GUIDE

TO THE

CALIFORNIA NONPROFIT CORPORATION LAW

FOR

CHARITABLE ORGANIZATIONS

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1. Introduction

Until recently, the California law governing nonprofit corporations was a puzzling hybrid of trust law, business corporation law, and a negligible amount of law pertaining specifically to nonprofit corporations. In 1978, the California legislature enacted a new and comprehensive Nonprofit Corporation Law ("NCL"), which became effective in 1980. A major purpose of the NCL was to eliminate confusion, by providing a unified and coherent body of statutory law specifically designed for nonprofit corporations. The NCL divides the universe of nonprofit corporations into three parts: religious corporations, mutual benefit corporations, and public benefit corporations. This paper focuses solely on public benefit corporations and concentrates particularly on the Board of Directors and the rights of members.

2. Board of Directors

The Board of Directors of a public benefit corporation is ordinarily elected, either by the members or by the directors themselves, as explained in the next section. If there are no members, all of the directors may be designated rather than

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elected; up to one-third of the board may be designated if the corporation has members. No director may be elected for a term longer than six years, although a director may be re-elected for unlimited number of terms. There is no limit to the number of directors who may serve on the board of a public benefit corporation, and the minimum is one.

A director may receive reasonable compensation for services performed as a director. But at least 51% of the board must consist of other than "interested" individuals--people who have not been compensated by the corporation during the prior twelve months for services performed for the corporation in a capacity other than as director. Compensation includes amounts paid directly to the director and, also, to most of the director's relatives. It is not uncommon for a board to have some directors who are "interested"--an accountant, legal counsel, the executive director--yet still be able to satisfy the 51% rule. Often, however, those directors will be in violation of the self-dealing rules, discussed later, requiring specific board approval.

For the board to take action, it must have a quorum. The NCL allows the board of a public benefit corporation to operate with a quorum of 20% of the authorized directors, if the bylaws so provide. The board may take action only in the following four

ways: (1) at a board meeting at which a quorum is present; (2) by conference telephone, so long as a quorum participates and the directors hear one another; (3) without a meeting, so long as every director consents in writing to the action taken; (4) without a meeting of the board, most action that it could take may be accomplished by an Executive Committee.

Notice of all meetings of the board must be given to the directors, unless each director signs a waiver of notice for the particular meeting. Notice is adequate if the time and place of the meeting is stated in the bylaws (a "regular" meeting), or if the notice is delivered personally or by telephone at least 48 hours before the meeting, or is mailed to each director at least four days before (a "special" meeting). The 48 hour and four-day time periods may be varied by the bylaws.

A director may resign at any time by giving written notice to the chairman, president, or secretary. Resignation is effective upon receipt, unless the notice specifies a later time. The director must also notify the Attorney General, if resignation would leave the corporation without any directors.

The topic of removal of directors is given detailed consideration by the NCL. The board alone may remove a director in all cases only if a court has acted--to convict the director of a felony or to declare that the director is of unsound mind or has breached his duty of care or loyalty to the corporation--

or unless the director has failed to attend a required number of meetings, which requirement was contained in the bylaws when the director was elected. In all other cases, the removal power of the board depends on whether the corporation has members. If there are members, they must approve the removal. The board alone may remove a director for reasons other than those just given only if there are no members. Directors who are designated rather than elected may be removed only with the written consent of the person who is entitled to make the designation. In appropriate circumstances, of course, a director may be removed as a consequence of an action brought in court.

Under the NCL, committees which are merely advisory and have power only to recommend action to the board need not have any directors as members. But all committees with board powers, such as an Executive Committee, must have at least two directors as members. The board may give the Executive Committee sufficient power so that, between meetings, the Executive Committee may act just as the board, other than with respect to exceptional matters, such as filing of vacancies on the Board, compensating directors, amending or repealing bylaws, or amending or repealing any resolution of the Board which by its expressed terms is not amendable or repealable. There are other specific actions the Executive Committee may not take, but, generally, an Executive Committee may function with most of the powers of the Board.

The officers of the corporation must be a chairman of the board or a president, a secretary and a chief financial officer. Any number of offices may be held by the same person except that neither the secretary nor the chief financial officer may serve at the same time as the president or chairman of the board.

The NCL specifically authorizes the Board to delegate management responsibilities to staff. The law also specifies that the board must retain the ultimate responsibility for managing and directing the organization, and the directors are given the absolute right, at any reasonable time, to inspect and copy all books and records of the corporation.

Perhaps the most important changes in the new law concern directors' liability. The former statutory law is silent on this issue, except to say that directors are not liable for the debts of the corporation. The NCL specifies the standard of care required of directors--a standard, by the way, similar to that required of directors of business corporations. The NCL standard of care requires that:

> "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."

The use in that standard of language having an unusual degree of subjectivity and ambiguity--"good faith," "believes," "best

interests," "reasonable inquiry," "ordinarily prudent person," "like position," "similar circumstances"--provides little to guide or to reassure a director. But the NCL provides, further, that, ordinarily, the director will be regarded as having satisfied that standard of care and will be protected from liability if the director acts in reliance on "information, opinions, reports or statements" prepared or presented by (1) an officer or employee whom the director believes to be reliable and competent; (2) counsel, accountants, or other professionals or experts, if the director believes the matter is within their area of expertise; (3) a committee acting within its authority, if the director does not serve on it and believes that it merits confidence.

Several points should be noted about those reliance protections. First, they don't protect the director who fails to attend board meetings and who, therefore, is unable to rely on information presented at the meetings. Second, they require that the board act in important matters in reliance on the advice of others; the board that receives no advice or that departs from the advice it receives is not protected. Third, to arrange for expert advice on a regular basis requires not

only the expenditure of funds but assumes a sophisticated style of management not present in every nonprofit corporation. Finally, careful use of the reliance provisions will provide the director with more certain protection against liability than was possible before the NCL.

This same reasonable or prudent man standard applies with respect to investments of the corporation. Except with respect to assets used for the exempt purpose of the organization, assets are not to be invested in a speculative manner. Rather, the directors are directed to look to the permanent disposition of the funds, considering the probable income as well as the probable safety of the corporation's capital. These restrictions are not applicable if the investments conform to written directions of a donor made at the time of the contribution.

Another significant change is in the area of conflict of interest or, to use the terms of the NCL, "self-dealing" transactions. Under former law, the development of court cases suggested that no conflict of interest was permissible. Under the NCL, a technical conflict of interest is permissible if there is full disclosure and if the board approves the matter. More specifically, if a director has a material financial interest in a transaction to which the corporation is a party, the corporation may not enter into that transaction unless it is approved. As mentioned earlier, this language will ordinarily cause the payment by the nonprofit corporation of

compensation to an employee who also serves as a director to be a self-dealing transaction. The self-dealing transaction may be approved by the Attorney General, by a court, or by the board. For the board approval to be effective it must occur prior to the transaction. Board approval occurs by the adoption of a resolution stating that: (1) it enters into the transaction for its own benefit; (2) the transaction is fair and reasonable to it; (3) the board considered and in good faith determined, after reasonable investigation under the circumstances, that it could not have obtained a more advantageous arrangement with reasonable effort under the circumstances, and (4) the resolution was adopted by a vote of a majority of the directors then in office, without counting the vote of the interested director or directors, in good faith, and with full knowledge of the material acts concerning the transaction and the director's interest in the transaction. If time constraints prevent board approval before the transaction occurs, it must be approved by an authorized committee or person and ratified by the board at its next meeting. If a public benefit corporation is also classified as a private foundation under the federal income tax laws, it should be aware that approval of a self-dealing transaction under California's NCL does not make it proper under federal law.

Finally, the NCL prohibits the corporation from making any loans or guarantees to any director or officer, unless approved by the Attorney General.

3. Members

Until the enactment of the NCL, it was not possible in California to have a nonprofit corporation with no members. If a nonprofit corporation had no members, within the ordinary meaning of the term, then the directors were the members. The NCL elimiates this legal fiction. It adds a precise statutory definition of members:

> "'Members' means any person who, pursuant to a specific provision of a corporation's articles or bylaws, has the right to vote for the election of a director or directors or on a disposition of all or substantially all of the assets of a corporation or on a merger or a dissolution . . . .[or] who is designated . . . as a member and . . . has the right to vote on changes to the articles or bylaws."

Thus, unless an individual has these voting rights, that person is not a statutory member and does not, therefore, obtain the rights conferred by the NCL on members, except to the extent that the articles or bylaws specifically provide otherwise.

If there are no members, the Board of Directors becomes self-perpetuating and the ultimate source of power of the corporation. With the presence of members, the nature of the nonprofit corporation changes fundamentally. For now, the source of power is the membership, which electes the Board of Directors. From this fundamental shift of power follow many of the membership rights under the NCL. If the members are to have a real voice in the election of directors, they must be and are allowed a reasonable opportunity to nominate the directors.

For similar reasons, the vote of the membership is ordinarily required to remove a director, and only the members may elect directors to fill vacancies, unless they have approved articles or bylaws giving this power to the Board of Directors. Since members can not act responsibly without information about the organization, they are given the right to inspect the books, records, and membership lists of the corporation for a purpose reasonably related to their interests as members, and also the right to receive annual financial reports. Members may not be expelled unless minimum standards of due process are met; and the Board of Directors may not amend, without the vote of the members, any provision of the articles or bylaws which would diminish or adversely affect the rights of the members. It follows that the existence of the nonprofit corporation may not be terminated by merger or dissolution or a dispostion of substantially all of it's assets without a membership vote.

Members may not use their power to benefit themselves financially. Distributions, without adequate consideration, may not be made to members. And, like shareholders of business corporations, members have limited liability. A member "is not, as such, personally liable for the debts, liabilities, or obligations of the corporation."

The bylaws may provide that regular membership meetings be held not less than every three years. If the bylaws make no provision, then annual meetings must be held. The first regular meeting must be held within 60 days after the date specified in the bylaws or, if no date is specified, within 15 months after the date of incorporation. If the meeting is not so held, the Superior Court may order it done.

Special meetings may be called by the board, the chairman of the board, the president or by any other person specified in the bylaws.

Written notice of all meetings at which members are required or permitted to take any action must be given to all members. Written notice of a regular membership meeting must be given not less than 10 nor more than 90 days before the date of the meeting. Minimum notice is 20 days if the notice is not mailed by first-class, registered or certified mail. The notice must specify the place, date, and time of the meeting and, in addition, those matters which the board, at the time of the mailing of the notice, intends to present for action by the members. If directors are to be elected, the names of all nominees at the time of the notice must also be specified.

Special meetings may be called by the board, the chairman of the board, the president or by any other person specified in the bylaws. The time for the meeting specified in the notice

must be not less than 35 nor more than 90 days after the board receives the request for the special meeting. If the board fails to give notice within 20 days after receiving a request for a special meeting, the person requesting that meeting is entitled to set the date of the meeting and give notice or, alternatively, to seek an order of the Superior Court requiring the corporation to give that notice. The place, date and time of the meeting must be specified in the notice and also the general nature of business to be transacted. No other business may be transacted at a special meeting. This provision is in contrast to the provision regarding regular meetings where any proper matter may be presented for action by the members whether or not notice of such matter has been given.

If the bylaws authorize a membership meeting to be conducted with a quorum of less than one-third of the voting power and less than one-third actually attend the meeting, then the only matters that may be voted on at such a members meeting are matters the general nature of which were described in the notice.

The vote required for the membership to act is a function of two separate provisions--the quorum requirement and the percentage vote needed for action. Unless the articles or bylaws provide otherwise, the vote of a majority of the members voting, with a quorum present, results in a valid act of the

membership. Thus, members of an organization of 200 members with a majority quorum may act by an affirmative vote as small as 51, so long as 101 members are present. Unless the articles or bylaws provide otherwise, members may vote at meetings, either in person or by proxy, or by written ballot. The proxy may be valid for more than three years unless revoked by the member. A proxy may not be irrevocable.

The quorum for a membership meeting is a majority of those voting, in person, by proxy, or by written ballot. The articles or bylaws may provide for a lower quorum; to increase the quorum requires approval of the members. If the quorum is set at less than one-third, the members may act only on matters notice of the general nature of which was given. Once a quorum is present at a membership meeting, the members may take valid action even though the departure of some members destroys the quorum, so long as at least a majority of the quorum approves of the action.

Unless prohibited by the articles or bylaws, any action which the members may take at a regular or special meeting may be taken, instead, by written ballot. The ballot must be sent to every member. It must state: (1) the number of votes needed for a quorum; (2) the number of votes needed for approval; (3) the time the ballot must be received to be counted; (4) that a member may specify a choice of approval and disapproval; and (5)

that, in an election for directors, a member may mark the ballot, "withhold." In counting the returns, withholds may not be counted for or against the proposal. The number of ballots received must satisfy the quorum requirements, and action occurs if the number of approvals would be sufficient to pass the measure if considered at a meeting.

Finally, although a public benefit corporation is free under the NCL to function with or without members, if the corporation is a membership organization, it may find it difficult to persuade its present members to vote to eliminate their rights and powers.

4. Conclusion

The NCL has unquestionably eliminated much confusion. And it provides a guide not previously available to the conduct of public benefit corporations. Although the NCL is subject to the criticism that it has replaced confusion with complexity, the entire legal environment within which all nonprofit corporations operate--corporate law, tax law, charitable solicitation law--has become more complex, not unlike society at large.

Perhaps the most obvious consequence of legal complexity will be an increase in the administrative expense of nonprofit corporations for compliance, including, particularly, expert advice to the board. More fundamental, however, may be the impact on the Board of Directors and, therefore, the staff.

Added complexity means added responsibility, and a consequent increase in the potential personal liability of directors. To minimize legal liability, a director must participate regularly in board meetings and must display an industriousness and attentiveness to the affairs of the corporation that, customarily, has not been associated with the position, usually unpaid, of a member of the Board of Directors of a nonprofit corporation.