Study B-501 March 1, 2002

First Supplement to Memorandum 2002-6

Uniform Unincorporated Nonprofit Association Act (Discussion of Issues)

Memorandum 2002-6 discusses proposed Corporations Code Section 18055, which provides that the proposed law would not apply to a "partnership, limited liability company, or other association formed pursuant to statute." The staff has identified a potential problem with that approach. That problem is discussed below.

R. Bradbury Clark of the Nonprofit Organizations Committee of the Business Law Section of the State Bar has raised a number of technical issues regarding the staff draft. His comments are also discussed below.

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

APPLICATION OF PROPOSED LAW

As drafted, proposed Section 18055(b) provides that the proposed law would not apply to a "partnership, limited liability company, or other association formed pursuant to statute." The intent was to exclude entities that fall within the proposed definition of "unincorporated association," but are already subject to entity-specific statutory schemes. In such cases, the entity-specific statutes should control.

Fraternal Fire Insurers

The staff has since discovered a type of unincorporated nonprofit association that appears to be "formed pursuant to statute" — fraternal fire insurers. Fraternal fire insurers are religious organizations or "secret fraternal societies" that provide fire insurance for their members. Ins. Code §§ 9080.3, 9081. Such an association is "formed by filing a certificate" with the Secretary of State and the clerk of each county in which insured property is located. Ins. Code § 9082.

If a fraternal fire insurer is unincorporated, it would appear to be subject to existing law applicable to unincorporated associations, including the provisions relating to member liability, property powers, service of process, etc. However,

because it is "formed pursuant to statute," a fraternal fire insurer would be excluded from application of the proposed law pursuant to Section 18055. This appears to be a problem.

Other Types of Association "Formed Pursuant to Statute"

The discovery of fraternal fire insurers suggests that there may be other types of unincorporated association that are "formed pursuant to statute," but which are presently subject to the unincorporated associations law.

The state is sufficiently interested in insurance to regulate the formation of fraternal fire insurers. There are many other areas of significant interest to the state: education, health care, agriculture, etc. There may be special types of unincorporated associations that are active in these areas and are subject to statutory formation requirements. A blanket exclusion of all associations that are "formed pursuant to statute" could cause unintended consequences to such groups.

Possible Alternative

An alternative approach would be to delete the proposed "entity exclusion" provision. Instead, language could be added providing that entity-specific provisions control when in conflict with provisions of the proposed law. That would allow the Commission to draft general rules applicable to all unincorporated associations without concern that an entity-specific rule would inadvertently be trumped. For example, proposed Section 18105 provides that an unincorporated association may "acquire, hold, manage, encumber, or transfer an interest in real or personal property." However, there is also a property powers provision specific to fraternal fire insurers, providing that such an association may:

> Own sufficient real property for its business purposes, and such other real property as it becomes necessary to purchase on foreclosure of its mortgages. Real estate obtained by such foreclosure shall be sold and conveyed within five years from the time title vests in the association.

Ins. Code § 9089(c). Under the proposed alternative, a fraternal fire insurer would generally be subject to the proposed unincorporated associations law, but the specific property ownership limitation provided in Insurance Code Section

9089 would prevail over the more general rule provided in proposed Section 18105.

The alternative approach could be implemented by revising proposed Section 18055 and adding a new Section 18060, as follows:

> **§ 18055. Exempt entities**
>
> 18055. This title does not apply to any of the following entities:
>
> (a) A government or governmental subdivision or agency.
>
> (b) A partnership~~,~~ or limited liability company~~, or other association formed pursuant to statute~~.
>
> **Comment**. Subdivision (a) of Section 18055 is drawn from former Section 24000.
>
> Subdivision (b) ~~provides that the law of unincorporated associations does not apply to an entity formed under another statute. This is similar to the rule that a for-profit entity is not a partnership if it is formed pursuant to a statute other than the Uniform Partnership Act of 1994, a predecessor statute, or a similar statute of another jurisdiction. Section 16202 (b).~~ is new. A partnership or limited liability company is subject to other law. See Sections 15501-15533 (Uniform Limited Partnership Act), 15611-15723 (California Revised Limited partnership Act), 16100-16962 (Uniform Partnership Act of 1994), 17000-17655 (Limited Liability Companies).

> **§ 18060. Relation to other law**
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> 18055. If a statute that is specific to a particular type of unincorporated association is inconsistent with a provision of this title, the specific statute prevails.
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> **Comment**. Section 18055 is new. It makes clear that the general provisions of this title are subordinate to entity-specific statutes. For example, Section 18105 authorizes an unincorporated association to own property. Insurance Code Section 9089 provides a more restrictive property ownership rule specific to fraternal fire insurers. A fraternal fire insurer can be unincorporated, in which case it would be subject to both sections. To the extent they are inconsistent, Insurance Code Section 9089 would prevail.

Specifically Excluded Entities

In the alternative discussed above, the staff has preserved the language excluding partnerships and limited liability companies from application of the proposed law. There may be other types of entities that are subject to comprehensive statutory schemes and should therefore be excluded entirely. **The**

staff recommends that a note be added following Section 18055, specifically requesting input on whether there are other types of unincorporated association that should be excluded from application of the proposed law.

TECHNICAL ISSUES

Definition of "Nonprofit Association"

Proposed Section 18015(a) provides that:

> "Nonprofit association" means an unincorporated association organized primarily for a purpose other than operating a business for profit.

Mr. Clark is concerned that use of the word "organized" would tie the definition to the purpose of the organization *at the time it was created*. This could be unduly restrictive where the nature of an organization changes over time. Perhaps **the provision could be redrafted to read:**

> "Nonprofit association" means an unincorporated association with a primary common purpose other than operating a business for profit.

Note that the word "common" was added to parallel the phrase "common purpose" in the proposed definition of "unincorporated association." See proposed Section 18025.

Mr. Clark is also concerned that the Comment to Section 18015(b) describes that subdivision as recognizing "that a nonprofit entity may carry on incidental for-profit activity in service of its primary purpose." The word "incidental" might imply that the for-profit activity must be somehow related to the primary purpose of the organization. The proposed statute does not include such a limitation — for-profit activity would be permitted so long as the profits are applied to the primary purpose of the association. He proposes deletion of the word "incidental." **The staff has no objection to that change.**

Definition of "Unincorporated Association"

Section 18025(b) makes clear that mere joint ownership of property does not itself establish an unincorporated association. That provision is drawn from the Uniform Unincorporated Nonprofit Association Act and from existing partnership law. At page 3 of the Memorandum 2002-6, the staff proposes a simplified version of the subdivision:

> Joint tenancy, tenancy in common, community property, or other forms of property tenure does not by itself establish an unincorporated association, even if coowners share use of the property for a common purpose.

Mr. Clark prefers the simplified version. However, he believes that the words "share use" may be problematic. There are situations where the owners of property arguably don't "use" or "share use" of property. For example, the property may be rented, or spouses may be separated, with only one of the spouses actually "using" property owned by both. Mr. Clark suggests replacing the word "use" with "ownership," thus:

> Joint tenancy, tenancy in common, community property, or other forms of property tenure does not by itself establish an unincorporated association, even if coowners share ownership of the property for a common purpose.

The staff is not sure that this is a helpful change, but has no objection to it either.

Section 18025(c) defines "person" for the purpose of the definition of "unincorporated association," making clear that an unincorporated association need not consist entirely of natural persons. The provision is drawn verbatim from the existing definition of "unincorporated association." Mr. Clark suggests that the word "commercial" be deleted and that "organization" be added as an alternative to "legal entity," since some organizations may not be recognized as separate legal entities, thus:

> As used in this section, "person" includes a natural person, corporation, partnership or other unincorporated organization, government or governmental subdivision or agency, or any other legal ~~or commercial~~ entity or organization.

The staff has no objection to deletion of "commercial", which seems superfluous. However, it isn't clear that addition of "organization" as an alternative to "entity" is necessary. If an organization is not recognized as a separate legal entity (and is instead a mere aggregation of individuals), should that group be considered a single "person?" It might make sense to revisit this question when the Commission turns its attention to various membership issues.

Group Subject to Title for Reasons of Fairness

Section 18050 would permit a court to treat an unincorporated organization as an "unincorporated association" under the proposed law "where fairness requires." Mr. Clark is concerned that the Comment's citation of *Barr v. United Methodist Church*, while proper, may give a mistaken impression that the provision is intended to apply only where fairness to third parties is at issue. He suggests that clarifying language be added to the statute and Comment, along the following lines:

> **§ 18050. Group subject to title for reasons of fairness**
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> 18050. Where fairness to an organization's members or agents or to others requires, a court may treat an unincorporated organization as an unincorporated association under this title.
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> **Comment**. Section 18050 recognizes that fairness may require that a group be subject to this title, whether or not it meets the definition of an "unincorporated association." See Barr v. United Methodist Church, 90 Cal. App. 3d 259 (1979) ("Fairness includes those situations where persons dealing with the association contend their legal rights have been violated. Formalities of quasi-corporate organization are not required."). Fairness may require providing an unincorporated organization and its members or agents with the benefits provided by this title, as well as protecting others who deal with or have claims against the organization or its members or agents.
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> See also Section 18025 ("unincorporated association" defined).

The proposed addition to the statute isn't strictly necessary, as the current language is adequately broad to encompass fairness to an organization's members or agents. However, **the staff has no objection to the Comment language**, which may be sufficient to address the point raised by Mr. Clark.

Exempt Entities

As discussed above, Section 18055 would exempt certain "entities" from application of the proposed law. Mr. Clark questions use of the word "entities" because the enumerated organizations could include an association that is not a legal entity. That would apparently not be the case if the Commission makes the changes to Section 18055 discussed earlier, because then the section would only apply to government organizations, partnerships, and limited liability companies — all of which are legal entities. **If the Commission does not adopt the approach**

discussed in the first part of this memorandum, then "entities" should probably be replaced with another term, perhaps "organizations."

Limit on Assertion of Unauthorized Action

With certain exceptions, Section 18120 protects third parties from an assertion that an unincorporated association's property transaction is unauthorized. One of the exceptions allows such an assertion in a "proceeding to enjoin an unauthorized act, or the continuation of an unauthorized act, where a third party has not yet acquired rights that would be adversely affected by the injunction." Section 18120(a). Mr. Clark believes this exception needs some refinement. There may be a situation where an injunction would adversely affect the interests of a third party, but should be permitted anyway because the third party actually knew that the transaction was unauthorized from the outset. This could perhaps be addressed by revising subdivision (a) as follows:

> 18120. No limitation on the power of an unincorporated association to acquire, hold, manage, pledge, encumber, or transfer an interest in real or personal property, or the manner of exercise of those powers, shall be asserted as between the unincorporated association or a member of the unincorporated association and a third person, except in the following proceedings:
>
> (a) A proceeding to enjoin an unauthorized act, or the continuation of an unauthorized act, where a third party has not yet acquired rights that would be adversely affected by the injunction, and where, at the time of the unauthorized act the third party lacked actual knowledge that the act was unauthorized.

The staff believes that this would be an improvement.

Respectfully submitted,

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