the law and had the resources to do so. However, this doesn't mean that it is unfair to restrict limited liability to nonprofit corporations.

Unincorporated nonprofit associations are significantly different from nonprofit corporations. As discussed above, nonprofit corporations are regulated in ways that help prevent mismanagement and protect creditors. Nonprofit associations are not — there are no standards of care for member or officer conduct, no record-keeping requirements, and no limits on distribution of association assets. These are significant differences which seem to justify disparate treatment with respect to liability.

The differences between nonprofit corporations and nonprofit associations could be minimized by adding provisions regulating nonprofit associations. This would strengthen the argument for treating the two similarly with respect to member liability. However, if nonprofit associations are made to resemble nonprofit corporations, then all that has been accomplished is to create a new and intermediate form of organization — a limited liability unincorporated nonprofit association. Unsophisticated organizations that could not satisfy whatever regulatory requirements govern the new form (e.g., conduct standards, recordkeeping requirements, asset distribution limits, registration with the state) would remain "garden-variety" nonprofit associations, subject to existing liability rules. This approach would seem to help the organizations that need it the least — sophisticated nonprofit associations that understand the law but choose not to incorporate despite the advantages of corporate form.

Trend Toward Limited Liability

Historically, courts have treated nonprofit associations as aggregations of individuals, participating together in a joint enterprise. As such, the members were jointly liable for obligations of the association. In more recent years, the law has developed in the direction of treating a nonprofit association as a legal entity, separate from its members. A nonprofit association can own property in its own name, sue and be sued on its own behalf, enter into contracts, and is liable for acts or omissions of itself or its agents as if it were a natural person. Members are no longer personally liable solely as a consequence of membership — some personal participation is required to justify personal liability. The statutory response to *Cooper* added an exemption from liability for contracts relating to real property and precluded any implication of authorization or ratification of a contract based solely on membership status.

In 1994, the California Legislature created a new form of for-profit unincorporated association — the limited liability company. Members of a

limited liability company enjoy limited liability similar to that accorded shareholders of a corporation. Unlike shareholders of a corporation, members of a limited liability company may directly manage the affairs of the company, as in a partnership. This separation of liability from control provides some precedent for the idea that a member of a nonprofit association should enjoy similar protection from contract liability, regardless of whether the member has exercised control by authorizing or ratifying a contract.

Note, however, that limited liability companies are subject to significant regulation, including some requirements similar to those imposed on nonprofit corporations. For example, members of a limited liability company owe a fiduciary duty to the company and to other members. Section 17153. A distribution to members is not permitted if it would reduce the company's assets beneath the level required to meet existing obligations. Section 17254. Limited liability companies are required to maintain certain records, including financial accounts. Section 17058. Failure to comply with certain filing and recordkeeping requirements can result in a range of penalties, including suspension of the company's powers, rights, and privileges. Sections 17651-17655. Also, as discussed above, a limited liability company must include language identifying it as a limited liability company in its name, alerting creditors to the fact that it is a limited liability entity.

Legislative creation of the limited liability company form does mark a significant extension of limited liability for members of an unincorporated association. One can argue that limited liability for members of a nonprofit association would require a only a short step in the direction that the law is already heading.

Conclusion

It may be true that many people expect that members will not be liable for a nonprofit association's obligations, even if the member has authorized or ratified the contract — although this seems less likely with regard to legally unsophisticated people. It is certainly true that the law has tended toward more limited member liability, both in the common law and in the statutes. These considerations may justify limiting the liability of members for contract obligations. This could be done by adding a provision along the following lines:

(a) Except as provided in subdivision (b), a member of a nonprofit association is not personally liable for a contractual obligation of the association.

(b) A member of a nonprofit association is personally liable for a contractual obligation of the association in the following circumstances:

(1) The member has expressly assumed personal liability for the obligation, in a written and signed agreement.

(2) The member would be liable under the common law governing alter ego liability of shareholders of a nonprofit corporation, taking into account differences in form between a nonprofit association and a nonprofit corporation.

Comment. This section is new. Subdivision (a) reverses the common law rule that a member of a nonprofit association is personally liable for a contractual obligation of the association if the member expressly or impliedly authorized the contract. See Security First Nat'l Bank of Los Angeles v. Cooper, 62 Cal. App. 2d 653 (1944). Former Sections 21100 & 21102, limiting the contract liability of a member under some circumstances, are superfluous and have not been continued.

Subdivision (b) provides for potential liability where a member has expressly assumed liability or where the member would be liable under the common law alter ego doctrine. See generally 9 B. Witkin, Summary of California Law *Corporations* §§ 12-23, at 524-35 (9th ed. 1989).

The provision relating to alter ego liability is discussed more fully below.

Although there are good arguments for the approach outlined above, the **staff is concerned** that such a change could undermine the socially beneficial regulation of nonprofit corporations by offering an unregulated (or lightly regulated) alternative that confers one of the principal benefits of incorporation. The staff is also concerned that unsophisticated creditors will be left with no recourse when dealing with an insolvent nonprofit association, despite their expectation that someone will honor the association's obligations.

CONTRACT LIABILITY OF OFFICERS

Ordinarily, an agent is not liable for a contract the agent executes on behalf of the principal. Thus, it would appear that involvement by an officer in negotiation and execution of a contract on behalf of a nonprofit association should not result in personal liability for the officer, so long as it is clear that the officer is acting as an agent of the nonprofit association. However, an officer may also be a member,

and it may be difficult to determine whether the officer is acting solely as an agent, or is also acting as a member. For example, if a person who is both a member and the president of a small association informs the membership that the person intends to execute a contract on behalf of the association and the membership authorizes the contract, is the person acting only as an officer, or has the person also joined in authorizing the contract as a member?

The staff recommends a provision along the following lines:

> An officer of a nonprofit association is not personally liable for a contractual obligation of the nonprofit association solely because the officer negotiates or executes the contract, if it is disclosed that the officer is acting as an agent of the association. This section does not preclude liability based on an officer's actions as a member.
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> **Comment**. This section is new. It applies the common law rule, that an agent is not liable for contracts entered into on behalf of a disclosed principal, to an officer of a nonprofit association. See 2 B. Witkin, Summary of California Law *Agency* § 145, at 141 (9th ed. 1987). The second sentence clarifies that an officer who is also a member may be independently liable for his or her actions as a member. For example, a member who is also an officer may authorize a contract as a member and then negotiate and execute the contract on behalf of the association as an officer. Liability may attach as a consequence of the authorization, but not as a consequence of the negotiation and execution.

This seems to be a clear expression of the rule. The courts would have to grapple with applying it to difficult factual circumstances.

TORT LIABILITY: EXISTING LAW

In *Orser v. George*, 252 Cal. App. 2d 660 (1967), the court considered whether the members of an unincorporated duck club were liable for one member's accidental shooting of a non-member. The court noted:

> It has been held that an unincorporated association is bound to use the same care as a natural person; but that mere membership does not make all members liable for unlawful acts of other members without their participation, knowledge or approval. Vicarious liability may exist, however, based upon the same factors we have discussed above — personal participation in an unlawful activity or setting it in motion.

The court found that the shooting was outside the scope of the club's purpose and was not encouraged by any other members. Thus, there was no vicarious liability.

In *Steuer v. Phelps*, 41 Cal. App. 3d 468 (1974), the court considered whether the members of a very small church group, with no officers or management, were liable for one member's negligence while driving on group business. The court noted:

> There is evidence that each individual member, rather than an officer, manager, or committee, participated directly in entrusting the car to Mrs. Henry to operate exclusively for purposes of the association. Under the doctrine of respondeat superior, it is elemental that one who entrusts another with the operation of his automobile is liable for the negligent operation of the vehicle, even though he neither authorized nor approved the driving in a negligent manner. … Mere authorization to Mrs. Henry to operate the car fastens liability upon the individual members who gave that authorization.

Thus, it appears that a member of a nonprofit association may be vicariously liable for the tortious conduct of an agent of the association, if the member personally participates in the tort (in which case the member is probably liable for the member's own conduct, rather than vicariously liable for the agent's conduct), or authorizes or "sets in motion" the agent's actions.

Existing law could be preserved either through silence or codification of the case law. Silence would preserve flexibility for the courts to develop the doctrine as future cases present new fact situations. Codification would provide greater certainty. Given the attempt to prepare a comprehensive statute governing unincorporated associations, codification may be preferable. The rule could be codified as follows:

> A member of a nonprofit association is personally liable for damage or injury arising out an act or omission of the association or an agent of the association if the member authorizes or sets in motion the conduct that results in the act or omission.
>
> **Comment**. This section is new. It codifies the common law rule governing liability of a member of a nonprofit association for torts of the association. See Steuer v. Phelps, 41 Cal. App. 3d 468 (1974) (liability may be based on authorization of activity that leads to tort, under doctrine of respondeat superior), Orser v. George, 252 Cal. App. 2d 660 (1967) (vicarious liability may derive from having

set unlawful activity "in motion"). Note that a member may also be liable for personal participation in tortious conduct. *Id.*

POSSIBLE LIMIT ON TORT LIABILITY

Committee Proposal

The Committee has proposed that a member of a nonprofit association should receive the same protection from tort liability as a member of a limited liability company — that is, no liability unless the member assumes liability, is personally involved in the tortious conduct, or grounds exist for imposing alter ego liability. Mr. Clark's three rationales for limiting member liability, discussed above, apply with the same force to the question of tort liability. In addition, there is one other possible reason for limiting member tort liability. As a general proposition, a person is not liable for another's wrongs, of which the person is innocent. An exception is the doctrine of respondeat superior, under which a "master" is held liable for the torts of his or her "servant." The court in *Steuer* expressly relied on the doctrine of respondeat superior in finding that the members could be liable for their co-member's negligent driving. It isn't clear that respondeat superior should apply to nonprofit associations.

Rationale for Doctrine of Respondeat Superior

In *Hinman v. Westinghouse Elec. Co.*, 2 Cal. 3d 956, 959-60 (1970), the court discussed the rationale for the doctrine of respondeat superior (quoting Prosser, emphasis added):

> Although earlier authorities sought to justify the respondeat superior doctrine on such theories as "control" by the master of the servant, the master's "privilege" in being permitted to employ another, the third party's innocence in comparison to the master's selection of the servant, or the master's "deep pocket" to pay for the loss, "the modern justification for vicarious liability is a rule of policy, a deliberate allocation of a risk. The losses caused by the torts of employees, which as a practical matter are sure to occur in the conduct of the employer's enterprise, are placed upon that enterprise itself, as a required cost of doing business. They are placed upon the employer because, having engaged in an enterprise which will, on the basis of past experience, involve harm to others through the torts of employees, *and sought to profit by it*, it is just that he, rather than the innocent injured plaintiff, should bear them; and because he is *better able to absorb them, and to distribute*

them, through prices, rates or liability insurance, to the public, and so to shift them to society, to the community at large."

A legally sophisticated nonprofit association, which may be involved in commerce (though not for profit), is arguably in the same position as a business with respect to the rationale stated above. Torts of employees may be reasonably certain to occur and the association may be best able to absorb and redistribute any resulting losses (through insurance or by charging higher prices for its goods or services if it is involved in commerce). However, nonprofit associations may also be small, legally unsophisticated, and entirely non-commercial — for example, the nine-member church group in *Steuer*. The court's rationale for respondeat superior does not clearly apply to such an organization, which does not seek to profit from its activity, and cannot easily absorb risk or spread risk across society by raising prices or rates.

Rationale Inappropriate With Respect to Some Nonprofit Associations

Considering that nonprofit associations include organizations like the church group in *Steuer*, it isn't clear whether existing law is appropriate. Perhaps a better rule would be to preserve respondeat superior liability for the association itself, while limiting member liability to cases where the member is personally involved in the tortious conduct. For large and sophisticated organizations, this would still provide an incentive to limit risk and would allocate any loss to the "person" best able to absorb and spread the risk — the association itself. For small organizations, like the church group in *Steuer*, the loss would fall on the agent who committed the tortious act and on the organization itself, but the members would be spared liability. This would mean that an injured person will not be adequately compensated in cases where the negligent agent and the association are insolvent. This is unfortunate. However, it isn't clear that justice would be better served by shifting the loss to a member who is personally innocent of any wrongdoing.

Conclusion

For the reasons discussed above (including the discussion of Mr. Clark's reasons for limiting contract liability) it may be appropriate to limit member tort liability. This would be consistent with the Committee's suggestion and with the intent behind Section 6(c) of the Uniform Act. Such a rule could be implemented with language along the following lines:

(a) Except as provided in subdivision (b), a member or officer of a nonprofit association is not personally liable for damage or injury arising out an act or omission of the association or an agent of the association.

(b) A member or officer of a nonprofit association is personally liable for damage or injury arising out an act or omission of the association or an agent of the association, in the following circumstances:

(1) The member or officer has expressly assumed the liability in a written and signed agreement.

(2) The member would be liable under the common law governing alter ego liability of shareholders of a nonprofit corporation, taking into account differences in form between a nonprofit association and a nonprofit corporation.

Comment. This section is new. It reverses the common law rule that a member of a nonprofit association is liable for a tortious act of the association or its agent if the member authorized the act or set it motion. See Steuer v. Phelps, 41 Cal. App. 3d 468 (1974); Orser v. George, 252 Cal. App. 2d 660 (1967). The section does not preclude liability for the member's own tortious conduct. For example, a member could be liable for authorizing an intentional tort or for negligently entrusting a vehicle to an incompetent driver.

Note that a nonprofit association is itself liable for acts or omissions of its agents, to the same extent as if it were a natural person. Section 24001.

Subdivision (b) provides for potential liability where a member has expressly assumed liability or where the member would be liable under the common law alter ego doctrine. See generally 9 B. Witkin, Summary of California Law *Corporations* §§ 12-23, at 524-35 (9th ed. 1989).

Note that a decision to limit tort liability would not necessarily be inconsistent, as a matter of policy, with a decision to preserve existing member liability for contracts. The two issues are significantly different. In the context of tort, imposition of member liability would mean holding an innocent person liable for the wrong of another, based on a risk-spreading rationale of dubious merit. In the context of contracts, member liability would simply bind a member to an agreement that the member has personally approved or ratified.

TORT SUIT BY MEMBER AGAINST ASSOCIATION

Under existing law, a member of a nonprofit association may sue the association for injuries resulting from conduct in which the member did not

participate and over which the member exercised no control. *Marshall v. ILWU*, 57 Cal. 2d 781 (1962), *White v. Cox*, 17 Cal. App. 3d 824 (1971). Section 24001, enacted on the Commission's recommendation in 1967, does not fully reflect this rule. The section could be updated by amending it as follows:

> 24001. ~~(a)~~ Except as otherwise provided by statute, an unincorporated association is liable ~~to a person who is not a member of the association~~ for an act or omission of the association, and for the act or omission of its officer, agent, or employee acting within the scope of his office, agency, or employment, to the same extent as if the association were a natural person.
>
> (b) Nothing in this section in any way affects the rules of law which determine the liability between an association and a member of the association <u>for a violation of fiduciary duties</u>.
>
> **Comment**. Section 24001 is amended to reflect existing law, which permits a member of an unincorporated association to sue the association in tort. See Marshall v. ILWU, 57 Cal. 2d 781 (1962) ("a member of a labor union is entitled to sue the union for negligent acts which he neither participated in nor authorized"), White v. Cox, 17 Cal. App. 3d 824 (1971) ("[We] conclude that unincorporated associations are now entitled to general recognition as separate legal entities and that as a consequence a member of an unincorporated association may maintain a tort action against his association.").

The staff believes that a change along these lines would provide helpful clarification. However, as the change in subdivision (b) indicates, there may be special issues relating to fiduciary duties owed by an association to its members (e.g., duty owed by homeowner's association to its members). Care should be taken to ensure that any amendment to subdivision (b) preserves existing law on such matters. If the Commission decides to recommend a change along the lines proposed above, the staff will refine the drafting to avoid any unintended changes to existing law and present a revised draft in a subsequent memorandum.

EXHAUSTION OF ASSOCIATION RESOURCES

In a partnership, the partners are personally liable for obligations of the partnership, but creditors must exhaust the assets of the partnership before reaching partners' assets. Section 16307(d). If the Commission decides that members should be liable for an association's contracts or torts in some circumstances, a rule requiring exhaustion of association assets before reaching

members' assets would probably be appropriate. Such a rule would provide a partial shield for members and would place initial responsibility for association obligations on the association itself. An exhaustion requirement could be implemented as follows:

> A judgment creditor of a member or officer of a nonprofit association may not levy execution against the assets of the member or officer to satisfy a judgment based on a claim against the nonprofit association unless any of the following apply:
>
> (a) A judgment based on the same claim has been obtained against the nonprofit association and a writ of execution on the judgment has been returned unsatisfied in whole or in part.
>
> (b) The nonprofit association is a debtor in bankruptcy.
>
> (c) The member or officer has agreed that the creditor need not exhaust the assets of the nonprofit association.
>
> (d) A court grants permission to the judgment creditor to levy execution against the assets of a member or officer based on a finding that assets of the nonprofit association subject to execution are clearly insufficient to satisfy the judgment, that exhaustion of the assets of the nonprofit association is excessively burdensome, or that the grant of permission is an appropriate exercise of the court's equitable powers.
>
> (e) Liability is imposed on the member or officer by law or contract independent of the existence of the nonprofit association.
>
> **Comment**. This section is similar to Section 16307(d) (exhaustion of partnership assets). It provides that a judgment creditor of a nonprofit association must exhaust the assets of the association before reaching the assets of any member or officer who is also liable, except in the specified circumstances.

This section has been adapted from Section 16307(d), which applies to partnerships. The staff would appreciate receiving input from experts in the law of nonprofit organizations as to whether there are any problems with the proposed adaptation.

LIABILITY FOR DISTRIBUTED ASSETS

If member liability is limited, either for torts or contracts, there should be some limit on distribution of assets to members. In light of the assumption that many members of unincorporated nonprofit associations will be ignorant of the law, a prohibition on distribution of assets to members would probably not be helpful. A better approach would be to provide that creditors can hold a member personally liable to the extent of the value of assets distributed to that member.

This would protect creditors from imprudent or fraudulent distributions and would work no great hardship on members, as they would only be required to disgorge assets that should properly have been reserved to meet the association's obligations. This approach could be implemented by adding a provision along the following lines:

> (a) A member of a nonprofit association is personally liable for a contractual obligation of the association or a tortious act or omission of the association or an agent of the association, if the member has received assets of the association, either through a distribution or through redemption or repurchase of a membership.
>
> (b) Liability under this section shall not exceed the value of the assets received.
>
> **Comment**. This section is new. It is similar to Section 17254(e) (liability for improper distribution by limited liability company).

The proposed draft implements the basic policy that distributed assets should be reachable by creditors. If the Commission decides to recommend such a rule, the staff will develop the idea further, to see if there are any limits that should be imposed (e.g., time limits).

ALTER EGO DOCTRINE

The Committee has proposed that members of a nonprofit association should be liable for contracts and torts of the association to the same extent as members of a limited liability company. Section 17101(b) provides that members of a limited liability company are "subject to liability under the common law governing alter ego liability." If the Commission decides that members of a nonprofit association should not be liable for contracts and torts of the association, it makes sense to recognize the possibility of alter ego liability, to ensure that members do not unjustly use a nonprofit association as a shield from liability. The nature of the alter ego doctrine and problems that arise in applying it to nonprofit associations are discussed below.

Nature of Doctrine

The alter ego doctrine is summarized nicely in *Communist Party of the United States v. 522 Valencia, Inc.*, 35 Cal. App. 4th 980, 993 (1995) (citations omitted) :

> Ordinarily, a corporation is regarded as a legal entity separate and distinct from its stockholders, officers and directors. Under the alter ego doctrine, however, where a corporation is used by an

> individual or individuals, or by another corporation, to perpetrate fraud, circumvent a statute, or accomplish some other wrongful or inequitable purpose, a court may disregard the corporate entity and treat the corporation's acts as if they were done by the persons actually controlling the corporation. …
>
> In general, the two requirements for applying the alter ego doctrine are that (1) there is such a unity of interest and ownership between the corporation and the individual or organization controlling it that their separate personalities no longer exist, and (2) failure to disregard the corporate entity would sanction a fraud or promote injustice. … The doctrine is applicable where some innocent party attacks the corporate form as an injury to that party's interests. The issue is not so much whether the corporate entity should be disregarded for all purposes or whether its very purpose was to defraud the innocent party, as it is whether in the particular case presented, justice and equity can best be accomplished and fraud and unfairness defeated by disregarding the distinct entity of the corporate form.

The alter ego doctrine is an equitable doctrine, and its application varies with the circumstances of each case, thus "only general rules may be laid down for guidance." *Stark v. Coker*, 20 Cal. 2d 839, 846 (1942).

Factors Justifying Application of Doctrine

Factors courts have cited in justifying application of the alter ego doctrine include the following:

Failure to Observe Corporate Formalities

Failure to issue stock may be an indication that the shareholders of a corporation are actually doing business as individuals and that the corporation is the shareholders' alter ego. See, e.g., *Automotriz del Golfo de California v. Resnick*, 47 Cal. 2d 792, 796 (1957) ("While the fact standing alone that a corporation remains inchoate without stockholders or stock is not of itself determinative of an alter ego relationship upon its part, nevertheless it does indicate that such corporation may exist merely to serve the interests of another — a corporation or an individual."). Failure "to follow normal corporate procedures with respect to holding meetings and keeping records" may also be a factor justifying imposition of alter ego liability. *Riddle v. Leuschner*, 51 Cal. 2d 574, 581 (1959).

Intermingling of Assets

Intermingling of corporate assets with those of other persons or entities to suit the purposes of the shareholders may be a factor justifying imposition of alter ego liability. *Id.*

Wholly Inadequate Capitalization

Failure to provide a corporation with reasonably adequate assets to cover its prospective liabilities may justify imposing alter ego liability on shareholders. In *Automotriz*, 47 Cal. 2d at 797, the court relied in part on inadequate capitalization to justify imposing alter ego liability, quoting Ballantine on Corporations (1946):

> If a corporation is organized and carries on business without substantial capital in such a way that the corporation is likely to have no sufficient assets available to meet its debts, it is inequitable that shareholders should set up such a flimsy organization to escape personal liability. The attempt to do corporate business without providing any sufficient basis of financial responsibility to creditors is an abuse of the separate entity and will be ineffectual to exempt the shareholders from corporate debts. It is coming to be recognized as the policy of the law that shareholders should in good faith put at the risk of the business unencumbered capital reasonably adequate for its prospective liabilities. If the capital is illusory or trifling compared with the business to be done and the risks of loss, this is a ground for denying the separate entity privilege.

Problem Applying Doctrine to Nonprofit Associations

As discussed above, nonprofit associations include a wide range of organizational types — from large commercial entities such as the Educational Testing Service, to very small, legally unsophisticated groups like the church group in *Steuer*. With respect to small, informal, and legally unsophisticated groups, application of the alter ego rules developed for corporations may be problematic. For example, existing law does not regulate the governance of nonprofit associations. There are no requirements as to structure, meetings, voting, or record-keeping. Thus, a perfectly valid nonprofit association, operating pursuant to its own customs and rules, may not even approximate adherence to corporate formalities. Similarly, a small and informal organization may be less than meticulous in its accounting practices and may mingle personal assets with the association's assets. Finally, by what standard should one judge whether a nonprofit association is reasonably capitalized? In business, potential liability

may be somewhat ascertainable. Potential liability may be much harder to judge in a small, non-commercial entity. For example, what is the potential liability of a small group of church members who drive to meetings and deliver tracts? Probably, such a group should have liability insurance on its vehicle, but is that sufficient? What if the group is sued for libel based on the contents of one of its tracts — should the members be personally liable if the group has no assets set aside in anticipation of such liability?

One could attempt to address the differences between nonprofit associations and nonprofit corporations by developing statutory exceptions to the alter ego doctrine as applied to nonprofit associations. This approach is taken in Section 17101(b), which provides that a member of a limited liability company is subject to alter ego liability "except that the failure to hold meetings of members or managers or the failure to observe formalities pertaining to the calling or conduct of meetings shall not be considered a factor tending to establish that a member or the members have alter ego …liability …, where the articles of organization or operating agreement do not expressly require the holding of meetings of members or managers."

Alternatively, one could simply note the fact that nonprofit associations are different from corporations and rely on the court to exercise their equity powers in a reasonable way. After all, alter ego liability is not imposed merely because there is an identity between shareholders and a corporation, it must also be that "failure to disregard the corporate entity would sanction a fraud or promote injustice." This latter approach is the one taken by staff in the proposed legislative language set out above on pages 16 and 21.

CONCLUSION

Once the Commission decides on the proper liability rules, the staff will incorporate those rules into a draft tentative recommendation setting out a comprehensive unincorporated associations act (with space reserved for later incorporation of matters not yet addressed).

Respectfully submitted,

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