

**RESPONSIBILITIES OF  
DIRECTORS AND OFFICERS OF  
CALIFORNIA NONPROFIT PUBLIC BENEFIT CORPORATIONS**

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*This outline should be viewed only as a summary of the law and not as a substitute for legal or tax consultation in a particular case. Your comments would be appreciated and are invited.*

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# **RESPONSIBILITIES OF DIRECTORS AND OFFICERS OF CALIFORNIA NONPROFIT PUBLIC BENEFIT CORPORATIONS**

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## **1. BACKGROUND**

- ◆ Managing a California nonprofit public benefit corporation is a regulated activity.
- ◆ Directors and officers are subject to several sets of rules which are contained in the California Nonprofit Public Benefit Corporation Law, the federal Internal Revenue Code, the California Revenue and Taxation Code, and the California Uniform Supervision of Trustees for Charitable Purposes Act, as amended by the Nonprofit Integrity Act of 2004. The federal Volunteer Protection Act may also apply and may override some California laws.

## **2. KEY DEFINITIONS**

### **2.1. Section 501(c)(3) organization**

- ◆ Any type of organization exempt from federal income tax under Section 501(c)(3)
- ◆ Could be a private foundation or a public charity

### **2.2. Nonprofit organization**

- ◆ Corporation, association or trust
- ◆ Not necessarily tax-exempt

### **2.3. Types of California Nonprofit Corporations**

- ◆ Public benefit (typical charity; Attorney General has a major role)

- ◆ Mutual benefit (trade association, auto club or country club; Attorney General has a small role)
- ◆ Religious (church)

#### 2.4. **Members**

- ◆ Analog to shareholders
- ◆ Not necessary or even advisable to have members of a public benefit or religious corporation
  - ⇒ Alternative: staggered board of directors
- ◆ Role of the Attorney General
  - ⇒ 8 attorneys, 15 auditors
  - ⇒ No one has gone to jail for many years (except for tax fraud), but civil enforcement and computer testing are active
  - ⇒ Actively promotes legislation, including the revised nonprofit law in the late 1970s, the raffle laws in 2000 and the Nonprofit Integrity Act of 2004 (SB 1262).

### 3. **DUTIES OF DIRECTORS**

The board of directors is responsible for managing the corporation in accordance with its articles of incorporation and bylaws.<sup>1</sup>

All activities and affairs must be conducted by the board or under its direction.

Although it delegates responsibility for day-to-day operations to the officers (and it may delegate the management of specific activities to an individual, committee or management company), the board remains ulti-

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<sup>1</sup> Cal. Corp. Code § 5210.

mately responsible for the proper performance of any delegated activities.<sup>2</sup>

### 3.1. **Duty of Care (The “Prudent Person” Standard)**

- ◆ Members of the board of directors have a legal obligation to use proper care in the performance of their duties.
- ◆ In California, the propriety of directors’ actions is evaluated under the “prudent person” rule.
  - ⇒ Under this standard, directors must perform their duties in good faith, in the corporation’s best interest, and with the same degree of care that an “ordinarily prudent person in a like position would use under similar circumstances.”<sup>3</sup>
  - ⇒ Proper care specifically includes a duty to make reasonable inquiries when the circumstances indicate that further information is necessary to properly evaluate a situation.<sup>4</sup>
- ◆ These standards apply to each director, without regard to whether the director is compensated by the corporation.<sup>5</sup>
- ◆ The duty of care applies to the performance of virtually all duties and responsibilities of the directors, including the nomination and election of directors.<sup>6</sup>

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<sup>2</sup> *Id.*

<sup>3</sup> Cal. Corp. Code § 5231(a).

<sup>4</sup> *Id.*

<sup>5</sup> Cal. Corp. Code § 5230(a).

<sup>6</sup> Cal. Corp. Code § 5232.

- ◆ Directors who fail to exercise due care in the performance of their duties might be liable to third parties or to the corporation itself for resulting damages.

### 3.2. Special Duties for Investments

- ◆ Different than the standard for trustees under California law
- ◆ California law instructs the directors of a nonprofit public benefit corporation to “avoid speculation” and to consider the income and safety of potential investments.<sup>7</sup>
- ◆ California also requires the directors to comply with any investment standards contained in the articles of incorporation, bylaws, or agreements transferring assets to the organization.<sup>8</sup>
  - ⇒ The board must follow the provisions of those instruments even when they mandate speculative investments.<sup>9</sup>
  - ⇒ Even the statutory duty of due care yields to express requirements contained in these documents.
  - ⇒ However, if these requirements conflict with good sense, the officers should seek advice of counsel. A court order granting permission to deviate from these requirements may be obtained.<sup>10</sup>

### 3.3. Other Rights and Duties

- ◆ Right to information and duty to obtain it

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<sup>7</sup> Cal. Corp. Code § 5240(b)(1).

<sup>8</sup> Cal. Corp. Code § 5240(b)(2); *see also* Cal. Prob. C. §§ 18500-09 (“Uniform Management of Institutional Funds Act” imposing special duties regarding restricted gifts), discussed at Section 7.2 below.

<sup>9</sup> Cal. Corp. Code § 5240(c).

<sup>10</sup> Cal. Corp. Code § 5241.

- ◆ Reliance on others
  - ⇒ Generally, directors may rely on information supplied in the course of their duties by the organization’s officers and employees, board committees, legal counsel, independent accountants, and other professional advisors.<sup>11</sup>
  - ⇒ However, a director may rely on information provided by others only if such reliance is reasonable under the “prudent person” standard.
  - ⇒ If a director has some indication that information is unreliable, further inquiry is necessary before the director approves any action by the corporation in reliance on that information.
- ◆ Committees: The board of directors may establish committees composed of board members to act on behalf of the entire board.<sup>12</sup>
- ◆ Right to resign: If a director wishes to resign but doing so would leave the corporation without a duly elected director in charge of the corporation’s affairs, the Attorney General must be notified before the resignation becomes effective.<sup>13</sup>
  - ⇒ Otherwise, directors may resign at any time after complying with the notice provisions in the bylaws.<sup>14</sup>

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<sup>11</sup> Cal. Corp. Code § 5231(b).

<sup>12</sup> Cal. Corp. Code § 5212.

<sup>13</sup> Cal. Corp. Code § 5226.

<sup>14</sup> Cal. Corp. Code § 5224(c).

### 3.4. **Directors as officers**

- ◆ A person can serve as both a director and an officer of a charitable organization.
- ◆ However, no more than 49% of the persons serving on the board can be either (a) compensated by the organization for services that they render to it or (b) a brother, sister, ancestor, descendent, spouse, brother-in-law, sister-in-law, son-in-law, daughter-in-law, mother-in-law or father-in-law of a person who is so compensated.<sup>15</sup> The bylaws will often reflect this requirement.

### 3.5. **Conflicts of interest:**

- ◆ Directors and officers doing business with the organization
  - ⇒ California law contains very specific rules regarding transactions between a nonprofit public benefit corporation and either a director or an entity in which a director has a material financial interest.<sup>16</sup>
  - ⇒ For this purpose, a “self-dealing” transaction is “a transaction to which the corporation is a party and in which one or more of its directors has a material financial interest” and which is not otherwise excluded from the definition of “self-dealing transactions.”
    - Action by the board of directors fixing the compensation of a director (either in his capacity as a director or an officer of the corporation) is not a “self-dealing” transaction.
    - If the transaction is part of a public or charitable program of the corporation and is both ap-

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<sup>15</sup> Cal. Corp. Code § 5227.

<sup>16</sup> Cal. Corp. Code § 5233.

proved by the corporation in good faith *and* without unjustified favoritism, and it results in a benefit to a director or the family of a director because they are in a class of persons intended to be benefited by the program, the transaction does *not* constitute self-dealing.

- If the interested director has no actual knowledge of the transaction and the amount involved does not exceed the lesser of 1% of the gross receipts of the corporation for the preceding fiscal year or \$100,000, it does not constitute self-dealing.

⇒ If a self-dealing transaction occurs, a legal action may be brought by the Attorney General, a director or officer of the corporation, or a person permitted by the Attorney General to act on behalf of the corporation.

- In such an action, the court has broad discretion to remedy the self-dealing.

◆ Common directors

◆ Loans, leases, guarantees

◆ Enforcement by Attorney General

⇒ Some transactions require *prior* notice to the Attorney General

◆ Prohibited transaction rules for private foundations

◆ Excess benefit rules (“intermediate sanctions”) for public charities

◆ Formal conflict of interest policies

### 3.6. **Indemnification and insurance**

◆ Liability protections

⇒ Requirement of obtaining or trying to obtain directors and officers liability insurance coverage

⇒ Volunteer Protection Act of 1997.<sup>17</sup>

- ◆ Optional vs. mandatory indemnification
- ◆ Effect of insurance pay-out on excess benefit calculation

### 3.7. Political activities

- ◆ Candidates vs. causes

## 4. OFFICERS

### 4.1. Duties

- ◆ In general, the officers implement the decisions of the board and operate the organization on a day-to-day basis.
- ◆ The officers have the duties specifically assigned to them by the bylaws and by resolutions of the board of directors.<sup>18</sup>

### 4.2. Signing documents

- ◆ Generally, officers -- not directors -- should sign documents on behalf of the organization.<sup>19</sup>
  - ⇒ A person who is both an officer and a director should clearly indicate that he or she is signing as an officer, not as a director.
- ◆ To avoid confusion regarding the capacity in which a particular document is executed, any document requiring the

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<sup>17</sup> 42 U.S.C. §§ 14501-04.

<sup>18</sup> Cal. Corp. Code § 5213(a).

<sup>19</sup> There are exceptions, but the exceptional documents -- such as articles of incorporation or certificates of dissolution -- would ordinarily be prepared by an attorney.

signature of the organization should set forth the name of the organization, the name of the person signing on behalf of the organization, and the title of the office held by such person. The following is an example of a proper signature block:

XYZ INSTITUTE,  
a California nonprofit public benefit corporation

By \_\_\_\_\_  
Dona Any, President

- This form of signature clearly indicates that the document is being signed on behalf of the organization and not by an individual.
- ◆ A proper signature provision helps to prevent individual liability and to preserve the organization as a separate entity.

#### 4.3. **Seal**

- ◆ A California nonprofit public benefit corporation may use a corporate seal, but this is not legally required.<sup>20</sup>

#### 4.4. **Fraud**

- ◆ Directors or officers who make false statements, participate in the making of false statements, or falsify corporate records are personally liable for any damages that result.<sup>21</sup>

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<sup>20</sup> Cal. Civil Code §§ 1628, 1629.

<sup>21</sup> Cal. Corp. Code § 6215.

## 5. CRIMINAL PENALTIES

California law imposes misdemeanor criminal penalties on managers of nonprofit public benefit corporations who commit various **prohibited acts**.

- ◆ Directors who approve of or concur in any distribution of the organization's assets intended to defraud creditors, members, or the organization itself are subject to misdemeanor criminal penalties.<sup>22</sup>
- ◆ It is a misdemeanor for a director or officer to make false statements or reports about the organization's financial condition intending to induce others to contribute to the organization, or to refuse to make any book entry, or to post any notice required by law.<sup>23</sup>
- ◆ Managers (as well as employees and other agents, such as accountants and attorneys) are also guilty of a misdemeanor if they:
  - ⇒ Receive property of the organization without fully disclosing the transaction in the organization's books;<sup>24</sup>
  - ⇒ Destroy, alter, or falsify the organization's books, papers, or securities;<sup>25</sup>
  - ⇒ Make or concur in omitting a material entry in any corporate record with fraudulent intent;<sup>26</sup> or

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<sup>22</sup> Cal. Corp. Code § 6811.

<sup>23</sup> Cal. Corp. Code § 6812.

<sup>24</sup> Cal. Corp. Code § 6813(a).

<sup>25</sup> Cal. Corp. Code § 6813(b).

<sup>26</sup> Cal. Corp. Code § 6813(b).

⇒ Knowingly provide false documents to a government auditor.<sup>27</sup>

## 6. OTHER LAWS

When acting as an employer, landlord, landowner, creditor, debtor, or in a similar business capacity, a nonprofit corporation is subject to all of the rules that apply to for-profit entities acting in the same capacity.

## 7. ENDOWMENTS

### 7.1. Acceptance letters

- ◆ The acceptance letter is critical.
- ◆ Should be counter-signed by the donor and retained in the corporation's permanent records.
- ◆ Corporation should have a policy for acceptance letters, which requires prior executive committee or board approval for exceptions.

### 7.2. Uniform Management of Institutional Funds Act

- ◆ Broader investment authority than the “preserve capital” approach in the Nonprofit Public Benefit Corporation Law<sup>28</sup>

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<sup>27</sup> Cal. Corp. Code § 6814.

<sup>28</sup> Section 18504 of the California Probate Code provides: “In addition to an investment otherwise authorized by law or by the applicable gift instrument, the [Board of Directors], subject to any specific limitations set forth in the applicable gift instrument, may do any or all of the following:

(a) Invest and reinvest [a restricted gift] in any real or personal property deemed advisable by the [Board], whether or not it produces a current return, including mortgages, deeds of trust, stocks, bonds, debentures, and other securities of profit or nonprofit corporations, shares in or obligations of associations or partnerships, and obligations of any government or subdivision or instrumentality thereof.

*(footnote continued on next page)*

- ◆ A “total return” or “modern portfolio theory” investment standard applies to the restricted funds.
  - ◆ Permits the corporation to spend unrealized appreciation, in addition to income on the portfolio.
  - ◆ Does not permit the corporation to dip into or “borrow” from principal.
- ⇒ A “proposal to propose” to allow this has been very controversial.

7.3. Spending policies

7.4. Restricted funds and “borrowing”

7.5. Enforcing pledges

## 8. OPERATING ISSUES

### 8.1. Fundraising

- ◆ Registering to solicit funds
- ◆ Registered fund-raisers
- ◆ Contracts with fund-raisers

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*(footnote continued from prior page)*

(b) Retain property contributed by a donor [as a restricted gift] for as long as the [Board] deems advisable.

(c) Include all or any part of [a restricted gift] in any pooled or common fund maintained by the [corporation].

(d) Invest all or any part of [a restricted gift] in any other pooled or common fund available for investment, including shares or interests in regulated investment companies, mutual funds, common trust funds, investment partnerships, real estate investment trusts, or similar organizations in which funds are commingled and investment determinations are made by persons other than the [Board].”

## 8.2. Gambling and raffles

## 8.3. **Business investments:**

### ◆ Unrelated business taxable income

- ⇒ Theory: unfair competition with businesses subject to income tax
- ⇒ Threat to the exemption: more than incidental business
- ⇒ Using corporate for-profit subsidiaries
- ⇒ Overlap with “private activity” prohibition
- ⇒ Debt-financed property

### ◆ **Holding securities**

- ⇒ Street name (and SIPC) vs. custodial accounts

### ◆ **Holding real estate for investment**

- ⇒ Acting as general partner of a general or limited partnership
- ⇒ The LLC alternative
  - To hold real estate
  - To isolate related but risky investments
  - “Series” LLCs and single-member LLCs

### ◆ Avoiding Ponzi schemes (or minimizing the risk) through asset allocation and portfolio diversification

## 8.4. Protecting trade names and trademarks

## 8.5. Joint ventures with for-profit businesses

### ◆ The nonprofit must control the tax-exempt activity

## 8.6. Issuers of tax-exempt bonds or certificates of participation

- ◆ Complying with the trust indenture to avoid acceleration
- ◆ Complying with the “**private activity**” rules to preserve the tax-exempt status of the interest payments

## 9. REVOCATION OF TAX-EXEMPT STATUS

### 9.1. Effect on charitable deductions

### 9.2. Retroactive vs. prospective revocation

### 9.3. Breach of duty?

## 10. ASSET TRANSFERS AND MERGERS

### 10.1. Prior notice to the Attorney General

- ◆ Before closing a transfer of substantially all of the entity’s assets, including sales or transfers incident to dissolving the entity.

### 10.2. The Attorney General can request additional information

- ◆ Including appraisals in the case of a sale

### 10.3. Mergers

- ◆ A nonprofit corporation can merger with another entity, including a for-profit corporation or another nonprofit corporation.
- ◆ A for-profit corporation can convert to a nonprofit, but the conversion is treated as a liquidation for federal income tax purposes.

## 11. ACTIVITIES OUTSIDE THE UNITED STATES

### 11.1. Increased role of federal agencies after 9-11-01

- ◆ FBI, Department of Justice

- ◆ “Lists” of “bad” foreign charities

11.2. Protecting the charitable contribution deduction for grants to be used outside the U.S.A.

- ◆ Expenditure responsibility

[End of outline.]