

## Memorandum 2002-59

**Uniform Unincorporated Nonprofit Association Act: Governance Issues**

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The Commission has decided to recommend the reorganization and improvement of existing unincorporated association law, rather than adoption of the Uniform Unincorporated Nonprofit Association Act ("Uniform Act"). This project is proceeding incrementally, with the Commission considering different subject areas and tentatively approving proposals before moving on to the next subject area. Once all of the subject areas have been considered, the staff will prepare a draft tentative recommendation reflecting the Commission's decisions.

To date, the Commission has considered issues relating to liability of association members and agents, property ownership, and civil procedure. Those are the subject areas addressed by existing California law and by the Uniform Act.

The final subject area that the Commission may wish to consider for inclusion in the proposed law is "governance" of an unincorporated association. The purpose of this memorandum is to provide a brief survey of various governance issues. If the Commission decides that these issues should be considered for inclusion in the proposed law, the staff will prepare a memorandum providing more detail (and draft language).

If the Commission decides against including any governance issues, the staff will prepare a draft tentative recommendation, based on the Commission's prior decisions. Except as otherwise indicated, statutory references in this memorandum are to the Corporations Code.

## BACKGROUND ON GOVERNANCE ISSUES

Representatives of the Business Law Section of the State Bar have suggested that the unincorporated association law should include some provisions relating to the governance of an unincorporated association. Such provisions might address formation, governing documents, standards of conduct, member admission and termination, meeting and voting procedures, charitable trust administration, and dissolution. The staff has asked that the Business Law

Section suggest which types of governance provisions they consider to be most important, but we have not yet received their response.

In considering whether to add governance provisions to the proposed law, two points should be kept in mind.

- (1) *Unincorporated associations will adopt a variety of governance forms.* Some organizations will follow procedures quite similar to those of a corporation or partnership. Others will have less traditional governance structures. For example, a group may practice consensus decisionmaking (where every member has a veto power over every decision), direct democracy (with every member voting on every issue), or may vest all decision making power in an executive committee or individual. Governance procedures may be set down in a constitution and bylaws or may arise on an ad hoc basis (and may change over time, as needs or personalities of the group change).
- (2) *The purpose of the unincorporated association law is not to recreate corporation law.* A group that wants to enjoy the benefits of corporation law should incorporate.

The remainder of this memorandum discusses various types of governance provisions that could be added to the proposed law.

#### FORMATION

The staff sees no reason to add a formation procedure to the proposed law. The proposed law has been drafted as a default scheme that would apply to any unincorporated group that is not subject to some other statute. If a specific formation procedure were imposed, many groups would fail to comply through ignorance of the law. The proposed law is intended to cover such groups.

#### GOVERNING DOCUMENTS

The proposed law is intended as a default scheme applicable to all unincorporated associations, regardless of their level of sophistication or formality. For that reason, the proposed law should not require any particular form of governing documents. Such a requirement could exclude groups that fail to comply through ignorance of the law.

However, there may be some benefit to creating a safe harbor procedure for amendment of an unincorporated association's governing documents. An unincorporated association that complies would then be immunized against any

challenge to the validity of its action. For example, a provision could be added providing that an amendment approved by a majority of a quorum of the membership is valid (unless the governing documents impose a stricter requirement). If the Commission is interested in the possibility of adding an amendment provision, the staff will prepare a more detailed analysis, including proposed legislation.

#### STANDARD OF CONDUCT

There may be some benefit to adding a provision governing the conduct of a director or other officer of an unincorporated association. By way of example, Section 7231 establishes the basic standard of care (and liability shield) for a director of a nonprofit mutual benefit corporation:

7231. (a) A director shall perform the duties of a director, including duties as a member of any committee of the board upon which the director may serve, in good faith, in a manner such director believes to be in the best interests of the corporation and with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances.

(b) In performing the duties of a director, a director shall be entitled to rely on information, opinions, reports or statements, including financial statements and other financial data, in each case prepared or presented by:

(1) One or more officers or employees of the corporation whom the director believes to be reliable and competent in the matters presented;

(2) Counsel, independent accountants or other persons as to matters which the director believes to be within such person's professional or expert competence; or

(3) A committee of the board upon which the director does not serve, as to matters within its designated authority, which committee the director believes to merit confidence, so long as, in any such case, the director acts in good faith, after reasonable inquiry when the need therefor is indicated by the circumstances and without knowledge that would cause such reliance to be unwarranted.

(c) A person who performs the duties of a director in accordance with subdivisions (a) and (b) shall have no liability based upon any alleged failure to discharge the person's obligations as a director, including, without limiting the generality of the foregoing, any

actions or omissions which exceed or defeat a public or charitable purpose to which assets held by a corporation are dedicated.

To the extent that a director of an unincorporated association is aware of the law, such a provision would provide useful guidance. Even if the director is unaware of the law, imposition of such a standard should not present an unfair surprise. A person in a position of authority who acts in bad faith, against the interests of the association, or with an unreasonable lack of care should not be surprised if held accountable.

Mutual benefit corporation law includes other provisions that might also be usefully adapted to unincorporated associations. See Sections 7231.5 (liability of volunteer director), 7233-7236 (interested director), 7237 (indemnification of director), 7238 (standard of conduct with respect to assets held in charitable trust). However, this possibility raises the question of how much of the corporation law should be imported into unincorporated association law? Is our goal to cover a handful of basic issues that have created problems in the past (i.e., property ownership, liability, and civil procedure issues)? Or is the goal to cover every contingency, creating a sort of “corporation-lite?”

If the Commission is interested in the possibility of adding standard of conduct provisions, the staff will prepare a more detailed analysis, including proposed legislation.

#### MEMBER ADMISSION AND TERMINATION

California courts have recognized that a member of an association has a common law right to “fair procedure” in some circumstances. The right to fair procedure is discussed at length in *Potvin v. Metropolitan Life Insurance Co.*, 22 Cal. 4th 1060 (2000).

With respect to decisions on admission to membership, the right to fair procedure seems to apply only where exclusion from membership would have “substantial economic ramifications.” Thus, fair procedure is required if a private association possesses “substantial power either to thwart an individual’s pursuit of a lawful trade or profession, or to control the terms and conditions under which it is practiced.” *Id.* at 1069. For example, a trade union with closed shop agreements has a labor monopoly that would prevent excluded persons from working in that trade.

The right to fair procedure in expulsion of an existing member is broader:

[One] may not be expelled from membership in a private association without charges, notice and hearing. This common law protection against arbitrary expulsion, judicially declared, is of broader application and has been extended not only to labor unions and professional and trade associations, but to mutual benefit societies and other fraternal and social groups. The underlying theme of these decisions, variously stated, is that membership in an association, with its associated privileges, once attained, is a valuable interest which cannot be arbitrarily withdrawn.

*Id.* (citations omitted).

Some sort of statutory fair procedure could be added to the proposed law as a safe harbor. An association that follows that procedure would be sure that its action satisfies the common law fair procedure requirement. By way of example, Section 7341 provides a procedure for suspension or expulsion of members of a nonprofit mutual benefit corporation:

7341. (a) No member may be expelled or suspended, and no membership or memberships may be terminated or suspended, except according to procedures satisfying the requirements of this section. An expulsion, termination or suspension not in accord with this section shall be void and without effect.

(b) Any expulsion, suspension, or termination must be done in good faith and in a fair and reasonable manner. Any procedure which conforms to the requirements of subdivision (c) is fair and reasonable, but a court may also find other procedures to be fair and reasonable when the full circumstances of the suspension, termination, or expulsion are considered.

(c) A procedure is fair and reasonable when:

(1) The provisions of the procedure have been set forth in the articles or bylaws, or copies of such provisions are sent annually to all the members as required by the articles or bylaws;

(2) It provides the giving of 15 days' prior notice of the expulsion, suspension or termination and the reasons therefor; and

(3) It provides an opportunity for the member to be heard, orally or in writing, not less than five days before the effective date of the expulsion, suspension or termination by a person or body authorized to decide that the proposed expulsion, termination or suspension not take place.

...

A provision along these lines would provide guidance and certainty to an association that is aware of the law. If cast as a safe harbor, the procedure would do no harm to an association that is unaware of the law.

Note that the provision quoted above does not regulate admission decisions. Regulating admission practices would be a more difficult proposition, because the right of fair procedure does not apply to all admission decisions. This would make it harder to draft a simple default rule.

If the Commission is interested in the possibility of adding a procedure for admission, suspension, or expulsion of a member, the staff will prepare a more detailed analysis, including proposed legislation.

#### MEETING AND VOTING PROCEDURES

There are a number of provisions that could be added to regulate the process of meeting and voting. For example, we could add a provision establishing a default quorum rule. In addition, default voting procedures could be crafted to authorize written balloting, proxy voting, etc. The Corporations Code offers good models for such rules. See, e.g., Corp. Code §§ 7510-7527 (meeting and voting in nonprofit mutual benefit corporation).

If such rules are drafted as safe harbor provisions, then no harm would be done by including them. They would provide guidance and certainty to groups that are aware of the law, without posing any trap for groups that are unaware of the rules. However, this level of regulation again raises the question of how much corporation law should be imported into the unincorporated association law?

If the Commission is interested in the possibility of adding meeting and voting provisions, the staff will prepare a more detailed analysis, including proposed legislation.

#### CHARITABLE TRUST ADMINISTRATION

Some assets of an unincorporated association may be subject to a charitable trust, either expressly or constructively. There are numerous provisions of law governing the administration of a charitable trust. For example, the Uniform Supervision of Trustees for Charitable Purposes Act provides for Attorney General oversight of charitable trusts. See Gov't Code § 12580 *et seq.* No changes need to be made to that act to provide for its application to unincorporated associations. See Gov't Code § 12582 ("trustee" defined).

However, there are a number of provisions applicable to a nonprofit public benefit corporation that might be usefully applied to a charitable unincorporated association. For example:

- Section 5142 provides an action for breach of a charitable trust.
- Section 5223 authorizes the Attorney General to bring an action to remove a director for certain improper acts.
- Section 5236 requires Attorney General approval before a loan may be made to any director or officer.
- Section 5250 provides that a public benefit corporation is subject to examination by the Attorney General.
- Section 5913 requires notice to the Attorney General before disposition of all or substantially of the corporation's assets.

Provisions analogous to these could be added to the proposed law. However, the overall effect of doing so might be negative. An unincorporated charitable group with significant assets is probably already aware of the requirement that it register with the Attorney General. See Gov't Code § 12585. If so, then it is already subject to significant supervision. A charitable group with minor assets, on the other hand, might be ignorant of the law. For such groups, new requirements could pose traps, creating potential liability and undermining the validity of transactions.

If the Commission is interested in the possibility of adding charitable trust administration provisions, the staff will prepare a more detailed analysis, including proposed legislation.

#### DISSOLUTION

The proposed law already includes provisions relating to one aspect of dissolution — distribution of the dissolving association's remaining assets.

There are other dissolution-related issues that could also be addressed. For example, there is case law on the method by which an unincorporated association may dissolve. If an unincorporated association's governing documents provide a method for dissolution, the association may dissolve pursuant to that method. Where no provision is made in the governing documents as to the method of dissolution, the association may be dissolved by the unanimous consent of its members, by the decision of a superior organization, or by court order. See *Holt v. Santa Clara County Sheriff's Benefit*

*Ass'n*, 250 Cal. App. 2d 925, 929-30, 59 Cal. Rptr. 180, 183 (1967). The proposed law could codify these rules.

In addition, the procedures for involuntary dissolution (i.e., dissolution pursuant to court order) could be fleshed out. *Cf.* Corp. Code §§ 8510-8519 (involuntary dissolution of nonprofit mutual benefit corporation).

Codification of *Holt* would provide useful guidance, without making any substantive change to the law. Addition of rules for involuntary dissolution might also be helpful, so long as they are drafted so as not to assume any particular type or formality of organization.

If the Commission is interested in the possibility of adding dissolution provisions, the staff will prepare a more detailed analysis, including proposed legislation.

#### CONCLUSION

The proposed law would probably be improved by the addition of some governance provisions. However, **the staff recommends against adding such provisions at this time.**

As a consequence of its relatively low priority with respect to the Commission's other work, this study has progressed slowly. We are now at a reasonable stopping point, and could distribute a tentative recommendation based on prior Commission decisions with little additional effort. This could lead to the introduction of legislation in 2004.

If the Commission chooses to include governance provisions in the proposed law, the additional delay involved would probably be considerable.

The staff would prefer to move forward with what we have completed so far, which is self-contained and in no sense requires the addition of governance provisions. This would not preclude later addition of governance provisions, either by the Commission or some other interested group, as a separate project.

Respectfully submitted,

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