

REFORMING NONPROFIT CORPORATION LAW

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INTRODUCTION

Recent surveys indicate that perhaps as many as one-fifth of all of the corporations in the United States are nonprofit, and that this proportion is steadily growing.¹ Nevertheless, the basic corporate law applicable to nonprofit organizations is at a remarkably immature state of development, and remains startlingly uninformed by either principle or policy. Confusion continues to surround even the most fundamental issues, including the purposes for which nonprofit corporations may be formed, the distinction between nonprofit and cooperative corporations, and the appropriate limits on distributions from nonprofit corporations to individuals who are associated with them. This unsettled state of affairs is reflected clearly in the fact that there have been three major efforts to reform nonprofit corporation law in recent years, and that the resulting statutes—the Model Act, the New York act, and the California act—all differ fundamentally in their most basic structural features.

Much of the confusion in this area evidently originates from the lack of any coherent conception of the basic purposes served by the nonprofit form of organization. In an effort to help fill this gap, I devoted an earlier article to a broad examination of the role that nonprofits perform in the modern economy.² This Article proceeds to consider fundamental issues in the organizational law applicable to nonprofit corporations, using the theories advanced in the earlier article as a guide to policy.

In essence, I argue here that existing nonprofit corporation law, including the various recent efforts at statutory reform, is, in fundamental respects, misconceived and badly flawed, and I proceed to suggest a restructuring of the law along more coherent and more functional lines. Because some of the difficulties in the existing law evidently result from confusion concerning the relationship between nonprofits and cooperatives, I also suggest some restructuring, and rather broader use, of the statutes governing cooperative corporations.

Much of the discussion deals with issues that are within the traditional realm of state corporation law. A number of other sources of law, however, bear on the organization of nonprofit corporations—from the Internal Revenue Code to the legal profession's Code of Professional Responsibility—and the discussion reaches out to encompass these sources as well.

¹ See H. OLECK, *NON-PROFIT CORPORATIONS, ORGANIZATIONS AND ASSOCIATIONS* 1-2 (3d ed. 1975); Oleck, *The Nature of Nonprofit Organizations in 1979*, 10 U. Tol. L. Rev. 962, 980-84 (1979).

² Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835 (1980).

I. THE ESSENTIAL FEATURES AND APPROPRIATE ROLE OF NONPROFIT ORGANIZATIONS

Before looking in detail at questions of organizational law, it is necessary to have a clear notion, first, of what is meant when it is said that an organization is "nonprofit,"³ and second, of the functions that are most appropriately served by the nonprofit form of organization. Indeed, as suggested above, it is precisely the lack of any coherent conception of the essential characteristics and role of nonprofit organizations that appears to be at the root of most of the difficulties in the existing law.

The discussion of these issues draws heavily on my earlier article concerning the role of nonprofit enterprise, in which they are explored in much greater detail.⁴ Those who wish a more thorough discussion are encouraged to turn to that essay.

A. *Characteristics and Classification*

The defining characteristic of a nonprofit organization is that it is barred from distributing profits, or net earnings, to individuals who exercise control over it, such as its directors, officers, or members. This does not mean that a nonprofit organization is prohibited from *earning* a profit. Rather, it is only the *distribution* of profits that is prohibited; net income, if any, must be retained and devoted to the purposes for which the organization was formed.⁵ Moreover, it is only net income, or pure profits, that may not be distributed; nonprofits are generally free to pay reasonable compensation to individuals, including controlling individuals, for labor services or capital provided to the organization. For simplicity, I shall refer to this prohibition on the distribution of profits as the "nondistribution constraint."

In the United States, most nonprofits of any consequence are incorporated. For these organizations, the nondistribution con-

³ The statutes, case law, and commentary occasionally use the term "not-for-profit" rather than "nonprofit". See, e.g., Note, *New York's Not-for-Profit Corporation Law*, 47 N.Y.U. L. REV. 761 (1972) [hereinafter cited as N.Y.U. Note]. Despite the efforts of some authors to draw a distinction between the two terms—efforts commonly rooted in confusion concerning the issues discussed in sections I and II of this Article—the two terms are generally used interchangeably in practice, and no reason exists to distinguish them. See Hansmann, *supra* note 2, at 838 n.17. This article treats the terms as synonymous, and uses the shorter of the two.

⁴ Hansmann, *supra* note 2.

⁵ See, e.g., Indiana Not-for-Profit Corporation Act, § 1(c), IND. CODE ANN. § 23-7-1.1-4(c) (Burns Supp. 1979); MONT. REV. CODES ANN. § 35-2-108 (1979); N.M. STAT. ANN. § 53-8-28 (1978).

straint is imposed, explicitly or implicitly, by the state nonprofit corporation statutes under which they are formed. Sometimes nonprofits, particularly private foundations and other philanthropic intermediaries, are not incorporated, but rather are formed as charitable trusts; for them, state trust law is the source of the nondistribution constraint. Finally, there are many unincorporated associations that might appropriately be termed nonprofit. The law that applies to such associations—and, in particular, the legal source of the nondistribution constraint—is vague, however, and their nonprofit status is therefore ambiguous. This Article concentrates almost exclusively on nonprofits that are incorporated, because this is not only by far the most economically significant category of nonprofits, but also the category for which the law is most in need of reformulation.

Because of the nondistribution constraint, a nonprofit corporation, unlike a business corporation, cannot issue shares of stock that grant their owners a simultaneous right to participate in both profits and control. Some other device for allocating ultimate control over the organization must therefore be employed. The nonprofit corporation statutes are typically quite flexible in this regard. If the articles of incorporation so provide, the right to elect the board of directors, and to vote on other fundamental issues, can be lodged in a group of individuals designated as the organization's members. Alternatively, the power to appoint the directors can be given to other specified individuals or organizations, or the board can simply be made autonomous and self-perpetuating.

Given the variety of forms and functions common among nonprofits, it simplifies reference and analysis to categorize nonprofit organizations both according to the sources of their income and according to the way in which they are controlled.

Those organizations that receive the bulk of their income from relatively unrestricted donations and contributions I shall call *donative* nonprofits; typical examples are CARE, the American Red Cross, and the American Heart Association. Those organizations that, on the other hand, obtain most of their income from prices charged for goods or services they produce I shall call *commercial* nonprofits; this category includes many nonprofit day care centers, nursing homes, and hospitals, as well as the American Automobile Association and Consumers Union (publisher of *Consumer Reports*). Whether a nonprofit is donative or commercial, I shall refer to the individuals who are the ultimate source of its income as its *patrons*. The patrons of a donative nonprofit, therefore, are its donors, while

the patrons of a commercial nonprofit are its customers. With an organization that has both donors and customers—as in the case of a college that receives alumni contributions as well as student tuition, and therefore combines both donative and commercial elements—the term *patron* will be used to include both groups.

Organizations that are controlled by their patrons I shall refer to as *mutual* nonprofits. Social clubs, which are controlled by their customers, provide one typical example; Common Cause, the citizens' lobby, which is controlled by its contributors, provides another. Those organizations that, on the other hand, are not controlled by their patrons I shall call *entrepreneurial* nonprofits. Most hospitals, for example, are in this latter category, as are many organizations for the relief of the poor and distressed, such as the Salvation Army.

The intersection of these two dichotomous classifications yields four categories of nonprofits: donative mutual, donative entrepreneurial, commercial mutual, and commercial entrepreneurial. Figure 1 below arrays common examples of the types of organizations that fall within these categories.

Figure 1

	mutual	entrepreneurial
donative	Common Cause National Audubon Society political clubs	CARE March of Dimes art museums
commercial	American Automobile Association Consumers Union country clubs	National Geographic Society Educational Testing Service community hospitals nursing homes

These four categories, it should be emphasized, merely describe polar or "ideal" types—extreme points on a continuum—rather than discrete forms of organization. Many nonprofit organizations cannot clearly be assigned to one type or another. Universities, for example, often combine elements of all four types: as already noted, they typically have both donative and commercial aspects; moreover, their boards of trustees are often elected in part by the alumni (who comprise the bulk of the former customers and current

donors), and in part are self-perpetuating, so that they are neither clearly mutual nor clearly entrepreneurial nonprofits.

It should also be emphasized that this categorization is offered simply for ease of description and reference, and not because I believe that these descriptive categories should be given legal significance. Indeed, one of the major themes of this Article is that, contrary to current trends, nonprofit corporation law should be unitary, applying essentially the same rules and standards to all nonprofit corporations regardless of classification.

B. *The Role of Nonprofit Organizations*

To understand the unique functions served by the nonprofit form of organization, it is helpful to compare the role of nonprofits with that of profit-seeking (or "for-profit" or "business") organizations.⁶

Like for-profit organizations, virtually all nonprofit organizations are, in a sense, engaged in the sale of services. This is, of course, true by definition for commercial nonprofits. Yet donative nonprofits, too, "sell" their services—and it is the donors who are the purchasers. For example, when an individual makes a contribution to the American Red Cross, or to the Metropolitan Opera, it is not quite a pure gift in the sense that the directors of the organization are free to do anything that they wish with the money. Rather, the contribution is a payment made with the understanding that it is to be devoted entirely to assisting disaster victims, or to presenting more and better opera productions. That is, such contributions are essentially efforts to "buy" disaster relief, or opera, and this is what the organizations in question exist to produce and "sell."

Why is it necessary that organizations such as these be nonprofit? In particular, why could not a for-profit firm provide the same services? The reason, in most cases, appears to be that either the nature of the service in question, or the circumstances under which it is provided, render ordinary contractual devices inadequate to provide the purchaser of the service with sufficient assurance that the service was in fact performed as desired. The advantage of the nonprofit form in such circumstances is that it makes the producer a fiduciary for its purchasers, and thus gives them greater assurance that the services they desire will in fact be performed as they wish.

⁶ For some observations on the role of nonprofit organizations vis-a-vis governmental organizations, see Hansmann, *supra* note 2, at 894-96.

1. Clarifying Examples

Some examples may help to make this clear.

a. *Third Party Payment*

Consider, initially, those donative nonprofits, such as CARE, the Salvation Army, and the American Red Cross, that collect contributions with which to provide relief to the poor and distressed. Why is it necessary that these organizations be nonprofit? Could not profit-seeking firms instead provide the same service—whether dried milk for hungry children in Africa, or bandages for disaster victims, or food for derelicts—in return for payments from philanthropically inclined individuals?

The answer, in considerable part, apparently lies in the fact that the individuals who receive the services in question have no connection with the individuals who pay for them. Thus, for example, suppose that a profit-seeking counterpart to CARE were to promise to provide one hundred pounds of dried milk to hungry children in Africa in return for a payment of ten dollars. Because the patron has no contact with the intended recipients, he or she would have no simple way of knowing whether the promised service was ever performed, much less performed well. Consequently, the owners of the firm would have both the incentive and the opportunity to provide inadequate service and to divert the money thus saved to themselves.

The advantage of the nonprofit form in such circumstances is that, because the nondistribution constraint prohibits those who control the organization from distributing to themselves out of the organization's income anything beyond reasonable compensation for services they render to the organization, they have less opportunity and incentive than would the managers of a for-profit firm to use the organization's income for anything other than what the organization's patrons intend it to be used for. In these circumstances, therefore, an individual would presumably much prefer to patronize a nonprofit organization than a for-profit organization. Consequently, it is not surprising that such redistributive services are provided almost exclusively by nonprofit firms.

b. *Public Goods*

Similar reasoning applies to the provision of what economists term a "public good"—that is, a good or service such that (1) the cost of providing the good to many persons is not appreciably more

than the cost of providing it to one; and (2) once the good has been provided to one person, it is difficult to prevent others from enjoying it as well.⁷ Typical examples are noncommercial broadcasting, public monuments, and scientific research.

Even if individual consumers are willing to contribute to the cost of such services, rather than yielding to the incentive to be "free-riders" on the contributions of others, it is likely that they will do so only if the services are provided by a nonprofit. The reason for this is simply that, owing to the indivisible nature of the service involved, the consumer generally has no simple means of observing whether his or her contribution has increased the level of the service provided. Rather, the consumer must take the producer's word that the contribution will be used to purchase more of the good, rather than simply going into someone's pocket. Such a promise will be easier to believe if the producing firm is subject to the nondistribution constraint. Thus, listener-supported radio, tax reform lobbying, and heart research are all typically financed through nonprofit organizations.

c. *Complex Personal Services*

Those organizations—most of which we would classify as commercial nonprofits—that provide complex and vital personal services, such as nursing care, day care, education, and hospital care, offer yet another example. The patients at a nursing home, for example, are often too feeble or ill to be competent judges of the care they receive. Likewise, hospital patients and consumers of day care, owing to the difficulty of making an accurate personal appraisal of the kind and quality of services they need and receive, must necessarily entrust a great deal of discretion to the suppliers of those services. The nondistribution constraint reduces a nonprofit supplier's incentive to abuse that discretion, and, consequently, consumers might reasonably prefer to obtain these services from a nonprofit firm.

2. "Contract Failure"

In short, nonprofit firms serve particularly well in situations characterized by what I shall refer to, for simplicity, as "contract failure"—that is, situations in which, owing either to the nature of the service in question or to the circumstances under which it is produced and consumed, ordinary contractual devices in themselves

⁷ Public goods, because of these characteristics, are often, but need not be, provided by the government. See generally E. MANSFIELD, MICROECONOMICS 470-94 (3d ed. 1979); See also text accompanying note 409 *infra*.

do not provide consumers with adequate means for policing the performance of producers. In such situations, the nonprofit form offers consumers the protection of another, broader "contract"—namely, the organization's commitment, through its nonprofit charter, to devote all of its income to the services it was formed to provide.

It follows that the charter of a nonprofit corporation serves a rather different purpose than does the charter of a business corporation. In a business corporation, the charter, and the statutory and decisional law in which it is embedded, serves primarily to protect the interests of the corporation's shareholders from invasion by those immediately in control of the corporation, including management and other shareholders. In a nonprofit corporation, on the other hand, the restrictions imposed on controlling individuals by the charter and the law are primarily for the benefit of the organization's patrons. As a consequence, business corporation law is often a poor model for nonprofit corporation law. Unfortunately, as will be seen below, this is a point that has often been missed by those who draft and interpret the law of nonprofit corporations.

3. Countervailing Considerations

The nonprofit form brings with it costs as well as benefits. The curtailment of the profit motive that results from the nondistribution constraint can reduce incentives for cost efficiency, for responsiveness to consumers, and for expansion or creation of new firms in the presence of increasing demand. Moreover, the inability of nonprofits to raise equity capital through the issuance of stock can severely hamper their ability to meet needs for new capital. Only when contract failure is relatively severe is it likely that the advantages of nonprofits as fiduciaries will clearly outweigh these corresponding disadvantages, and thus give the nonprofit firm a net advantage over its for-profit counterpart.

Further, the nondistribution constraint is obviously not airtight. Indeed, as will be emphasized below, the constraint is often poorly policed⁸ and even, in many cases, poorly defined.⁹ As a consequence, the managers of nonprofits often find, and take advantage of, the opportunity to profit at the expense of the organization. Such behavior, of course, further reduces the advantages offered to patrons by nonprofit as opposed to for-profit firms in situations of contract failure.

⁸ See text accompanying notes 319-83 *infra*.

⁹ See text accompanying notes 176-266 *infra*.

In the case of services for the needy, public goods, and other services commonly provided by donative nonprofits, the need for a fiduciary organization is so obvious that for-profit firms are virtually unheard of. On the other hand, contract failure is not so obviously a critical problem for many consumers of the services that are often provided by commercial nonprofits, such as day care, nursing care, hospital care, and education. As a consequence, these services are commonly provided by for-profit as well as nonprofit firms.

C. *Nonprofits Versus Cooperatives*

In the popular mind and, as will be seen below, in the law as well, the cooperative and nonprofit forms are sometimes confused. They are, however, distinct organizational types that generally serve distinctly different purposes.

Most states have separate cooperative corporation statutes under which cooperatives can be formed. These statutes typically provide that the organization's customers may both exercise voting control over the organization and receive distributions of the organization's net earnings;¹⁰ thus, the nondistribution constraint that characterizes nonprofits is not applied to cooperatives. Together with this difference in form, there is a difference in function. Cooperatives tend to arise, not in situations of contract failure, but rather in situations in which the organization's customers feel a need to maintain control of prices set by the enterprise—as, for example, when the enterprise occupies a position of natural monopoly.¹¹

The functions served by the two organizational forms may at times overlap. As will be discussed at length below, some organizations (such as social clubs) that do not appear to be a response to contract failure, and that might more appropriately be formed as cooperatives, have, for various reasons, commonly been formed as mutual nonprofits, and the continuing efforts to adjust nonprofit corporation law to accommodate such organizations have been a major source of confusion and weakness in that law.¹²

D. *Summary*

In sum, I am suggesting that the essential role of the nonprofit organization is to serve as a fiduciary for its patrons in situations of

¹⁰ See, e.g., N.Y. COOP. CORP. LAW §§ 14, 72 (McKinney 1951 & Supp. 1979).

¹¹ See Hansmann, *supra* note 2, at 889-90.

¹² See text accompanying notes 290-318 *infra*.

contract failure. This statement, it should be emphasized, has both a positive (descriptive) and a normative aspect. Taken descriptively, it is an assertion that nonprofit organizations tend to arise in situations in which there is evidence of contract failure and not in cases in which contract failure is absent. Casual empiricism appears to support this conclusion, at least in its broad contours.¹³ More important for the purposes at hand, however, is the normative aspect of this analysis—namely, the assertion that the fiduciary role described here is the *appropriate* role for nonprofit organizations. It follows from this assumption that the law should be designed to make the nonprofit form as effective as possible in performing this role. And this is the premise that underlies everything said below.

II. PERMISSIBLE PURPOSES FOR NONPROFIT CORPORATIONS

The prevailing confusion concerning the appropriate role of nonprofit organizations is nowhere so clearly reflected as in the varying approaches taken in the state statutes toward the purposes for which nonprofit corporations may be formed. And because, particularly in the most recent efforts at statutory reform, the treatment of permissible purposes is central to the approach taken by the statute as a whole, this is necessarily the first issue to be considered.

A. *Statutory Limitations on Purposes for Incorporation*

In a number of states, the nonprofit corporation statutes explicitly limit the purposes for which nonprofit corporations may be formed, typically confining them to activities of a charitable, educational, scientific, fraternal, or similar character. The following

¹³ Thus, in industries in which contract failure is clearly an insignificant problem, as in the production and distribution of standard industrial equipment or agricultural produce, nonprofits are virtually nonexistent. Instead, nonprofits are confined almost exclusively to the provision of personal services that are quite complex, or that are purchased in circumstances that put the patron at some sort of informational disadvantage.

To be sure, the organizational law of nonprofits—not to mention tax law, regulatory law, and subsidy programs—has not always been designed with a clear view of the proper functions of nonprofits in mind. The result has undoubtedly been to distort somewhat the evolution of the nonprofit sector, inhibiting the development of nonprofits in some areas in which contract failure is a problem and encouraging their development in some other areas beyond the extent that appears justified by the degree of contract failure. Thus, the law, together with other elements, *see* Hansmann, *supra* note 2, at 897, is a supply-side variable that may prevent nonprofits from developing in the precise pattern that might be expected by looking only at the pattern of demand for the services of nonprofits to which contract failure alone would presumably lead.

provision in the Illinois General Not-For-Profit Corporation Act provides a good example:

Not for profit corporations may be organized under this Act for any one or more of the following or similar purposes: charitable; benevolent; eleemosynary; educational; civic; patriotic; political; religious; social; literary; athletic; scientific; research; agricultural; horticultural; soil, crop, livestock and poultry improvement; professional, commercial, industrial or trade association; promoting the development, establishment and expansion of industries; electrification on a co-operative basis; telephone service on a mutual or co-operative basis; ownership and operation of water supply facilities for drinking and general domestic use on a mutual or co-operative basis; ownership of residential property on a co-operative basis; and administration and operation of property owned on a condominium basis.¹⁴

In contrast, many other states impose no such restrictions, simply permitting incorporation of a nonprofit for any lawful purpose.¹⁵ Thirty years ago the former, more restrictive form of statute was the most common.¹⁶ The recent trend, however, has been toward the latter, more liberal approach.¹⁷ This liberalizing trend has sometimes been loudly protested.¹⁸ Nowhere, however, does it appear to have been intelligently debated. It is difficult to find a coherently stated rationale for the limitations contained in the older statutes, or conversely to find a clear statement of the reasons for the recent trend toward their elimination. Even the

¹⁴ Illinois General Not For Profit Corporation Act, § 4, ILL. ANN. STAT. ch. 32, § 163a3 (Smith-Hurd Supp. 1978). The Illinois statute is unusual in explicitly including cooperatives and condominiums among the permissible purposes. For a discussion of the relationship between nonprofit and cooperative corporations, see text accompanying notes 67-118 *infra*.

¹⁵ *E.g.*, WIS. STAT. ANN. § 181.03 (West 1957). The Wisconsin statute does, however, prohibit the formation under it of organizations devoted to certain activities, such as banking, that are governed by other statutes. *Id.* See also OHIO REV. CODE ANN. § 1702.03 (Page 1978); OKLA. STAT. ANN. tit. 18, § 852 (West Supp. 1980); TENN. CODE ANN. § 48-401 (1979).

¹⁶ See Note, *Permissible Purposes for Nonprofit Corporations*, 51 COLUM. L. REV. 889 (1951).

¹⁷ Interestingly, Illinois, whose statute is quoted at the text accompanying note 14, *supra*, is an exception to this trend. Early in the century, Illinois permitted nonprofits to incorporate "for any lawful purpose." See *People ex rel. Bonney v. Rose*, 188 Ill. 268, 59 N.E. 432 (1900). Restrictions on permissible purposes were first imposed in 1937. See *People ex rel. Padula v. Hughes*, 296 Ill. App. 587, 16 N.E.2d 922 (1938).

¹⁸ *E.g.*, Oleck, *Proprietary Mentality and the New Non-Profit Corporation Laws*, 20 CLEV. ST. L. REV. 145 (1971).

authors of the Model Act state that “[t]he most difficult decision of policy in drafting the Model Nonprofit Corporation Act is the determination of the purposes for which corporations may be organized under it.”¹⁹ Evidently unable to reach agreement on the issue, the authors of the Model Act offer two alternative purposes clauses, with little in the way of useful guidance in choosing between them.²⁰ The first clause, apparently supported by a majority of the drafting committee,²¹ contains a lengthy list of permissible purposes somewhat in the style of the more traditional statutes.²² The alternative clause follows the more modern trend by permitting incorporation “for any lawful purpose or purposes.”²³ In short, we are left largely on our own to determine whether and why it makes sense to limit the purposes for which nonprofit corporations may be formed.

B. *Interpreting the Limitations*

Before one can judge the wisdom of the limitations on purposes imposed by the more traditional statutes, one needs to develop some understanding of the meaning of those limitations. This, as it turns out, is not an easy task.

1. Profit Seeking as a Purpose

As a preliminary matter, it is important to realize that one issue that should not be in dispute at this point is whether a nonprofit corporation can be organized and operated for the purpose of providing profits to those who control it. As discussed in section I, the very essence of a nonprofit corporation is its commitment not to distribute profits to controlling persons. Thus, when any organization incorporates as a nonprofit, it should be pledging adherence to the nondistribution constraint. A nonprofit corporation act that permits nonprofit corporations to be formed “for any lawful purpose” should therefore logically be interpreted as permitting the pursuit of any purpose *that is not inconsistent with the nondistribution constraint*.

¹⁹ ALI-ABA MODEL NONPROFIT CORP. ACT viii (1964) [hereinafter cited as MODEL ACT].

²⁰ The confusion concerning permissible purposes that underlies the Model Act goes much deeper than this. See text accompanying notes 78-85 *infra*.

²¹ MODEL ACT, *supra* note 19, at viii.

²² *Id.* § 4.

²³ *Id.* alternative § 4.

Similarly, a statute that, like the Illinois statute quoted above,²⁴ contains a restricted list of permissible purposes should be interpreted as requiring more than mere compliance with the nondistribution constraint; in addition, the organization must confine itself to certain enumerated types of activities. The nonprofit corporation statutes are often drafted in a manner that appears to make this point clear. For example, many statutes include the nondistribution constraint as part of the definition of the term "nonprofit,"²⁵ and some go further by including a separate provision in the statute that explicitly enjoins any corporation formed under the statute from distributing net earnings to controlling persons.²⁶ Not infrequently, however, a statute, or the commentary on a statute, confuses this issue. For example, the Model Act, which includes the nondistribution constraint both in its definition of the term "nonprofit"²⁷ and as a specific injunction applicable to all corporations formed under the Act,²⁸ would appear unambiguous in this regard. Yet, in the preface to the Act, its authors suggest confusingly that their alternative purposes clause, which permits incorporation "for any lawful purpose," would in fact permit profit seeking as an objective (provided the profits are not distributed currently) while the other, more restrictive purposes clause would not.²⁹ The recently enacted New York statute, as shall be seen below,³⁰ reflects similar confusion.³¹

2. Permissible Purposes Under the Restrictive Statutes

Assuming, therefore, that profit seeking as an objective is—or should be—ruled out under any nonprofit corporation statute, what further restrictions are imposed by those statutes with restrictive purposes clauses? That is, what purposes are included, and what are excluded, by such statutes?

²⁴ See text accompanying note 14 *supra*.

²⁵ *E.g.*, Illinois General Not For Profit Corporation Act § 2(c), ILL. ANN. STAT. ch. 32, § 163a1(c) (Smith-Hurd 1970).

²⁶ *E.g.*, CAL. CORP. CODE § 5410 (West Supp. 1980).

²⁷ MODEL ACT, *supra* note 19, § 2(c).

²⁸ *Id.* § 26.

²⁹ *Id.* viii-ix.

³⁰ See text accompanying notes 86-101 *infra*.

³¹ The purposes clause from the Illinois statute, quoted at text accompanying note 14 *supra*, also reflects fundamental confusion of this sort on its face, for it explicitly includes cooperatives among its permitted purposes although, as noted in section I, the cooperative form, as usually understood, includes the authority to distribute net earnings to shareholders and members and therefore is inconsistent with the nondistribution constraint that characterizes nonprofits.

Consider the Illinois statute quoted above.³² It is not difficult to identify various types of activity that are more or less clearly encompassed by that list. For example, there would presumably be little question about the right to incorporate a church, a scientific research institute, or a school under that statute. On the other hand, it is rather difficult to be precise about the activities that are excluded by that list. There is only one reported decision in Illinois—and none, it appears, in any other state—explicitly sustaining the refusal to grant a nonprofit corporate charter to an organization (in the Illinois case, a labor union) simply on the ground that its intended purposes, though presumably consistent with the nondistribution constraint, were not within the restricted set of purposes authorized by the corporation statute.³³ As a con-

³² See text accompanying note 14 *supra*.

³³ *People ex rel. Padula v. Hughes*, 296 Ill. App. 587, 16 N.E.2d 922 (1938).

One case, also decided in Illinois, frequently cited in discussions of permissible purposes for nonprofit incorporation is *People ex rel. Bonney v. Rose*, 188 Ill. 268, 59 N.E. 432 (1900). That case, unfortunately, simply compounds the confusion in this area. Plaintiffs Bonney et al. had sought to charter a Chicago street railway company as a nonprofit corporation in Illinois, which at the time had a nonprofit corporation statute permitting nonprofit incorporation "for any lawful purpose, other than for pecuniary profit." See note 17 *supra*. Secretary of State Rose refused to grant a charter, whereupon the plaintiffs brought suit for mandamus. Documents submitted by the plaintiffs, and reproduced in the Illinois reports, suggest that although the organization would effectively have been a commercial nonprofit financed by user fees, the plaintiffs intended to operate the organization strictly on a nonprofit basis—that is, in conformity with the nondistribution constraint. Indeed, the plaintiffs expressed a rather idealistic motivation. See 188 Ill. at 27-28 (letter from petitioners to respondent Secretary of State).

Nevertheless, the Supreme Court sustained the Secretary of State's refusal to grant a charter, stating, without supporting argumentation or evidence, only that "[i]t is evident that the corporation sought to be organized is a corporation solely for business purposes and the pecuniary profit and gain of the incorporators, and that it does not fall within the purview of the statute." 188 Ill. at 275, 59 N.E. at 432. Presumably, either the court had reason to believe that the plaintiffs' motivation was less idealistic than they suggested, and that they intended to draw profits from the enterprise, or else the court was simply confused about the nature of nonprofit organizations and, in particular, unable to conceive that an activity normally organized on a profit-seeking basis could also be organized on a nonprofit basis.

Similar confusion has been evident in New York, at least until passage of the new New York nonprofit corporation statute, discussed below at text accompanying notes 86-101 *infra*. See note 98 *infra*; 1942 Op. N.Y. A'tty Gen. Ann. Rep. 219 (nonprofit corporate charter denied for what would essentially be a commercial mutual nonprofit selling transportation services to its members at cost, on the ground that provision of such services is an activity of a "business nature," *id.* 220, and therefore must be organized under the business corporation statute).

One can only speculate concerning reasons for the general absence of reported cases. The purposes listed in the statutes may cover, or may be sufficiently loosely interpreted by the state authorities to cover, most types of nonprofits that anybody would want to establish—or would want to establish badly enough to lead them to carry litigation to the appellate courts. Also, individuals who are denied a nonprofit corporate charter in one state may simply seek to incorporate in another state, rather than undertake prolonged litigation.

sequence, one is left to the language of the statute itself, and to the interpretations given to enumerated purpose clauses in related contexts, such as state and federal statutes granting tax exemptions and other forms of preferential treatment.³⁴

In general, it is commercial nonprofits that are hardest to fit within the language of restrictive statutes such as that in Illinois. Donative nonprofits, almost by definition, generally either redistribute wealth or provide public goods.³⁵ Their activities can therefore often be characterized by such terms as "charitable," "benevolent," "eleemosynary," or "civic" without excessive straining.³⁶ Of course, many commercial nonprofits would presumably also come within the language of the Illinois statute. This would appear to be the case, for example, with a secondary school or a private golf club operated as a commercial nonprofit. Moreover, there is considerable authority today for the view that nonprofit hospitals are to be classified as "charitable" organizations even when they do not depend on donations and provide no free or below-cost care,³⁷ and thus are strictly commercial nonprofits.³⁸ It is, rather, commercial nonprofits operating outside the usual areas of nonprofit activity that appear to be excluded. For instance, a commercial

³⁴ For example, section 501(c)(3) of the Internal Revenue Code exempts from income taxation nonprofit organizations that serve, *inter alia*, religious, charitable, scientific, testing for public safety, literary, or educational purposes. These categories have been subject to considerable administrative and judicial interpretation. See cases collected in P. TREUSCH & N. SUGARMAN, TAX-EXEMPT CHARITABLE ORGANIZATIONS 71-128 (1979).

³⁵ When a patron makes a contribution to a donative nonprofit, the services financed with that contribution must necessarily either be for the benefit of the patron himself or for the benefit of third parties (if they were for the benefit of those in control of the organization, it would not be a true nonprofit—that is, it would violate the nondistribution constraint). In the latter case, the organization is redistributive, though not necessarily for the benefit of the needy. In the former case, the services must have the character of public goods (which is to say they benefit others at the same time they benefit the patron, *see* text accompanying notes 6 & 7 *supra*) because, if they were private consumption goods for the patron, then the organization would by definition be a commercial rather than a donative nonprofit.

³⁶ See note 40 *infra*.

³⁷ The Internal Revenue Service has now taken this position in interpreting I.R.C. § 501(c)(3), discussed in note 34 *supra*. Rev. Rul. 69-545, 1969-2 C.B. 117. The 1969 Revenue Ruling does require, however, that an emergency room be open to all, including indigents. The validity of this interpretation of the term "charitable" was sustained in *Eastern Ky. Welfare Rights Org. v. Simon*, 506 F.2d 1278 (D.C. Cir. 1974), although the suit was subsequently dismissed by the Supreme Court for lack of standing, 426 U.S. 26 (1976).

³⁸ The various public utility cooperatives expressly authorized in the statute are also commercial in the sense in which the term is used in section I. Illinois is, however, unusual—and, as shall be argued in section V, quite misguided, *see* text accompanying notes 267-318 *infra* and note 31 *supra*—in making explicit provision for the incorporation of cooperatives under its nonprofit corporation statute.

nonprofit seeking to provide some ordinary consumer good or service would be difficult to place among the categories permitted by the Illinois statute.

To see the issues more clearly, it helps to consider an example. Thus, suppose—to take an extreme case—that several individuals desire to organize a shoe store as a nonprofit corporation. The incorporators plan to control and operate the shoe store themselves. They, or some of them, will serve as employees of the store. They plan to observe the nondistribution constraint scrupulously, never paying to themselves anything beyond a reasonable salary for work performed for the store. They do not expect the store to receive any donations, from themselves or anyone else. The store's income will come exclusively from the prices charged for the shoes it sells. Any financing required will be obtained by means of loans, credit, and merchandise obtained on consignment. Like any other shoe store, this store will sell its shoes to anyone, rich or poor, who is willing to buy them. The shoes they sell will be purchased from commercial for-profit manufacturers. In short, the store will be a pure entrepreneurial commercial nonprofit.

Why would the incorporators choose to structure such an enterprise as a nonprofit corporation? Perhaps because (1) they are entering the business primarily for the sake of enjoyment; (2) they have no capital of their own, so that the most that they would be likely to earn from such an enterprise under any form of organization would be a salary, and (3) they feel that the nonprofit form will help assure their customers that they are charging no more than a fair price for the shoes they sell. Or perhaps they are hostile to capitalism on ideological grounds, feeling that it fosters exploitative relationships between owners and workers. Or perhaps they are simply acting on a whim.

It would be difficult to place a shoe store within any of the relatively specific categories listed in the Illinois statute such as "religious," "literary," or "horticultural." If the store is to come within the statute, therefore, it will presumably need to qualify as "charitable," "benevolent," or "eleemosynary." Because it is doubtful whether, in modern doctrine, the latter two terms add anything to the first,³⁹ the inquiry comes down to determining whether the shoe store would fall within the legal definition of "charitable." And, although the definition of charity has been broadened somewhat in recent years, most courts would probably decide this ques-

³⁹ See G.C. BOGERT & G.T. BOGERT, *THE LAW OF TRUSTS AND TRUSTEES* § 370 (2d ed. 1964) [hereinafter cited as *BOGERT ON TRUSTS*].

tion in the negative.⁴⁰ Thus, the shoe store appears to fall outside the list of permissible purposes provided by the Illinois statute, and our would-be incorporators therefore apparently fail to qualify for a charter.

A nonprofit shoe store, of course, may seem implausible; it was chosen as an example to present the issues involved in their starkest and clearest light. There are many other types of enterprises that would be more likely than a shoe store to choose the nonprofit form, however, and that would still arguably fail to qualify for a charter under the Illinois statute. These might include, for example, pharmacies, book stores, and periodical publishers.

C. *The Consequences of Denying Nonprofit Incorporation*

Suppose, to continue the example, that the prospective incorporators of the nonprofit shoe store were denied a nonprofit corporate charter. What is at stake? What alternatives would be open to them? In particular, could they create an effective substitute for the nonprofit corporate form by means of other legal devices? The question is worth considering in detail, not only because it helps us understand the direct consequences of refusing to grant a nonprofit charter, but also because it helps illuminate some important features of the corporate law that applies to both nonprofit and for-profit corporations.

One alternative would be to establish the store as a business corporation, and then operate it as a nonprofit. That is, the managers of the store could (1) finance all of their capital needs through debt (as we assumed they would do if they were able to set it up formally as a nonprofit), (2) issue some common shares to the directors of the enterprise for token consideration, and (3) follow a firm policy of never paying dividends on the common stock. In financial terms this would be the equivalent of the nonprofit corporation that our entrepreneurs originally desired to create.

⁴⁰ Broadly speaking, the legal concept of charity has traditionally included two concepts: (1) aid to the poor; and (2) projects that benefit the community at large such as public works. See generally *id.* § 369. The rather unthinking recent extension of this definition to include hospitals organized strictly as commercial nonprofits, see note 37 *supra*; Hansmann, *supra* note 2, at 882, and to commercial nonprofit nursing homes, see Rev. Rul. 72-124, 1972-1 C.B. 145, has not been pressed further to include many other types of commercial nonprofits. For example, the Internal Revenue Service has recently been upheld by the Tax Court in refusing to classify as charitable, and therefore exempt, a pharmacy operating as a commercial nonprofit selling drugs at discount or cost to elderly and handicapped persons. *Federation Pharmacy Servs., Inc. v. Commissioner*, 72 T.C. 687 (1979), *aff'd*, 625 F.2d 804 (8th Cir. 1980).

Would such an operation contravene the business corporation law? It probably would if stock in the corporation were sold to investors who did not endorse the policy of no dividends.⁴¹ But there appears to be no precedent for denying the right of management to pursue a no-dividend policy when all of the shareholders are in agreement with such a policy. In any case, who would have both the desire and the standing to contest such a policy in those circumstances?

Yet such an organization would not be completely equivalent to a nonprofit corporation, because it would not be legally bound to the nondistribution policy. It would be open to the shareholders at any time to succumb to the temptation to enrich themselves by paying out dividends, and thereby convert the organization into a for-profit corporation in fact as well as in form. As a consequence, the organization's patrons might justifiably be a bit suspicious of it, and withhold some of the trust that they might place in an ordinary nonprofit.

To meet this difficulty, the incorporators could perhaps seek to have the no-dividend policy written into the organization's articles of incorporation. Even this would be only a partial solution, however, because, in general, it is within the power of a business corporation's shareholders—at least if they act unanimously—to amend the articles of incorporation; a provision in the articles attempting to make the no-dividend clause unamendable could well be unenforceable.⁴² Indeed, the notion of chartering a business corporation

⁴¹ See *Dodge v. Ford Motor Co.*, 204 Mich. 459, 499-509, 170 N.W. 668, 682-85 (1919) (not within discretion of directors to reduce distributions to shareholders in order to benefit the public).

⁴² Or, what is the same thing, amendable. See ABA-ALI MODEL BUS. CORP. ACT § 58 (1974) (apparently granting to a majority of the shareholders the right to make any amendments they wish in the articles of incorporation, so long as the resulting articles are not inconsistent with current state law). Likewise, a contractual agreement among shareholders not to pay out dividends could presumably be voided by unanimous agreement among shareholders. *But see* *Kittinger v. Churchill*, 161 Misc. 3, 292 N.Y.S. 35, *aff'd*, 249 A.D. 703, 292 N.Y.S. 51 (1936) (shareholders in a religious organization formed under the business corporation statute denied some of the usual powers of shareholders on the theory that to do otherwise would frustrate the intent of the founders of the organization to establish what was essentially a nonprofit entity).

The problem with both of these devices is that the beneficiaries of the no-dividend provision, namely, the organization's patrons, are not parties to it, and therefore their consent need not be obtained to eliminate the provision. Of course, more complicated approaches exist that would be effective. For example, each patron could be sold a share of no par, class B common stock for nominal consideration each time he or she patronized the organization. The class A common stock would be held by the incorporators and their successors, and would carry general operating control over the organization. The articles could then provide that a majority of both classes must vote approval of any change in the no-dividend clause (indeed, this would probably be required by the Model Act provision cited

containing such a no-dividend restriction in its articles—and particularly an unamendable restriction—raises some difficult issues. For is not a corporation with such a clause in its charter in fact a nonprofit corporation? And if the state grants a charter to such a corporation under the business corporation statute, is it not thereby subverting the policy, embodied in the nonprofit corporation statute, of denying the right to form a nonprofit corporation for such a purpose? That is, should not a state business corporation statute be construed to forbid the chartering of a business corporation that contains a nondistribution clause in its charter, on the ground that such a corporation is in fact a nonprofit corporation and must therefore be formed under the state's nonprofit corporation statute⁴³—at least if the latter statute restricts the purposes for which nonprofits may be formed?

In any case, it would undoubtedly be extremely difficult, and perhaps impossible, to convince prospective patrons that such an unusual organization is in fact the fiduciary equivalent of a nonprofit; suspicion would be the natural response. And because the primary function of a nonprofit is to serve as an organization that patrons can trust, this could effectively defeat the purpose of operating the organization along nonprofit lines. Similar obstacles would stand in the way of basing such an organization on the partnership or proprietorship form, or of attempting any private contractual approach to the problem. There would, of course, remain the option of obtaining a special nonprofit charter from the legislature⁴⁴ or establishing the enterprise as a governmental corporation, but both of these approaches would, at the very least, be cumbersome and, for most prospective incorporators, infeasible alternatives. In short, it is extremely difficult to construct a facsimile of a nonprofit organization from for-profit statutes.⁴⁵ As a consequence,

supra in any case), effectively giving the patrons a veto. But this would be quite unwieldy—and patrons might be extremely slow to understand it. Such an organization, incidentally, would have something in common with a cooperative. See text accompanying notes 267-318 *infra*.

⁴³ See *Kittinger v. Churchill*, 161 Misc. at 15, 292 N.Y.S. at 47 (suggesting that, in general, it is improper to form, as a business corporation, an organization that is religious in character and expressly intended to be nonprofit).

⁴⁴ But why would, or should, a legislature grant a special charter to a nonprofit for a purpose that is not permissible under the general nonprofit corporation act?

⁴⁵ Sometimes the charitable trust form can serve as an alternative to the nonprofit corporate form, but, for organizations such as our shoe store, this would not be an available option, because the only purposes for which a charitable trust can be formed are those that the law deems charitable. See note 50 *infra* & accompanying text. Indeed, because charity is among the permissible purposes for nonprofit incorporation in every state, no state exists in which an organization could be established as a charitable trust but not as a nonprofit corporation.

denying nonprofit incorporation to enterprises such as our shoe store involves denying them a significant organizational option.

D. *Can The Restrictions Be Justified?*

With the foregoing considerations in mind, we can proceed to consider the arguments that might be invoked in support of restrictions on nonprofit incorporation.

I. Tax Exemption and Other Subsidies

It might be thought that the restrictions can be justified as a means of limiting the range of organizations that receive the benefits of tax exemption or of other forms of subsidy or preferential treatment that are commonly extended to nonprofits. It does not, however, make sense to refuse to permit a particular activity to be organized on a nonprofit corporate basis simply because it does not appear to merit tax-exempt status or some other type of special benefit. Just because an organization is incorporated as a nonprofit does not mean that it qualifies for tax exemption at the federal or state level. Rather, the tax statutes generally exempt only a specified subset of all nonprofit organizations.⁴⁶ The same is also true for most other forms of special treatment, such as reduced postal rates⁴⁷ and exemption from federal securities registration requirements.⁴⁸ Thus, granting an organization a nonprofit corporate charter does not necessarily involve extending any of these benefits to it. The question of incorporation can therefore be considered separately from such other matters of policy.

To be sure, tax exemption and other special benefits have generally been broadly administered to include the greater part of the activity conducted in the nonprofit form.⁴⁹ As a consequence, broadening the range of activities conducted by nonprofits might be expected to lead to a broadening of the range of activities receiving such special treatment. Rather than dealing with this problem by restricting the availability of nonprofit incorporation, however, it seems wiser to confront it directly by refining and rationalizing the subclasses of nonprofits that qualify for each form of special treatment—a task that is, in any case, long overdue.

⁴⁶ The numerous specific categories of nonprofits that qualify for exemption from the federal income tax are set forth in I.R.C. § 501(c). See note 34 *supra*.

⁴⁷ 39 U.S.C. § 3626(e) (1976 & Supp. III 1979).

⁴⁸ 15 U.S.C. § 77c(a)(4) (1976).

⁴⁹ See Hansmann, *supra* note 2, at 881-84.

2. Tying Up Assets and Other Public Burdens

Contemporary restrictions on the permissible purposes for non-profit corporations find precedent in, and indeed presumably derived their original inspiration from, the limitations that the law has always placed on the purposes for which charitable trusts can be formed. These latter limitations are the source of the legal definition of charity,⁵⁰ which is the broadest and the most commonly encountered category in the lists of permissible purposes that appear in the nonprofit incorporation statutes.

Historically, there were several good reasons for limiting the purposes for which charitable trusts could be formed. First, and most important, the charitable trust provided a device whereby assets could be devoted to a particular purpose in perpetuity. Some type of limitation on purposes therefore helped to prevent society's wealth from becoming tied up to a large extent in useless pursuits—a particularly important consideration at a time when wealth was primarily in the form of land, which was more or less in finite supply.⁵¹ In addition, the state generally took upon itself much of the responsibility for policing and enforcing charitable trusts, and there was little reason to undertake such a burden where no commensurate public benefit was involved.⁵²

Such considerations perhaps continue to justify restrictions on the formation of charitable trusts. It is not at all clear, however, that they have any relevance to the formation of nonprofit corporations.

Consider first the problem of tying up assets in perpetuity. Many nonprofits do, of course, hold assets subject to perpetual conditions. For example, a college might hold funds received from a donor under the condition that the principal is not to be invaded, and that income from the principal is to be devoted in perpetuity to, for example, the salary of a professor of romance languages. Such perpetual restrictions on gifts to nonprofit cor-

⁵⁰ The historical development of charitable trusts and of the legal concept of charity is well surveyed in G. JONES, *HISTORY OF THE LAW OF CHARITY 1532-1827* (1969).

⁵¹ See BOGERT ON TRUSTS, *supra* note 39, at 341-52. A further concern, which appears to have become quite pronounced by the eighteenth century and to have been in considerable part responsible for the narrow definition of charity adopted at that time, was the desire to prevent wealthy individuals from impoverishing their heirs by giving away their fortunes. See G. JONES, *supra* note 50, at 105-08.

⁵² For example, the Statute of Charitable Uses, 1601, 43 Eliz., c. 4, which is commonly cited for its listing of charitable purposes, was enacted to establish public commissions for policing and enforcing certain types of charitable trusts. See G. JONES, *supra* note 50, at 22-56.

porations are often enforceable, in some states under the theory that they create charitable trusts, and in other states under other, vaguer doctrines.⁵³ Thus, one might fear that an unrestricted right to form nonprofit corporations might unduly encourage endowments for frivolous purposes. Yet this seems an insubstantial problem. No matter which theory courts have invoked in enforcing perpetual restrictions on gifts to nonprofit corporations, they appear always to have confined their decisions to corporations whose purposes are charitable.⁵⁴ No support appears to exist for the proposition that perpetual restrictions on the use of money or property given to *noncharitable* nonprofit corporations are valid, unless the terms of the restrictions limit the corporation to use of the donation for purposes that are clearly charitable, thus effectively making the corporation the trustee of a charitable trust for that particular donation.⁵⁵ Yet all nonprofit corporation statutes already provide for the incorporation of any nonprofit established for charitable purposes. Thus, extension of permissible purposes to include all noncharitable organizations as well would not result in a proliferation of restricted endowments for noncharitable purposes. In any case, if perpetual restrictions on endowed funds become a problem in the nonprofit sector, the obvious response is to place more stringent limitations on the enforceability of such restrictions⁵⁶ rather than to limit the purposes for which nonprofits may be formed in general.

To be sure, there might be cause for concern that widespread use of the nonprofit form could cause capital to be tied up in relatively unproductive uses even in the absence of endowments with donor-imposed restrictions. Because the managers of a nonprofit generally have no claim to its assets, they have no direct financial incentive to devote those assets to the most economically productive purposes. On the contrary, because their jobs and salaries may be at stake, nonprofit managers have an incentive to perpetuate the organization as long as possible. As a result, a nonprofit with substantial assets, whose services are no longer in great demand, might nevertheless continue providing those services until it has consumed all of its capital, instead of transferring its assets to another, more socially useful, activity.

⁵³ See W. CARY & C. BRIGHT, *THE LAW AND THE LORE OF ENDOWMENT FUNDS* 14-18, 78 (1969).

⁵⁴ See *id.*

⁵⁵ Cf. *Schaeffer v. Newberry*, 235 Minn. 282, 50 N.W.2d 477 (1951) (devise of land to village for use as a public park held to be creation of a charitable trust).

⁵⁶ As proposed, for example, in L. SIMES, *PUBLIC POLICY AND THE DEAD HAND* 132-39 (1955).

Problems of this nature, however, do not appear sufficiently serious to justify limiting the permissible scope of nonprofit corporate activity. It appears unlikely that many nonprofits that have outlived their usefulness will possess substantial assets. This is especially true for commercial nonprofits, the type most commonly excluded by corporation statutes with restrictive purposes clauses; when demand for the services of a commercial nonprofit drops sharply, the resulting loss of income from customers is likely to lead to operating losses that cannot long be covered by liquidating assets. Moreover, direct controls, such as further restrictions on the capacity of nonprofits to accumulate assets beyond those necessary to make adequate provision for the likely financial needs of the reasonably foreseeable future,⁵⁷ again appear preferable to a policy as indiscriminating as denying incorporation for broad classes of activity.

Nor does it seem reasonable to restrict the scope of nonprofit activity for the sake of easing the burden of public supervision. To begin with, most states devote so few resources to supervising nonprofits in general⁵⁸ that a proportionate increase in those resources to deal with expanded nonprofit activity would be negligible.⁵⁹ Moreover, the burden of public supervision might be reduced if, as is suggested below,⁶⁰ the standing of private parties to sue nonprofits for malfeasance were considerably broadened. Indeed, for commercial nonprofits, such as shoe stores, a generous view of patrons' standing to sue, together with appropriate provision for mandatory disclosure of basic financial information,⁶¹ could well obviate the need for all but the most cursory public supervision.

3. Protecting Patrons

Section I of this Article suggests that, in general, the role to which nonprofit organizations are best suited is the provision of goods and services under circumstances in which contract failure makes profit-seeking firms an undesirable source of supply. It might therefore appear that formation of nonprofits should be limited to just those activities for which contract failure is clearly evident.

⁵⁷ Restrictions on accumulations are already applied by many states, at least to nonprofits that are classified as charities. See E. FISCH, D. FREED AND E. SCHACHTER, CHARITIES AND CHARITABLE FOUNDATIONS §§ 117-119 (1974) [hereinafter cited as CHARITABLE FOUNDATIONS]; BOGERT ON TRUSTS, *supra* note 39, at § 352.

⁵⁸ See text accompanying notes 323-26 *infra*.

⁵⁹ See text accompanying notes 319-29 *infra*.

⁶⁰ See text accompanying notes 345-83 *infra*.

⁶¹ See text accompanying notes 390-406 *infra*.

When contract failure is not involved, there is generally no reason to expect nonprofit firms to provide any particular advantage over profit-seeking firms. On the contrary, in such a situation, one would expect nonprofits to be less desirable suppliers than proprietary firms, given their problems of limited access to capital and poor incentives for efficient production. Yet some consumers, accustomed to thinking only that, in general, nonprofits are somehow "better" than profit-seeking firms,⁶² might continue to patronize nonprofits even though it appears (accurately, as it turns out) that they are offering a bargain that is inferior to that of their profit-seeking competitors.⁶³

To be sure, the existing restrictions on nonprofit activity are never explicitly rationalized or interpreted from this (or, for that matter, from any other) perspective. Yet perhaps they are not entirely inconsistent with it either. The limitations on nonprofit activity—as embodied, for example, in the term "charitable"—have tended to loosen to encompass new activities once there has been evidence of a substantial tendency for nonprofits to undertake such activity.⁶⁴ At most, the effect of the limitations has probably been simply to place the burden on those seeking to establish a new form of nonprofit enterprise to convince a judge, a secretary of state, or a state attorney general that there is good reason to grant them a charter. In the absence of clear criteria for what constitutes a good reason, analogy to activities already permitted to nonprofits will be a common form of justification. And what such activities generally have in common is contract failure.

Obviously, the restrictions on nonprofit activity have not previously been applied in a self-conscious effort to contain such activity to clear cases of contract failure. One might nevertheless argue that in the future they should be. Yet good reasons exist for rejecting restrictions that are based on such considerations. To begin with, the potential harm to consumers from allowing nonprofits to undertake traditionally proprietary activities appears insignificant, for we are talking here about preventing nonprofits from operating precisely in those areas in which consumers are best able to look out for their own interests—that is, where, owing to the absence of

⁶² See Hansmann, *supra* note 2, at 896-97.

⁶³ See Clark, *Does the Nonprofit Form Fit the Hospital Industry?*, 93 HARV. L. REV. 1416 (1980). Professor Clark suggests that, in using the nonprofit as opposed to the for-profit form for organizing hospitals, and by gaining correlative tax advantages, physicians might effectively be committing a fraud against consumers of hospital services. *Id.* 1441-47.

⁶⁴ See Hansmann, *supra* note 2, at 882.

contract failure, the goods and services offered by competing non-profit and for-profit producers are most easily compared. Further, there is no obvious reason to believe that the legislators, state officials, and judges who are responsible for establishing and administering the restrictions on nonprofit incorporation will be better qualified than the market to make judgments concerning the relative performance of nonprofit and for-profit producers in any particular activity.

4. Protecting Normative Behavior

As I suggested in my earlier article, the normative constraints that are important in assuring that nonprofits adhere to their fiduciary obligations might be strongest in those areas in which nonprofits have long been established, and correspondingly weaker in those areas in which nonprofits undertake novel activities.⁶⁵ As a consequence, one might wish to be cautious about letting nonprofits enter new fields, for fear that abuses in such fields will be rather common—so common, perhaps, as to make the nonprofit firms, on average, no more reliable than the for-profit firms. One could go even further with this line of reasoning. It might be that the presence of a “proprietary mentality” within some parts of the nonprofit sector will tend to undermine the collective morality of that sector as a whole, thus leading to a breakdown of fiduciary standards even in areas that traditionally have been nonprofit.⁶⁶

Such reasoning could provide some justification for the more conservative approach to nonprofit incorporation, the effect of which is to allow only gradual expansion of nonprofit activity beyond the areas in which it has already become established. Yet, whatever one might think about the validity of this line of reasoning, there appear to be other, more appropriate responses to the hazards it points up. In particular, it would appear far better policy to take steps to address breaches of fiduciary duty directly, by improving the mechanisms for enforcing the fiduciary responsibilities of nonprofit managers, rather than simply to make it difficult for all nonprofits, honest or not, to enter new fields in which they might serve a valuable role. Such an alternative policy appears all the wiser because a variety of available measures exists for improving the accountability of nonprofits, some of which are suggested below.⁶⁷

⁶⁵ *Id.* 875-76.

⁶⁶ There is a hint of this line of reasoning in Professor Oleck's attack, *see* notes 15-18 *supra* & accompanying text, on the newer, more liberal nonprofit corporation statutes.

⁶⁷ *See* text accompanying notes 319-83 *infra*.

5. Protecting Proprietary Behavior

There remains a final, rather different argument for limiting the scope of nonprofit activity—an argument that is nearly the converse of the one just discussed.

Contrary to the view implicitly taken by many economists, there is good reason to believe that aggressive profit-seeking behavior is not a natural part of our genetic endowment, but is instead the product of considerable acculturation. Businessmen manage enterprise to maximize profits, through such means as reducing costs and expanding sales and production, in large part because they have grown up in a society that places considerable value on such activity and provides constant schooling in the methods appropriate to it. Thus, for example, efforts to establish capitalist economies in less-developed countries are not always successful; the taste for pecuniary rewards, and for the business means appropriate to achieving them, requires a good deal of indoctrination to take hold.

Consequently, one might argue that a society based on a free enterprise economy must be ever vigilant to maintain the entrepreneurial ethic. It is important, for the sake of economic efficiency, to assure vigorous rivalry among proprietary enterprise in all sectors of the economy in which competitive markets are appropriate. A broad expansion of nonprofit activity might pose a threat in this regard. If nonprofit enterprise is allowed to enter a sector, the entrepreneurial ethic might start to disappear from that sector. Profit-seeking activity might begin to appear slightly disreputable, and producers in the sector might abandon everything they learned at business school and revert to their natural instincts to be agreeable, to place strong emphasis on a sense of community and pleasurable human intercourse within and among their firms, to avoid overwork and compulsive striving, and so forth. Doubters need only look at England to see that a society can quickly lose its entrepreneurial instincts. It therefore follows that nonprofit activity should be closely confined to just those areas in which it is absolutely necessary for reasons of contract failure.

Yet even if this argument is taken seriously—and I am not trying to suggest that it should be⁶⁸—it is by no means obvious that

⁶⁸ Lest I be considered merely facetious in presenting this line of reasoning, however, let me suggest that it might have played a role in the thinking of the nineteenth and early twentieth centuries, when nonprofit corporation statutes were originally being formulated. Surely there was some strong sentiment to the effect that certain activities belonged only in the private, profit-seeking sector. One reflection of this sentiment can be found in the restrictive attitude that the courts

limiting the permissible scope of nonprofit enterprise is an appropriate response to the problem involved. For, again, no particular reason exists to believe that state authorities will be able to identify those markets in which the capitalist ethic is least (or most) in need of preservation. Moreover, if one is really concerned about the need to bolster entrepreneurial activity in the United States today, there would appear to be many more obvious places to begin than by placing arbitrary restrictions in nonprofit corporation statutes.

6. Summary

Restricting the purposes for which nonprofits can be incorporated serves no obvious need that could not better be served by other means. Moreover, to the extent that the statutory restrictions actually limit the scope of nonprofit activity, they might well cause unnecessary harm. The service sector of our economy is growing rapidly, both in absolute terms and as a fraction of the nation's total economic activity. Much of this growth is coming from the development of new types of services—in areas such as research, health and custodial care, communications, and consulting and advisory services. It may be that the nonprofit form offers the most suitable means of organizing a substantial share of this activity.⁶⁹ A restrictive, and particularly a conservative, approach to nonprofit incorporation might therefore inhibit the development of these services, or push them inappropriately into the proprietary or governmental sectors.

The wiser course would be to permit nonprofit corporations to be formed for the purpose of undertaking any activity whatever (consistent, of course, with the nondistribution constraint and the criminal law).⁷⁰ At the same time, however, one should realize that

sometimes took toward the power of municipalities to engage in activities normally pursued by proprietary organizations. See *Keen v. Waycross*, 101 Ga. 588, 29 S.E. 42 (1897); *MacRae v. Concord*, 296 Mass. 394, 6 N.E.2d 366 (1937). On the public/private distinction in corporation law generally and its relationship to nineteenth century liberal thought, see Frug, *The City as a Legal Concept*, 93 HARV. L. REV. 1057 (1980).

⁶⁹ See V. FUCHS, *THE SERVICE ECONOMY* (1968); Hansmann, *supra* note 2, at 835 n.1.

⁷⁰ Until recently, it was not uncommon for states to grant considerable discretion to a judge or a state official (such as the secretary of state) to grant or deny a nonprofit corporate charter. In many cases, this authority was used to deny charters, on grounds of "public policy," to organizations whose purposes simply offended the sensibilities of the officials involved. Such discretionary authority consequently came under attack from the commentators, see Dwight, *Objections to*

this liberal approach to incorporation makes it all the more important that appropriate measures are taken to assure that all nonprofits adhere to their fiduciary duties. Likewise, the expansion of the nonprofit sector makes it crucial to define just which, if any, nonprofits should have the benefit of the many special privileges commonly accorded to them, from tax exemption to freedom from involuntary bankruptcy.

E. *The Leading Modern Statutes*

In recent years, three nonprofit corporation statutes have been drafted that deserve special attention because of the effort that has gone into their development, the prominence of the jurisdictions in which they have been adopted, and the widely divergent approaches they take to fundamental issues. These are the Model Nonprofit Corporation Act, the New York Not-For-Profit Corporation Act, and the California Nonprofit Corporation Law.

Among other things, these statutes differ fundamentally in their treatment of corporate purposes. These differing approaches are worth considering in detail, not only because the preceding discussion helps to illuminate some of the problems from which they suffer, but also because their treatment of corporate purposes bears directly on other important features of these statutes to be discussed below.

Judicial Approval of Charters of Non-Profit Corporations, 12 BUS. LAW 454 (1957); Note, *Judicial Approval as a Prerequisite to Incorporation of Non-Profit Organizations in New York and Pennsylvania*, 55 COLUM. L. REV. 380 (1955), and in recent years there has been a general retreat from such broad grants of discretion. Pennsylvania, for example, eliminated its statutory requirement for judicial approval in 1972, see Act of Nov. 15, 1972, No. 271, § 7319, 1972 Pa. Laws 1063, 1089 (codified at 15 PA. CONS. STAT. ANN. § 7319 (Supp. 1979) (as amended)), repealing Act of Jan. 18, 1966, No. 1406, § 10, 1965 Pa. Laws 1406, 1420, and the New York Court of Appeals has now placed an extremely narrow interpretation on the discretion afforded judges by the still extant provision for judicial approval in the New York statutes, *Gay Activists Alliance v. Lomenzo*, 31 N.Y.2d 965, 341 N.Y.S.2d 108, 293 N.E.2d 255 (1973); *Association for the Preservation of Freedom of Choice, Inc. v. Shapiro*, 9 N.Y.2d 376, 214 N.Y.S.2d 388, 174 N.E.2d 487 (1961). Ohio, on the other hand, has recently taken a startling step in the opposite direction. In *State ex rel. Grant v. Brown*, 39 Ohio St. 2d 112, 313 N.E.2d 847 (1974), the Ohio Supreme Court sustained the discretionary refusal by the Ohio Secretary of State to grant a nonprofit corporate charter to the Greater Cincinnati Gay Society on the ground that "the promotion of homosexuality as a valid life style is contrary to the public policy of the state." *Id.* at 113-14, 313 N.E.2d at 848.

There is obviously no more—indeed, there is quite a bit less—reason to permit state officials to exercise personal discretion in selecting permissible purposes than there is to include restrictive lists of permissible purposes within the language of the corporation statutes. No state gives its secretary of state or its judges the right to grant or deny charters to business corporations on the basis of their personal evaluation of the potential utility of its products; there is no reason to adopt a different policy with respect to nonprofit corporations.

1. The Model Act

The Model Nonprofit Corporation Act⁷¹ was originally drafted in 1952 by the Committee on Corporate Laws of the Section of Corporation, Banking and Business Law of the American Bar Association, and was subsequently revised in 1957 and 1964. It has had considerable influence, having been adopted in whole⁷² or in part⁷³ in a substantial number of states.

The Model Act was consciously drafted to follow as closely as possible the provisions of the Model Business Corporation Act, and deviates from the latter Act only so much as its authors thought was clearly necessary to accommodate the difference in subject matter.⁷⁴ Because, as discussed in section I above,⁷⁵ the function served by the nonprofit corporate form differs in fundamental respects from that served by the business corporation, this has made the Model Nonprofit Corporation Act something less than the ideal model. In general, the Model Act's provisions are minimal and permissive. It avoids entirely many difficult and important issues, such as the conditions, if any, under which officers, directors, members, or other controlling individuals can engage in self-interested transactions.⁷⁶ It is extremely vague or confused about other issues, such as the conditions under which assets may be distributed to members on dissolution. I shall comment in detail below on various of the specific shortcomings of the Model Act.⁷⁷ For the moment, it is only its provisions on permissible purposes for incorporation that are at issue.

As already noted, the Model Act provides two alternative purposes clauses. The first (section 4 of the Act), which is evidently the clause favored by a majority of the drafting committee,⁷⁸ provides that:

⁷¹ MODEL ACT, *supra* note 19.

⁷² *E.g.*, Iowa Nonprofit Corporation Act, §§ 1-101, IOWA CODE ANN. §§ 504A.1 to 504A.101 (West Supp. 1980).

⁷³ *E.g.*, Illinois General Not for Profit Corporation Act, §§ 1-101, ILL. ANN. STAT. ch. 32, §§ 163a to 163a100 (Smith-Hurd 1970 & Supp. 1978); MONT. REV. CODES ANN. §§ 35-2-101 to 35-2-1105 (1979); N.M. STAT. ANN. §§ 53-8-1 to 53-8-99 (1978). *See also* MODEL ACT, *supra* note 19, at x (states adopting Model Act in whole or in large part as of 1964).

⁷⁴ MODEL ACT, *supra* note 19, at vii.

⁷⁵ *See* text accompanying notes 5-13 *supra*.

⁷⁶ This failure cannot be ascribed to any lack of precedent. The problem of self-interested transactions is addressed in the ABA-ALI MODEL BUS. CORP. ACT § 41 (1974). Some nonprofit corporation statutes contain conflict of interest provisions patterned after business corporation statutes. *See* notes 209 & 210 *infra* & accompanying text.

⁷⁷ *See* text accompanying notes 242-48 and 258 *infra*.

⁷⁸ MODEL ACT, *supra* note 19, at viii.

Corporations may be organized under this Act for any lawful purpose or purposes, including, without being limited to, any one or more of the following purposes: charitable; benevolent; eleemosynary; educational; . . .; athletic; . . .; animal husbandry; . . .; but labor unions, cooperative organizations, and organizations subject to any of the provisions of the insurance laws of this State may not be organized under this Act.⁷⁹

The alternative version of section 4 states simply that “[c]orporations may be organized under this Act for any lawful purpose or purposes except . . . [list, if any].”⁸⁰ These two clauses appear—except for the explicit exclusion of labor unions, cooperatives, and insurance companies in the first—to be precisely equivalent. Indeed, the traditional list of acceptable purposes in the first clause seems entirely superfluous. The remarkably confused comments that the authors of the Model Act offer in their preface, however, suggest that they intended some fundamental differences in meaning between the two alternative provisions.⁸¹

To begin with, we are told that “[a] substantial minority of the Committee favors broadening the permitted purposes to any purpose not forbidden by law. Provision for this type of Act is made in alternate Section 4 so as to facilitate local choice.”⁸² Thus, the permissible purposes listed in the first version of section 4 must in fact be intended to have some limiting force as examples of types of purposes that are permissible; evidently, the authors intended the words “including, without being limited to, any one or more of the following purposes” to mean “such as the following purposes, and other purposes of a similar type.”

Even more surprisingly, the draftsmen go on to say that “[t]hus under alternative Section 4 a corporation may be organized to help its members make profits or to make profits itself through earnings or capital gains for eventual distribution to its members in liquidation,”⁸³ and they proceed to offer, as an example of a purpose encompassed by the alternative clause, “a joint business venture for the profit . . . of its members.”⁸⁴ Thus, the authors evidently feel that their alternative purposes clause—but not the first one—should be read to permit profit-seeking activity. To be sure, the prefatory

⁷⁹ *Id.* § 4.

⁸⁰ *Id.* alternative § 4.

⁸¹ *Id.* viii-ix.

⁸² *Id.* viii.

⁸³ *Id.* ix.

⁸⁴ *Id.*

comments reflect the authors' view, embodied in other provisions of the Model Act, that distributions of profits should be confined to distributions made to members on dissolution, and that current distributions of profits are impermissible even under the alternative purposes clause. Yet, as will be seen below,⁸⁵ this curious distinction between current and terminating distributions, which appears to derive from yet further confusions about the appropriate role of nonprofits, and which is by no means confined to the Model Act, places only a limited qualification on the authors' remarkable willingness to abandon the nondistribution constraint.

2. The New York Statute

In the 1960s New York undertook a wholesale revision of its nonprofit corporation laws. The resulting statute,⁸⁶ effective in 1970, is of particular interest not only because it fails to follow the Model Act, but also because it represents a distinctly novel legislative approach to nonprofit incorporation.

The major innovation in the New York statute is its division of all nonprofit corporations into four types, defined as follows:

Type A—A not-for-profit corporation of this type may be formed for any lawful non-business purpose or purposes including, but not limited to, any one or more of the following non-pecuniary purposes: civic, patriotic, political, social, fraternal, athletic, agricultural, horticultural, animal husbandry, and for a professional, commercial, industrial, trade or service association.

Type B—A not-for-profit corporation of this type may be formed for any one or more of the following non-business purposes: charitable, educational, religious, scientific, literary, cultural or for the prevention of cruelty to children or animals.

Type C—A not-for-profit corporation of this type may be formed for any lawful business purpose to achieve a lawful public or quasi-public objective.

Type D—A not-for-profit corporation of this type may be formed under this chapter when such formation is authorized by any other corporate law of this state for any business or non-business, or pecuniary or non-pecuniary,

⁸⁵ See text accompanying notes 176-266 and 385-406 *infra*.

⁸⁶ N.Y. NOT-FOR-PROFIT CORP. LAW §§ 101-1515 (McKinney 1970 & Supp. 1979).

purpose or purposes specified by such other law, whether such purpose or purposes are also within types A, B, C above or otherwise.⁸⁷

The purpose of this classification is to provide for different degrees of regulation for the different types. Type B is the most closely regulated category, whereas type A is given the most latitude.⁸⁸ I shall have a good deal to say later on—most of it negative—about the wisdom of such an effort to establish different categories of nonprofits.⁸⁹ For the moment, our concern is simply to understand what purposes are provided for in these various categories.

Type D is simply a connector to other special-purpose statutes governing particular types of nonprofits, such as religious corporations or organizations involved in housing finance. It is designed to avoid the necessity of repeating, in each of the special-purpose statutes, all of the basic provisions of the general statute. Thus, we need be concerned at this point only with types A, B, and C, which are the only types that can be formed directly under the general act.⁹⁰

The type B listing authorizes charitable purposes, plus a few other specific activities that may or may not fall within the common law definition of charity. The rather arbitrary set of activities specifically mentioned are drawn from section 501(c)(3) of the federal Internal Revenue Code, which essentially defines the class of nonprofits that is entitled to the maximal set of preferences under the federal income tax.⁹¹ The commentary to the statute states that type B is intended to encompass those organizations in which “[t]he benefit group is the public or some broad segment of it,” and “[t]he supporting group often is the general public.”⁹² Even with—or per-

⁸⁷ *Id.* § 201(b) (McKinney 1970).

⁸⁸ See, for example, the provisions regulating dissolution of the corporation and distribution of its assets. *Id.* §§ 1002-1005, 1008.

⁸⁹ See text accompanying notes 267-318 *infra*.

⁹⁰ It is worth noting that the type D list expressly includes “pecuniary” purposes. This evidently results from an effort to avoid restrictions on the types of statutes to which type D can serve as a link in the future. But the intent is ambiguous. The use of the term “pecuniary” may result from the expectation that private housing finance corporations will be formed under the Act. See N.Y. NOT-FOR-PROFIT CORP. LAW, explanatory mem., at xii. (McKinney 1970). Such corporations, although pecuniary in the sense of “having to do with money,” could still adhere to the nondistribution constraint. If, however, “pecuniary” means profit-seeking without regard for the nondistribution constraint, it is plainly inconsistent with the statute’s description of type D organizations as “not-for-profit.”

⁹¹ That is, both exemption from taxation for the organization under I.R.C. § 501, plus qualification for the charitable deduction under I.R.C. § 170.

⁹² N.Y. NOT-FOR-PROFIT CORP. LAW, commentary to § 201 (McKinney 1970).

haps because of—this interpretive gloss, the boundaries of type B are somewhat vague. Would a book club, for example, qualify as a type B nonprofit, on the grounds that it is “literary”? Would it depend on whether the club simply sells books to its members at cost, or on whether the club provides a forum for lectures or discussions concerning books? Would it matter what kinds of books are involved? Or whether membership in the club is open to anyone who seeks it?⁹³

The definition provided for type B is a model of clarity, however, compared with that given for type A. The commentary to the statute states that type A is “intended to cover the usual membership type organization where the support of the organization is derived from a limited class called ‘members’ and where the non-pecuniary benefits flow primarily to such limited class.”⁹⁴ It would have been easy enough to draft the definition of type A to say just this and thus include roughly the same class of nonprofits defined in section I as commercial mutual nonprofits. As it is, however, the language defining type A nonprofits says something rather different, and much more ambiguous. Thus, it provides “for any lawful non-business purpose or purposes, including, but not limited to”⁹⁵ Is this intended to mean something more restrictive than “for any lawful non-business purpose or purposes”? Then there is the question what a “non-business” purpose is—a question to which we shall return below.⁹⁶ Finally, the list of purposes given as specific examples includes many that are not always pursued on a membership basis. For example, an “athletic” organization might be organized as an entrepreneurial rather than as a mutual nonprofit. If so, would it fail to qualify as type A?

Types A and B together contain most of the activities commonly included in the older statutes that limited permissible purposes. Type C is evidently intended to include purposes of a less

⁹³ That type B is evidently influenced by I.R.C. § 501(c)(3) is of only minimal assistance in this regard, because the principles or policies that underlie that provision of the tax code have never been clearly articulated. Partly as a consequence of this, the boundaries of I.R.C. § 501(c)(3) are themselves quite vague. See Hansmann, *Why Are Nonprofit Organizations Exempted from Corporate Income Taxation* (forthcoming in 1981 in *THE INTERACTION OF THE PUBLIC, PRIVATE, AND NONPROFIT SECTORS* (M. White ed.)) [hereinafter cited as *Exempted Nonprofit Organizations*]. Further, one New York court has held that a nonprofit organization's exemption under § 501(c)(3) did not necessarily qualify it as a type B corporation. *Bodell v. Ghezzi*, 50 A.D.2d 674, 375 N.Y.S.2d 426 (1975). Type B, therefore, is obviously narrower than § 501(c)(3).

⁹⁴ N.Y. NOT-FOR-PROFIT CORP. LAW, comment to § 201 (McKinney 1970).

⁹⁵ *Id.* § 201 (McKinney 1970 & Supp. 1979).

⁹⁶ See text following note 100 *infra*.

traditional sort. The statutory commentary states, in particular, that type C is designed to permit the formation of a nonprofit corporation "for a purpose normally carried on by business corporations for profit."⁹⁷ Presumably this is what the statute means by a "business purpose."⁹⁸ Thus, the hypothetical shoe store we have been using as an example would evidently be a type C nonprofit.⁹⁹ This leaves some unfortunate ambiguities, however. These ambiguities can be seen clearly if we consider whether the coverage of type C would be different if it simply said "for any lawful purpose not covered by type A or type B." Two categories of purposes could conceivably be covered by the latter phrase but not by type C as it is now defined: (1) organizations formed for a non-business purpose not included in types A and B; and (2) organizations formed for a business purpose that does not meet the requirement of having a "public or quasi-public objective." The statutory language and commentary leaves it quite unclear whether categories (1) and (2) are empty. If they are not empty—and this is a

⁹⁷ N.Y. NOT-FOR-PROFIT CORP. LAW, comment to § 201 (McKinney 1970).

⁹⁸ The special focus on "business purposes" in the new New York statute evidently is an effort to deal with confusion that developed under the old nonprofit corporation statute (entitled the Membership Corporations Law) and the old business corporation statute (entitled the Stock Corporation Law):

As these statutes were interpreted by court decisions and opinions of the Attorney General, "any lawful business purpose" under Stock Corporation Law Section 5 meant a profit purpose, since business and profit were synonymous and the quoted language of Section 10 of the Membership Corporations Law excluded all business purposes whether the corporation was to be formed for profit or not for profit. Thus a not for profit corporation could not be formed under the Stock Corporation Law. A not for profit corporation could be formed under the Membership Corporations Law unless it was to be formed for a business purpose. If to be formed for a business purpose, it could not be formed under that statute because it would be for a purpose for which a corporation could be formed under any other general law which phrase included the Stock Corporation Law. The rather strange result of this cross-breeding of the concepts of "for profit" and "not for pecuniary profit" and "for a business purpose" and "not for a business purpose" was that one could form under the Stock Corporation Law a "for profit corporation" for a "business purpose" and under the Membership Corporations Law a "not for pecuniary profit corporation" for a non-business purpose but one could not form a "not for pecuniary profit corporation" (non-profit corporation) for a "business purpose" under either law. This condition began to cause problems when non-profit corporations in the business area became common.

Leshner, *The Non-Profit Corporation—A Neglected Stepchild Comes of Age*, 22 Bus. LAW. 951, 953-54 (1967) (footnote omitted). Unfortunately, as the following discussion suggests, the new New York statute, rather than putting an end to such pointless concern about what a "business purpose" is and what difference it makes, simply perpetuates it in a slightly different form.

⁹⁹ Whatever a "business purpose" may be, if a nonprofit corporation charter includes any such purpose among its purposes the corporation must be type C. N.Y. NOT-FOR-PROFIT CORP. LAW § 201(c) (McKinney 1970). See also Bodell v. Ghezzi, 50 A.D.2d 674, 375 N.Y.S.2d 426 (1975).

perfectly plausible reading of the statutory language—then the types of nonprofits provided for in the New York statute, when combined, are less inclusive than the simple phrase “for any lawful purpose,” and hence the New York statute must be included among those that continue to place overall limitations on the purposes for which nonprofit corporations may be formed.

It is apparent that much of the vagueness surrounding the four-fold typology of the New York statute—and the similar vagueness that is to be found in all of the statutes, new and old, that seek to define or categorize permissible purposes for nonprofit corporations—has its source in language that leaves it unclear which attributes, or even what kinds of attributes, of an organization are important. Sometimes, for example, the terms focus on the nature of the services that the organization provides, such as “agricultural,” “athletic,” or “educational.” At other times, the language points more or less clearly to the structural features of the organization, and in particular to the relationships among those who finance, control, and obtain services from it; this is true, for example, of the language quoted above from the official commentary that accompanies the statutory typology in the New York statute.¹⁰⁰

In yet other cases, the language employed refers to both types of characteristics in some uncertain combination. The term “business purpose” is in this latter category. It appears from the context and commentary that this term is being used to refer to the types of services that are normally provided by for-profit firms, such as distribution of shoes, books, and pharmaceuticals. But it appears that this term is also intended to convey something about the relationship between the organization and its patrons; in particular, it seems intended to encompass, in general, only those nonprofits that I have labeled commercial. Thus, our hypothetical shoe store would presumably be engaged in a “business purpose” if it were organized and operated strictly as a commercial entrepreneurial nonprofit (as hypothesized), but perhaps would not be if it were financed in part by donations and sold its shoes below cost to the poor. Conversely, a private preparatory school would, one suspects, be categorized by the authors of the New York statute as serving a “non-business educational” purpose (and therefore in type B rather than type C) even if it were organized strictly as a commercial entrepreneurial nonprofit, simply because secondary school education (thought not infrequently organized on a for-profit basis) is not typically the sort of thing that one refers to as

¹⁰⁰ See note 92 *supra* & accompanying text.

a "business." But then, maybe this is not the interpretation that was intended. Or maybe—most likely of all—the statute reflects no clear intention at all.¹⁰¹

3. The California Statute

The California Nonprofit Corporation Law¹⁰² is the most recent of the important modern statutes, having been adopted in 1978 and having gone into effect on January 1, 1980. It is of interest not only because it constitutes a wholesale replacement of the pre-existing statutory provisions, but also because it represents a rejection of the approaches taken in the two other major recent efforts at statutory revision—the Model Act and the New York statute—and because it is the most comprehensive and carefully drafted of all the existing nonprofit corporation statutes.

Like the New York statute, the California statute divides nonprofit corporations into types. California's statute, however, has only three types, and they are rather differently defined than in New York. As in New York, the purpose of defining different types is to apply different standards to them. The California act goes further than the New York act in distinguishing the different types, however, for it actually consists of three entirely separate corporation statutes, one for each type.

The first type under the California statute comprises what the statute terms "nonprofit public benefit corporations."¹⁰³ Nonprofit corporations coming within this category are those that are established "for any public or charitable purposes."¹⁰⁴ The statute, which is not accompanied by commentary, gives no definition of the purposes that qualify as "public."¹⁰⁵ The second type comprises "nonprofit religious corporations,"¹⁰⁶ defined simply as nonprofit corporations established "primarily or exclusively for any

¹⁰¹ The one New York case to address this point apparently agrees: "nor have we found any legislative history which is clearly dispositive of the issue." *Bodell v. Ghezzi*, 50 A.D.2d at 675, 375 N.Y.S.2d at 426.

¹⁰² CAL. CORP. CODE §§ 5000-10845 (West Supp. 1980). See generally Fryer, *New California Nonprofit Corporation Law: A Unique Approach*, 7 PEPPERDINE L. REV. 1 (1979); *California Nonprofit Corporation Law: A Symposium*, 13 U.S.F. L. REV. 724 (1979).

¹⁰³ CAL. CORP. CODE §§ 5110-6910 (West Supp. 1980).

¹⁰⁴ *Id.* § 5111.

¹⁰⁵ Indeed, the authors of the Act seem deliberately to have kept this term vague. See Hone, *California's New Nonprofit Corporation Law—An Introduction and Conceptual Background*, 13 U.S.F. L. REV. 733, 739 (1979).

¹⁰⁶ CAL. CORP. CODE §§ 9110-9690 (West Supp. 1980).

religious purpose.”¹⁰⁷ Finally, the third type bears the label “non-profit mutual benefit corporations”;¹⁰⁸ the statute provides that a corporation of this type may be formed

for any lawful purpose . . . ; provided that a corporation all of the assets of which are irrevocably dedicated to charitable, religious, or public purposes and which as a matter of law or according to its articles or bylaws, must, upon dissolution, distribute its assets to a person or persons carrying on a charitable, religious, or public purpose or purposes may not be formed under this part.¹⁰⁹

Since the California courts have held that all of the assets of a nonprofit corporation organized exclusively or primarily for charitable purposes (including religious purposes) are impressed with a charitable trust, and therefore must be devoted solely to charitable purposes upon dissolution of the organization,¹¹⁰ such an organization would presumably be barred from incorporating as a mutual benefit nonprofit. Conversely, it appears from the statutory language that a mutual benefit nonprofit may be formed for any lawful purpose that is not primarily charitable or religious, so long as the organization’s articles do not expressly dedicate its assets irrevocably to charitable, religious, or “public” purposes.

Because nonprofit mutual benefit corporations are defined as a residual category, the California act has the advantage that, unlike the New York statute and the Model Act,¹¹¹ it unambiguously permits nonprofit corporations to be formed under it for any lawful purpose. On the other hand, the boundaries of the three types of nonprofits provided for in the California statute are vague and confusing. One can only guess, for example, what a “public” purpose is, and thus how broad the category of public benefit nonprofits is intended to be.¹¹² In fact, there appears to be considerable

¹⁰⁷ *Id.* § 9111.

To some extent, New York also treats nonprofit corporations formed for religious purposes as a separate category. Although such organizations are treated as type B nonprofits under the New York Not-For-Profit Corporation Law, they are excused from some of the provisions applied to other type B nonprofits, and they are in part governed by a separate statute for religious corporations. N.Y. RELIG. CORP. LAW § 2b (McKinney Supp. 1979).

¹⁰⁸ CAL. CORP. CODE §§ 7110-8910 (West Supp. 1980).

¹⁰⁹ *Id.* § 7111.

¹¹⁰ *Lynch v. Spilman*, 67 Cal. 2d 251, 431 P.2d 636, 62 Cal. Rptr. 12 (1967); *Pacific Home v. County of Los Angeles*, 41 Cal. 2d 844, 264 P.2d 539 (1953).

¹¹¹ That is, the Model Act with the initial § 4 defining permissible purposes, rather than the alternative.

¹¹² The California courts have cited with approval the RESTATEMENT (SECOND) OF TRUSTS § 368 (1959), which states that “[c]haritable purposes include (a)

overlap in this typology. For example, because in California, as in most American jurisdictions, religious purposes are considered to be charitable purposes,¹¹³ a religious organization evidently has the option of forming either as a religious or as a public benefit nonprofit. Likewise, any organization dedicated to purposes that are "public" but not charitable—if there are such purposes—could evidently form either as a public benefit or as a mutual benefit nonprofit, and the same appears to be true of an organization formed for purposes that are charitable only in part.¹¹⁴

Further, although the label "nonprofit mutual benefit corporation" suggests an intention—similar to the apparent intention of the New York statute in creating that state's type A nonprofits—to create a separate category for organizations designed essentially to serve the private needs of their members (that is, commercial mutual nonprofits), the statutory definition for mutual benefit nonprofits is far broader than this, apparently extending to all activities that are not primarily charitable. For example, such commercial entrepreneurial nonprofits as our hypothetical shoe store would evidently qualify as a mutual benefit nonprofit; indeed, unless selling shoes falls within the undefined category of "public" purposes, it could be formed only as a nonprofit mutual benefit corporation.

4. Summary

Whereas the Model Act appears simply to perpetuate the confusing practice, characteristic of the previous generation of nonprofit corporation statutes, of offering a restrictive list of permissible purposes, the more recent New York and California statutes have compounded the confusion inherent in such a listing by creating not just one, but several different restrictive categories of nonprofits,

the relief of poverty; (b) the advancement of education; (c) the advancement of religion; (d) the promotion of health; (e) governmental or municipal purposes; (f) other purposes the accomplishment of which is beneficial to the community." *Lynch v. Spilman*, 67 Cal. 2d 251, 261, 431 P.2d 636, 642, 62 Cal. Rptr. 12, 18 (1967). It is not clear what, if anything, the term "public" adds to this definition.

¹¹³ See note 112 *supra*.

¹¹⁴ In contrast to the provision for nonprofit religious corporations, which states that they must be formed "primarily or exclusively for any religious purposes," CAL. CORP. CODE § 9111 (West Supp. 1980), the provisions for nonprofit public benefit corporations state simply that they may be formed "for any public or charitable purposes," *id.* § 5111. This suggests that an organization may be formed as a nonprofit public benefit corporation even when its purposes are public or charitable only in part. But, under the cases cited, note 110 *supra*, if the noncharitable purposes for which such an organization is formed are more than merely incidental, the law will not impose a charitable trust on the organization's assets; consequently, such an organization would presumably also have the option of forming as a nonprofit mutual benefit corporation.

each of which is plagued by definitional ambiguities of the same sort that infected the older statutes, such as the Illinois act quoted earlier.¹¹⁵ The difficulty with the categories created by the New York and California statutes is not, however, simply that they have added a new dimension of ambiguity. Rather, as shall be discussed at length below, the whole notion of multiple categories of non-profits is misconceived, reflecting fundamental confusion concerning the proper role and structure for nonprofit organizations.¹¹⁶

Before pursuing this issue further, however, it is instructive to consider the corresponding restrictions that have been placed on the functions served by for-profit organizations.

III. LIMITATIONS ON FOR-PROFIT ACTIVITY

Just as there are some services that nonprofits are prohibited from providing, there are other services that, in some jurisdictions, can be provided only by nonprofits—that is, services that cannot, by law, be provided by profit-seeking firms. Moreover, whereas the restrictions on the overall scope of nonprofit activity appear to be in general decline, the restrictions on for-profit activity are evolving in a more varied pattern; in some cases they are being eliminated, while in other cases new restrictions are being enacted or proposed.

A. Sources of the Restrictions

The limitations on permissible activities that are often found in nonprofit corporation statutes generally have no parallel in the business corporation statutes, which typically allow the formation of a business corporation “for any lawful purpose.”¹¹⁷ Rather, the sources of the limitations on profit-seeking corporate activity are varied, sometimes deriving from statutory law, sometimes from common law, and sometimes from rules promulgated within particular professions.

I. Medical Care

Until quite recently, it was effectively impossible, in most states, to organize the provision of medical treatment through the medium of a profit-seeking corporation.

¹¹⁵ See text accompanying note 14 *supra*.

¹¹⁶ See text accompanying notes 267-318 *infra*.

¹¹⁷ See, e.g., PA. STAT. ANN. tit. 15, § 1201 (Purdon 1967).

a. *Corporate practice rule*

One source of this constraint has been the "corporate practice rule," which derives from a combination of common law doctrine and a tenuous interpretation of physician licensing statutes.¹¹⁸ In its usual application, this rule proscribes any arrangement whereby a business corporation hires a physician as a salaried employee for the purpose of providing medical treatment to people who contract with the corporation for such treatment. Thus, the rule has been applied to prohibit various forms of incorporated group medical practice or prepaid health plans, as well as arrangements whereby a physician, such as a radiologist or a pathologist, serves as an employee of a hospital rather than as an independent fee-for-service practitioner with a hospital staff affiliation.¹¹⁹ The reasoning that underlies the rule is as follows: By statute, a state medical license is required of every person who practices medicine. Because corporations are not granted medical licenses, they must be unlicensed persons, and therefore not authorized to practice medicine. And, the courts have decided, when a patient contracts with a corporation for the purpose of receiving medical treatment from one of its salaried physicians, rather than contracting directly with the physician, the corporation is practicing medicine.

Such logic might appear, on its face, to prohibit both nonprofit and for-profit corporations from providing medical services through salaried physicians. Yet the rule has generally been applied only to for-profit corporations.¹²⁰ When confronted with a nonprofit corporation, the courts often put a policy gloss on the rule, arguing that its purpose is to prevent laymen from interfering with the physician-patient relationship, or to prevent "commercialization" of the practice of medicine. And these evils are only likely to arise, it is argued, when the physician is being supervised by a profit-seeking

¹¹⁸ The sources and applications of the corporate practice rule in medicine are surveyed in Hansen, *Laws Affecting Group Health Plans*, 35 IOWA L. REV. 209, 211-19 (1950); Willcox, *Hospitals and the Corporate Practice of Medicine*, 45 CORNELL L.Q. 432 (1960); Note, *The Role of Prepaid Group Practice in Relieving the Medical Care Crisis*, 84 HARV. L. REV. 887, 960-62 (1971) [hereinafter cited as Harvard Note]. See generally Hansen, *Group Health Plans—A Twenty-Year Legal Review*, 42 MINN. L. REV. 527, 534-36 (1958) [hereinafter cited as Hansen II]; Comment, *Prepayment Health Care Plan Enabling Acts—Are Their Restrictive Features Constitutional?*, 7 DUQ. L. REV. 125, 128 (1968).

¹¹⁹ See *Parker v. Board of Dental Examiners*, 216 Cal. 285, 14 P.2d 67 (1932); *People ex rel. Kerner v. United Medical Service, Inc.*, 362 Ill. 442, 200 N.E. 157 (1936).

¹²⁰ See Hansen II, *supra* note 118, at 534-36; Harvard Note, *supra* note 118, at 961. But see *Garcia v. Texas State Bd. of Medical Examiners*, 384 F. Supp. 434 (W.D. Tex. 1974) (*per curiam*), *aff'd mem.*, 421 U.S. 995 (1975); 1963 Ohio Att'y Gen. Rep. No. 82.

employer.¹²¹ The result is that the corporate practice rule has acted as a selective prohibition on the practice of medicine by for-profit, but not nonprofit, corporations.¹²²

b. *Blue Shield Laws*

Another restriction on the provision of medical services by profit-seeking corporations has its source in state "Blue Shield" statutes. Such laws were passed in most states, largely at the urging of the state medical societies, beginning in the 1930s.¹²³ Evidently they were in large part a response to the development, during the depression, of lay-controlled health service plans.¹²⁴ These statutes typically required that any prepaid health services plan be formed according to their terms. Further, they generally required, *inter alia*, that the state medical society must approve the articles of incorporation, or have effective control over the organization's services.¹²⁵ The result was commonly that profit-seeking prepaid group practice arrangements were effectively barred in states with such statutes, and that the only nonprofit group medical care plans that developed were physician-dominated Blue Shield type plans that simply insured the patient for the fee of the participating practitioners.¹²⁶

¹²¹ *E.g.*, *Complete Serv. Bureau v. San Diego County Medical Soc'y*, 43 Cal. 2d 201, 272 P.2d 497 (1954); *People ex rel. State Bd. of Medical Examiners v. Pacific Health Corp.*, 12 Cal. 2d 156, 160, 82 P.2d 429, 431 (1938), *cert. denied*, 306 U.S. 633 (1939).

¹²² In the wake of favorable developments involving federal taxation, many states have adopted professional corporation statutes in recent years. These acts specifically provide for the formation of business corporations that offer professional services, including medical services, through licensed professionals who are salaried employees. See Dunn, *Professional Corporations: Their Development and Present Status with Respect to the Practice of Medicine*, 24 U. FLA. L. REV. 625 (1972); Shores, *Professional Corporations*, 10 WAKE FOREST L. REV. 691 (1974); Note, *Professional Corporations*, 9 IDAHO L. REV. 219 (1972). These acts, however, create only a modest exception to the corporate practice rule, because they typically restrict ownership and control of such professional service corporations to individuals who are licensed to provide the services rendered by the corporation. *E.g.*, Pennsylvania Professional Corporation Law, § 10, PA. STAT. ANN. tit. 15, § 2910 (Purdon Supp. 1978). See Dunn, *supra*, at 636-37. In most respects, the resulting corporations do not differ significantly from traditional professional partnerships.

¹²³ See Hansen II, *supra* note 118, at 531-32; Harvard Note, *supra* note 118, at 962-63.

¹²⁴ See Hansen II, *supra* note 118, at 531; Duquesne Comment, *supra* note 118, at 126-27.

¹²⁵ See Hansen II, *supra* note 118, at 531-34; Duquesne Comment, *supra* note 118, at 129-30; Harvard Note, *supra* note 118, at 963.

¹²⁶ The actual administration of the Blue Shield laws, and the various arrangements that have sometimes succeeded in avoiding the more restrictive features of the laws, are surveyed in Harvard Note, *supra* note 118, at 964-69.

c. Federal HMO Legislation

With the precipitous rise in health care costs in recent years, increasing concern has developed among health care planners over the efficiency of the existing organization of medical care delivery. One consequence of this has been considerable enthusiasm for the development of "health maintenance organizations" (HMOs), which are essentially prepaid group practice plans for physician services.¹²⁷ To help foster such organizations, Congress enacted the Health Maintenance Organization Act of 1973.¹²⁸ This act expressly preempts state Blue Shield and related legislation in so far as such legislation interferes with the development of HMOs meeting the standards of the federal act.¹²⁹ Because a for-profit HMO is not disqualified under the federal act,¹³⁰ this legislation eliminates at least some of the barriers to the formation of profit-seeking HMOs.

Yet the federal act in itself falls just short of equalizing the positions of for-profit and nonprofit HMOs. First, the act does not apply to HMOs that do not meet its standards, and those standards are so strict that, it has been argued, it is quite difficult to establish a viable HMO—for-profit or nonprofit—that meets them.¹³¹ Although the Health Maintenance Organization Amendments of 1976¹³² relaxed those standards somewhat, they remain quite strict. Further, the 1973 act does not explicitly override the corporate practice rule, and, although some commentators have argued that the act can and should be interpreted to have that effect,¹³³ organizers of profit-seeking HMOs in some states will still face some uncertainty in this connection, even if they meet all of the federal standards.¹³⁴ Finally, to qualify under the federal act, at least one-third of the policymaking body of an HMO must be consumers of the

¹²⁷ For a thoughtful survey of the issues, see Havighurst, *Health Maintenance Organizations and the Market for Health Service*, 35 *LAW & CONTEMP. PROB.* 716 (1970).

¹²⁸ Pub. L. No. 93-222, 87 Stat. 914 (codified as amended at 42 U.S.C. §§ 300e to 300e-17 (1976 & Supp. II 1978)).

¹²⁹ 42 U.S.C. § 300e-10 (1976).

¹³⁰ See *id.* §§ 300e, 300e-1 (1976 & Supp. II 1978).

¹³¹ See Starr, *The Undelivered Health System*, *PUB. INTEREST*, Winter 1976, at 66, 74-77.

¹³² Pub. L. No. 94-460, 90 Stat. 1945 (codified as amended at 42 U.S.C. §§ 300e-1 to 300e-11, 300e-13, 300e-15, 300n-1 (1976 & Supp. II 1978)).

¹³³ E.g., Kissam & Johnson, *Health Maintenance Organizations and Federal Law: Toward a Theory of Limited Reformmongering*, 29 *VAND. L. REV.* 1163, 1218 (1976).

¹³⁴ Some of this uncertainty may be removed through one of the 1976 amendments to the HMO act, 42 U.S.C. § 300e-10(c) (1976), which requires the Secretary of Health, Education and Welfare to prepare a list of those state laws, regulations, and practices that appear to be inconsistent with the federal act.

organization's services.¹³⁵ This requirement might act as a barrier to the establishment of profit-seeking HMOs, although, because the act does not specify how the members of the policymaking body are to be selected, it would appear relatively easy to comply with this provision without sacrificing the for-profit form.

d. State HMO Legislation

The federal HMO legislation apparently does not pre-empt all state legislation affecting HMOs.¹³⁶ Rather, the federal act simply defines particular types of HMOs that qualify for special benefits—such as federal grants and loans, mandatory inclusion in the health benefit options that employers offer to their employees, etc.—and then explicitly pre-empts certain enumerated types of state laws only to the extent that such laws restrict the formation and operation of HMOs meeting the federal standards.¹³⁷ As a consequence, the passage of the federal act has been paralleled by the recent enactment of HMO enabling acts in most states.¹³⁸ These state statutes are generally more permissive than the federal act, in that they authorize the formation of HMOs that do not meet the restrictive federal standards concerning types of services offered, permissible fee structures, and enrollment policies.¹³⁹

Most of the state enabling acts, like the federal HMO statute, provide for the formation of for-profit as well as nonprofit HMOs.¹⁴⁰ Moreover, most of the state statutes, unlike the federal act, do not require consumer representation in the HMO governing body.¹⁴¹ As a consequence, the traditional restrictions on organizing health care for profit have now been effectively eliminated in a large number of states. This trend has not been universal, however; at least three states have passed HMO enabling acts that provide only for the formation of nonprofit HMOs.¹⁴²

¹³⁵ 42 U.S.C. § 300e(c)(6) (1976 & Supp. II 1979).

¹³⁶ See Kissam & Johnson, *State HMO Laws and the Theory of Limited Reformmongering*, 25 U. KANS. L. REV. 21, 29-30, 49-50 (1976).

¹³⁷ 42 U.S.C. § 300e-10 (1976).

¹³⁸ See Kissam & Johnson, *supra* note 136, at 21.

¹³⁹ For a survey of the requirements established by the state statutes, see *id.* 36-56.

¹⁴⁰ *Id.* 35-36.

¹⁴¹ *Id.* 49.

¹⁴² MINN. STAT. ANN. § 620.02(4) (West Supp. 1980); PA. STAT. ANN. tit. 40, § 1554(a) (Purdon Supp. 1980); S.D. CODIFIED LAWS ANN. § 58-41-2 (1978). For-profit HMOs might, however, be able to organize under the insurance laws of these states. See Kissam & Johnson, *supra* note 136, at 39.

2. Legal Services

The constraints on the organizational forms that may be utilized in the practice of law have paralleled those traditionally applied to the practice of medicine. In law, however, as opposed to medicine, those traditional constraints remain largely intact.

The corporate practice rule has been applied to lawyers, much as it has been applied to doctors, to prohibit them from serving as employees of corporations that sell legal services to the public.¹⁴³ The principal restraints on the organization of legal services have not come, however, from either common law or statutory law. Rather, they have been effected through the codes of ethics promulgated within the profession itself.

Why have doctors turned to the courts and to the legislatures for regulation of their forms of practice, while lawyers have been content to rely on their ethical codes? The reason is perhaps that lawyers, in contrast to other professionals, have been uniformly successful in giving their ethical codes the force of law. The American Bar Association's Code of Professional Responsibility¹⁴⁴ has been adopted in every state (sometimes with modifications) as a statement of rules governing the practice of law.¹⁴⁵ Typically, such adoption has been accomplished by means of pronouncement of the highest court in the state, in the exercise of its authority to supervise the conduct of attorneys.¹⁴⁶ Lawyers acting in violation of the Code are subject to discipline or disbarment.¹⁴⁷

The current Code of Professional Responsibility, like its predecessor the Canon of Ethics, clearly proscribes any arrangement,

¹⁴³ *E.g.*, *In re Co-operative Law Co.*, 198 N.Y. 479, 91 N.E. 15, 120 N.Y.S. 1120 (1910). See Wormser, *Corporations and the Practice of Law*, 5 FORDHAM L. REV. 207 (1936).

¹⁴⁴ ABA CODE OF PROFESSIONAL RESPONSIBILITY (1977) [hereinafter cited as ABA CODE].

¹⁴⁵ A. KAUFMAN, PROBLEMS IN PROFESSIONAL RESPONSIBILITY 29 (1976). The current Code was adopted in 1969. The ABA's Canons of Professional Ethics, which preceded the Code, had similar authority in many, though not all, states. *Id.*

¹⁴⁶ See, *e.g.*, PA. R. OF DISCIPLINARY ENFORCEMENT § 103 (West Pa. R. Ct.) (Purdon Supp. 1980).

¹⁴⁷ See, *e.g.*, PA. CODE OF PROFESSIONAL RESPONSIBILITY, preamble and preliminary statement (West Pa. R. Ct.) (Purdon Supp. 1980). In contrast, the licensing and supervision of doctors is typically the responsibility of legislatively created state boards, and the statutes creating these boards do not always include violation of the state medical society's code of ethics as grounds for discipline. See, *e.g.*, Pennsylvania Medical Practice Act of 1974, § 15, PA. STAT. ANN. tit. 63, § 421.15 (Purdon Supp. 1980).

other than a conventional law firm partnership or professional service corporation, whereby a lawyer serves as an employee of an organization that sells legal services to the public on a profit-seeking basis.¹⁴⁸ Yet the Code does explicitly permit lawyers to serve as employees in a legal aid office "[o]perated or sponsored by a bona fide nonprofit community organization."¹⁴⁹

These restrictions have evidently been effective in assuring that any organization that provides legal services to the public, and that is not controlled entirely by lawyers, is operated on a non-profit basis.¹⁵⁰ Moreover, in law, as opposed to medicine, there has to date been little debate about the wisdom of such restrictions. Although there has been considerable discussion about, and even experimentation with, prepaid group practice legal service plans that parallel the HMO concept in medicine, it seems almost universally to be taken for granted that such plans will not be, and ought not to be, operated by profit-seeking entrepreneurs.¹⁵¹

¹⁴⁸ ABA CANONS OF PROFESSIONAL ETHICS No. 35; ABA CODE, *supra* note 144, D.R. 2-103(D). A recently proposed replacement for the Code takes a somewhat less restrictive approach to lawyer ownership or management of law firms, though it continues to reflect distrust of such arrangements. ABA MODEL R. OF PROFESSIONAL CONDUCT § 7.5 (Discussion Draft), *reprinted in* 48 U.S.L.W. 1, 27 (1980).

¹⁴⁹ ABA CODE, *supra* note 144, D.R. 2-103(D)(1)(b).

¹⁵⁰ Pfennigstorf & Kimball, *Legal Service Plans: A Typology*, 1976 AM. B. FOUNDATION RESEARCH, J. 411, which surveys existing legal service plans, reports no such plans organized as business corporations with salaried attorneys. Although some insurance companies sell legal insurance, these companies simply provide reimbursement for client-selected attorneys; none of them has tried instead to provide direct service through attorneys employed by the company itself. *Id.* 488.

¹⁵¹ This issue has apparently never been raised in the course of the five annual conferences on prepaid legal services sponsored by the American Bar Association in the early 1970s. AMERICAN BAR ASSOCIATION, TRANSCRIPT OF PROCEEDINGS OF THE NATIONAL CONFERENCE ON PREPAID LEGAL SERVICES (1971-75). The topic does receive brief consideration in B. CHRISTENSEN, *LAWYERS FOR PEOPLE OF MODERATE MEANS* (1970), a study sponsored by the American Bar Foundation and prepared for the American Bar Association Special Committee on Availability of Legal Services. This study concludes, without much serious discussion, that proprietary plans employing salaried attorneys "offer far too great a threat to the professional independence of the lawyer in relation to whatever modest social value they may have," *Id.* 280. *But see* Pfennigstorf & Kimball, *Regulation of Legal Service Plans*, 1977 AM. B. FOUNDATION RESEARCH J. 357, 413-18, which offers a more extensive and open minded discussion of the issues.

The four Supreme Court decisions establishing a constitutional right to make collective arrangements for securing legal services, *United Transportation Union v. State Bar of Mich.*, 401 U.S. 576 (1971); *United Mine Workers District 12 v. Illinois State Bar Ass'n*, 389 U.S. 217 (1967); *Brotherhood of R.R. Trainmen v. Virginia ex rel. Va. State Bar*, 377 U.S. 1 (1964); *NAACP v. Button*, 371 U.S. 415 (1963), all involved nonprofit organizations, and do not obviously extend to for-profit legal service plans.

3. Nursing Care

At present, nursing homes can generally be organized freely on a for-profit as well as a nonprofit basis. As of 1970, roughly eighty percent of the nation's nursing homes were proprietary, about fifteen percent were nonprofit, and the rest were governmental.¹⁵² The widespread abuses that seem to characterize that industry,¹⁵³ however, have sometimes been thought to be associated primarily with its proprietary elements,¹⁵⁴ and this has led to several recent proposals for the elimination of the profit motive from the industry.¹⁵⁵ Most prominent among these has been the 1975 report of New York's Stein Commission, which called for an immediate moratorium on the licensing of new proprietary nursing homes, together with the adoption of measures "designed to gradually phase out proprietary nursing facilities in New York and to substitute voluntary, nonprofit institutions as the mainstay of this industry."¹⁵⁶

4. Education

Like nursing homes, educational institutions generally are not prohibited from being organized and operated on a proprietary basis, whether at the primary, secondary, or higher level.¹⁵⁷ Accrediting organizations, however, commonly require that an insti-

¹⁵² *Hearings on Trends in Long Term Care Before the Subcom. on Long-Term Care of the Senate Special Comm. on Aging*, 91st Cong., 2d Sess., pt. 1, at 13 (1970) [hereinafter cited as *Senate Long Term Care Hearings*].

¹⁵³ See generally M. MENDELSON, *TENDER LOVING GREED* (1974).

¹⁵⁴ See Regan, *Quality Assurance Systems in Nursing Homes*, 53 J. URB. L. 153, 210-14 (1975); Shulman & Galanter, *Reorganizing the Nursing Home Industry: A Proposal*, 54 MILBANK MEMORIAL FUND Q. 129 (1976). But see M. MENDELSON, *supra* note 153, at 195-212.

¹⁵⁵ See TEMPORARY STATE COMM'N ON LIVING COSTS AND THE ECONOMY, REPORT ON NURSING HOMES AND HEALTH RELATED FACILITIES IN NEW YORK STATE (1975) [hereinafter cited as TEMPORARY STATE COMM'N REPORT]; Regan, *supra* note 154, at 213; Shulman & Galanter, *supra* note 154; *Senate Long Term Care Hearings*, 92d Cong., 1st Sess., *supra* note 152, pt. 11, at 905-06 (1971).

Presumably as a result of this association between financial abuse and proprietary motivation, one state has statutorily barred proprietary operators from the particularly susceptible and risky form of nursing home care known as life care. MICH. COMP. LAWS ANN. § 554.805(5) (Supp. 1979). See Comment, *Continuing-Care Communities for the Elderly: Potential Pitfalls and Proposed Regulation*, 128 U. PA. L. REV. 883, 918-19, 919 n.183 (1980).

¹⁵⁶ TEMPORARY STATE COMM'N REPORT, *supra* note 155, at 13.

¹⁵⁷ Koerner, *The Case of Marjorie Webster*, PUB. INTEREST, Summer 1970, at 40, 43-50.

tution be nonprofit before it can be accredited,¹⁵⁸ and lack of accreditation can be a substantial handicap.¹⁵⁹

The authority of accrediting organizations to refuse to accredit a college solely on the grounds that it is proprietary was recently attacked in federal court by Marjorie Webster Junior College, a small two-year college for women in Washington, D.C. that is organized as a closely held business corporation. Middle States Association of Colleges and Secondary Schools, Inc., the regional accrediting association responsible for accrediting schools in the District of Columbia, had repeatedly refused even to consider Marjorie Webster for accreditation.¹⁶⁰ The college therefore brought suit against the Association, arguing, first, that the Association's action constituted a conspiracy in restraint of trade in violation of the antitrust law, and second, that the Association's activities were sufficiently governmental in character to subject it to constitutional requirements of due process, and that the Association's refusal to consider the College for accreditation strictly

¹⁵⁸ Thus, accreditation of colleges offering programs of general instruction is presently in the hands of six regional associations whose nonoverlapping jurisdictions cover the entire country and its outlying possessions. *Id.* 41-43. These associations are organized on a nonprofit basis and are controlled by their membership, which consists of the schools they have accredited. The six regional associations in turn have affiliated to form a national organization, the Federation of Regional Accrediting Commissions of Higher Education (FRACHE), which, *inter alia*, sets general policy on eligibility for accreditation. See generally *id.*; Comment, *The Legal Status of the Educational Accrediting Agency: Problems in Judicial Supervision and Governmental Regulation*, 52 CORNELL L. REV. 104-06 (1966) [hereinafter cited as Cornell Comment]. See also *Marjorie Webster Junior College, Inc. v. Middle States Ass'n of Colleges and Secondary Schools, Inc.*, 302 F. Supp. 459 (D.D.C. 1969), *rev'd*, 432 F.2d 650 (D.C. Cir.), *cert. denied*, 400 U.S. 965 (1970).

The accrediting associations generally require that a college be nonprofit before it can even be considered for accreditation. This policy is reflected in the standards of eligibility established by FRACHE, which include the requirement that "[t]he institution . . . be a nonprofit organization with a governing board representing the public interest." 302 F. Supp. at 461-62.

¹⁵⁹ Failure to receive accreditation from the appropriate regional association need not be fatal to a college; under state law it may still have the authority to grant degrees. See *id.* 460 (college chartered and authorized to grant degrees in spite of lack of regional accreditation); Cornell Comment, *supra* note 158, at 118. Lack of accreditation does, however, make it more difficult for the college's students to gain acceptance for their credits at other institutions to which they may wish to transfer, undoubtedly lowers the status of the school in the eyes of potential applicants and those who advise them, and may disqualify the college and its students from participating in certain federal aid programs, such as National Defense Student Loans and the College Work-Study Program. 302 F. Supp. at 468, 478.

¹⁶⁰ The history of Marjorie Webster Junior College and its dealings with Middle States is recounted in Koerner, *supra* note 157. Although the Association had consistently refused to consider proprietary colleges for accreditation, it has not been similarly restrictive in its accreditation of secondary schools and has in fact accredited three proprietary secondary schools. 302 F. Supp. at 477.

because of its proprietary character was sufficiently arbitrary, discriminatory, and unreasonable to constitute a denial of due process.¹⁶¹

The District Court ruled in favor of Marjorie Webster on both counts, and ordered the Association to evaluate the college for accreditation and to accredit it if it qualified under the Association's criteria aside from the requirement that a school be nonprofit.¹⁶² This decision was reversed on appeal, however, by the District of Columbia Circuit.¹⁶³

Thus, in the area of higher education, the law has given its blessing to a system that, though not as exclusive of proprietary organizations as the legal and medical professions have traditionally been, still places such organizations at a substantial disadvantage.

B. A Rationale for the Restrictions

The restrictions on for-profit activity just surveyed, and various other similar restrictions that exist or have been proposed,¹⁶⁴ are somewhat easier to rationalize than are the restrictions on nonprofit activity that were the subject of section II. As noted in section I, there may be certain goods and services that are so difficult for consumers to evaluate accurately—even when purchased directly from the provider for the consumer's own consumption—that consumers will generally be better off if they deal only with nonprofit providers.¹⁶⁵ Yet some consumers, perhaps precisely because of the difficulty they experience in evaluating the services in question, might nevertheless be induced to patronize for-profit providers if

¹⁶¹ *Id.* 462.

¹⁶² *Id.* 471.

¹⁶³ 432 F.2d 650 (D.C. Cir.), *cert. denied*, 400 U.S. 965 (1970). With respect to the antitrust claim, the court of appeals held that the process of accreditation, "absent an intent or purpose to affect the commercial aspects of the profession"—which the court evidently thought absent here—did not fall within the scope of the Sherman Act. *Id.* 654 (footnote omitted). As for the due process claim, although the court was willing to assume, without deciding, that the Association's activities constituted state action, and therefore were subject to the limitations of the fifth amendment, the court ruled that, particularly in light of its conclusion that accreditation was not absolutely essential to Marjorie Webster's continued operation, *see id.* 656 n.32, Middle States's refusal to consider the College solely on the basis of its proprietary character was not so clearly unreasonable as to violate the constitutional standard. *Id.* 658-59.

¹⁶⁴ *See, e.g.*, Jencks, *Should News Be Sold for Profit?*, WORKING PAPERS FOR A NEW SOCIETY, July/Aug. 1979, at 12 (suggesting that newspapers be required to organize on a nonprofit basis).

¹⁶⁵ For further discussion, see Hansmann, *supra* note 2, at 862-72.

given the opportunity. Consequently, some might argue that for-profit firms should be excluded from some areas, thus eliminating the possibility that consumers might make unwise choices.

Logic of this sort has been offered to justify the restrictions on proprietary organizations that are found in each of the areas just surveyed. For example, in defense of the existing restrictions on proprietary law firms, it has been argued that

[t]here is no real community of interest between [an] agency seeking to sell legal services and the prospective recipients; there is considerable prospect that the agency's interest in making a profit may conflict with the interests of individual clients, if only to the extent that costs and profits may curtail the amount of time a lawyer spends on a particular client's problem or may encourage the professionally unwarranted substitution of 'ready-made' solutions for individual service¹⁶⁶

Similarly, in the Marjorie Webster case, the court of appeals concluded that "the desire for personal profit might influence educational goals in subtle ways difficult to detect but destructive, in the long run, of that atmosphere of academic inquiry that, perhaps even more than any quantitative measure of educational quality, appellant's standards for accreditation seek to foster."¹⁶⁷

Such restrictions on the range of choice offered to consumers need not reflect a patronizing attitude toward the capacity of consumers to look out for themselves. It might be perfectly reasonable to delegate to a legislature, or to an accrediting organization, the task of determining whether in a particular area contract failure is likely to be so severe that virtually no wise consumer, if fully informed of the potential problems, would choose to patronize a for-profit firm. In such situations, there might be considerable economies in delegating choice to a collective body, rather than forcing each consumer to gather and evaluate information concerning this choice on his or her own, only to come to the same conclusion.

C. *Some Objections*

There are, however, some serious considerations that weigh against such restrictions.

¹⁶⁶ B. CHRISTENSEN, *supra* note 151, at 280.

¹⁶⁷ 432 F.2d at 657.

1. Are Nonprofits Really Better?

To begin with, one must ask, for each service involved, whether nonprofits can in fact generally be relied on to provide consumers with significantly and consistently better service than their for-profit counterparts. The answer might be expected to vary from one service to the next, depending on such considerations as the degree of contract failure involved, the extent of the countervailing inefficiencies (such as cross-subsidization and poor incentives for cost minimization) that accompany the nonprofit form, the vigilance with which the authorities can and do enforce the nondistribution constraint, and the extent to which informal normative constraints—such as professional ethics and the involvement of religious institutions—have developed to reinforce the probity of the nonprofit firms. For example, even the harshest critics of the nursing home industry have not universally been of the opinion that nonprofit homes as a class are clearly superior to proprietary homes; many proprietary homes provide outstanding service, and many of the worst offenders are incorporated as nonprofits.¹⁶⁸

Moreover, forcing an industry to be organized exclusively on a nonprofit basis may create particularly strong incentives to evade the nondistribution constraint. If a profit-seeking entrepreneur should see an opportunity to make a large return in such an industry—perhaps because supply of the service is not keeping pace with demand owing either to lack of capital or lack of entrepreneurial initiative among the existing nonprofit providers—he or she could seek to exploit that opportunity only through the nonprofit form. Thus, the amount of policing required to maintain a given level of fiduciary integrity among nonprofits in a given sector may increase substantially as for-profit firms are forced out of it.

2. Inadequate Supply of Capital

Forcing an industry exclusively into the nonprofit form necessarily deprives that industry of access to equity capital. As a consequence, the sector is likely to be hampered in its ability to attract needed capital, and may frequently be unable to expand sufficiently quickly to keep pace with growth or shifts in demand. Thus, a prohibition against proprietary firms, particularly in a rapidly growing area such as nursing care or prepaid group medical practice, might well cripple the development of the industry unless public

¹⁶⁸ See M. MENDELSON, *supra* note 153, at 195-212.

programs are established to assure an adequate supply of capital. Such programs might involve direct governmental grants or loans, or alternatively could provide subsidies or guarantees for private loans.¹⁶⁹ Whichever of these mechanisms is chosen, a governmental agency will be required to undertake the function otherwise served by the market in allocating capital. The direct costs of administering such a program, as well as the efficiency losses that result from any misallocation of capital to which it leads, must therefore be given serious consideration before outlawing for-profit firms.¹⁷⁰

3. Protection of Special Interests

Another serious problem with limitations on proprietary firms is that often they seem designed not to protect the interests of consumers, but rather to protect the interests of the professionals who derive their living from the service in question.

To some degree this appears to be the case in both medicine and law. Until recently, both professions have consisted almost exclusively of licensed professionals who practice either alone or in small partnerships and who operate on a fee-for-service basis. The advent of incorporated enterprise in these fields, financed and perhaps controlled by investors from outside the profession, threatens the welfare of the existing practitioners in several respects.

First, this new form of organization could prove more efficient than the existing arrangements, thus driving down the price that can be charged for a given quality of service, and reducing the return to those practitioners already committed to the existing arrangements.

Second, if, as tends to be the case when nonprofessionals are barred from any degree of control, only licensed professionals are

¹⁶⁹ As one example, the Health Maintenance Organizations Act of 1973 makes provision for grants, contracts, loans, and loan guarantees for the benefit of nonprofit HMOs to cover start-up costs. 42 U.S.C. §§ 300e-2 to 300e-8 (1976 & Supp. II 1978). Actual appropriations and disbursements under the Act, however, have been far too small to support the formation of any substantial number of new nonprofit HMOs. See Starr, *supra* note 131, at 75.

¹⁷⁰ The federal government has devised a series of programs seeking to improve the allocation of capital to nonprofit hospitals, beginning with the Hill-Burton program of capital grants that was established in 1946. A survey of these efforts, which have culminated in the National Health Planning and Resources Development Act of 1974, Pub. L. No. 93-641, 88 Stat. 2225 (1975) (codified in scattered sections of 42 U.S.C.), appears in the Senate Report on the latter act, S. REP. NO. 1285, 93d Cong., 2d Sess. 1-66, reprinted in [1974] U.S. CODE CONG. & AD. NEWS 7842, 7842-7905. An econometric study of hospital capital allocation, including an effort to judge the effectiveness of Hill-Burton grants in correcting misallocations, is offered by P. Ginsburg, *Capital in Non-Profit Hospitals* (Dec. 1970) (unpublished doctoral thesis submitted to Harvard University).

in a position to invest equity capital in the provision of services (as they can in medicine and law through solo practice, partnerships, and professional corporations),¹⁷¹ then they can 'capture all of the returns from capital for themselves. And if, as is likely, this means that professional services in some areas are characterized by a shortage of capital because the professionals involved are unable or unwilling to provide sufficient resources out of their own pockets, then the capital that they have invested may provide them with monopoly returns. Admitting investors from outside the profession (by permitting the development of proprietary firms controlled by lay investors), would therefore be likely to lead to increased overall levels of invested capital, and could eliminate those monopoly returns.¹⁷²

Third, the development of incorporated enterprise controlled by laymen could lead to the result that many professionals serve as salaried employees rather than as managers of their own practice. To the extent that such an arrangement is more efficient than current practices, existing practitioners accustomed to the conventional arrangements would be forced to choose between abandoning those arrangements in favor of the new form, and thus sacrificing aspects of their practice that they may have come to enjoy such as autonomy, small scale, and extensive personal dealings with clients, or continuing those arrangements and suffering a loss of business. Similarly, many professionals might fear a loss of prestige for the profession as a whole if many of its members should come to occupy positions as salaried employees rather than independent practitioners.¹⁷³

Similar concerns might help to explain the strong opposition of accrediting associations—which are controlled by the nonprofit in-

¹⁷¹ See note 122 *supra*.

¹⁷² Suppose that the aggregate amount of a given type of professional services produced, Q , is a function of the number of professionals, L , and the amount of invested capital, M . Let there be $L = \bar{L}$ professionals. Suppose that the cost of capital is r , and that the market demand price for the services is $P(Q)$, $P' < 0$. Aggregate net income for the professionals will then be $I = PQ - rk$, which will be maximized at that level of K for which

$$r = P \frac{dQ}{dK} + \frac{dP}{dQ} Q \frac{dq}{dK}.$$

If outside investors were permitted to invest freely in the industry, however, they would, under conditions of competition, presumably invest to the point where

$r = \frac{dQ}{dK}$, which represents the social optimum given $L = \bar{L}$, and which involves a larger amount of capital.

¹⁷³ See, e.g., B. CHRISTENSEN, *supra* note 151, at 284-91.

stitutions they have accredited—even to consider accrediting proprietary colleges. In large part, nonprofit colleges are controlled by their faculties, both directly through representative bodies and committees and indirectly through the established custom of selecting administrators almost exclusively from among the professoriate. One would not expect these professionals to be eager to encourage the development of new forms of organization that would threaten that control.

Nor need professionals have a direct financial nexus with an institution for them to have a strong personal stake, and in particular a financial stake, in its nonprofit status. For example, as has been noted elsewhere,¹⁷⁴ doctors probably benefit considerably from affiliation with nonprofit hospitals. This may be an important reason why the nonprofit form has continued to predominate in the hospital sector.

4. Alternative Forms of Regulation

Finally, before prohibiting proprietary activity in any sector, it is wise to consider whether other forms of regulation might effectively curb abuses and, at the same time, avoid many of the disadvantages of exclusive reliance on nonprofit firms.

One such approach is to legislate minimally acceptable standards of services, enforceable by public inspection. Another is to create an agency that will evaluate the quality of service provided by firms and publish its ratings for use by individual consumers; such an agency could be either private—such as Consumers Union and the educational accrediting organizations—or public. Of course, these approaches are likely to be more workable with some types of services than with others.¹⁷⁵

D. Conclusions

On balance, it is difficult to justify any of the existing or proposed prohibitions on proprietary firms. They make sense only on a clear showing that proprietary firms are seriously inferior to nonprofit firms in providing a given service, that consumers are quite likely not to recognize this difference, and that any advantages that might otherwise be gained by prohibiting proprietary firms will not

¹⁷⁴ Clark, *Does the Nonprofit Form Fit the Hospital Industry?*, 93 HARV. L. REV. 1416 (1980); Hansmann, *supra* note 2, at 866-68; Pauly & Redisch, *The Not-For-Profit Hospital as a Physicians' Cooperative*, 63 AM. ECON. REV. 87 (1973).

¹⁷⁵ See Hansmann, *supra* note 2, at 868-72.

be outweighed by the constraints on capital investment and the dominance of professional interests that are likely to accompany such a prohibition. Absent such a showing, the better policy is probably to leave consumers free to choose between nonprofit and for-profit suppliers, and concentrate instead on policies designed to keep both kinds of firms as responsible as possible and to provide consumers with reliable information about them.

IV. REFINING THE NONDISTRIBUTION CONSTRAINT

The prohibition on distributions of net earnings to controlling individuals is the essential defining feature of a nonprofit organization. If nonprofits are to fulfill their appropriate role, this constraint must be well defined and well policed. Unfortunately, current law in this area is often misguided, reflecting the prevailing confusion concerning the function of the nonprofit form. In some respects, the nondistribution constraint has been applied too strictly, and in others far too loosely. As a result, the effectiveness of the nonprofit corporate form in serving its essential functions has often been severely impaired. The following discussion focuses on several important areas in which the law in this respect is in particular need of clarification or reform.

A. Organizations Formed to Advance the Financial Interests of Their Members

Many nonprofit organizations provide services that directly or indirectly serve the financial interests of their members. It might at first appear that such activity is tantamount to profit seeking and thus necessarily violates the nondistribution constraint. The courts exhibit considerable confusion on this point; in some states such an argument has been more or less clearly rejected, while in others it has been invoked to deny or revoke nonprofit corporate status for various types of organizations.¹⁷⁶

I. Some Examples

Trade associations, for example, are obviously formed in large part for the purpose of making their members' businesses more profitable. With this in mind, the Pennsylvania Supreme Court in

¹⁷⁶ The commentators, too, have shown confusion on the issue. See, e.g., N.Y.U. Note, *supra* note 3, at 768-71.

1929 sustained the refusal of a nonprofit corporate charter to an association of Chevrolet dealers despite the fact that the existing statute provided for the incorporation, as nonprofits, of organizations "[f]or the encouragement and protection of trade and commerce."¹⁷⁷ The court reasoned that the statutory language applied to "associations which are primarily helpful to the trade and commerce of the locality, like civic organizations, rather than to bodies whose chief aim is to increase the business and profits of those engaged in a certain limited branch of an industry who might become its members."¹⁷⁸ The Pennsylvania statute was subsequently amended, in 1933, to permit incorporation as a nonprofit for "any purpose or purposes which are lawful and not injurious to the community,"¹⁷⁹ while defining a nonprofit corporation as one established "for a purpose or purposes not involving pecuniary profit, incidental or otherwise, to its members."¹⁸⁰ Again, the courts found that associations of businesspersons with a common trade did not fall within the statutory language. Thus, an association of businesspersons owning automatic phonograph machines was denied nonprofit incorporation on the grounds that:

[c]learly, the "improvement of the . . . economic conditions," the "extension of markets," and the promotion of "the general welfare of the industry and [to] stimulate public interest in the products of its members," must be regarded as intended for the pecuniary profit of the members of the association. Further, what is intended in the "study [of] each other's problems for their mutual welfare and well-being" or the taking of "action for the betterment of the members of the corporation and the industry in general" if not the pecuniary benefit, incidental or otherwise, of the members of the proposed corporation?¹⁸¹

¹⁷⁷ *In re Pittsburgh Chevrolet Dealers' Ass'n*, 296 Pa. 431, 433, 146 A. 26, 26 (1929).

¹⁷⁸ *Id.* 433, 146 A. at 26.

¹⁷⁹ Law of May 5, 1933, art. II, § 201, 1933 Pa. Laws 289 (repealed 1972).

¹⁸⁰ *Id.* art. I, § 22(3) (repealed 1972).

¹⁸¹ *In re Incorporation of Automatic Phonograph Owners Ass'n*, 45 Pa. D. & C. 551, 553 (Phila. County C.P. 1942). *Accord*, *In re Application for Charter of Fayette & Greene County Beer Distribution Ass'n*, 13 Fayette Legal J. 39 (C.P. 1949); *In re Fayette Gasoline Retailers Ass'n*, 1 Fayette Legal J. 21, 32 Pa. D. & C. 165 (C.P. 1938). Interestingly, the Pennsylvania courts did not extend the same reasoning to labor unions, which were freely granted the right of nonprofit incorporation. See *In re Independent Garment Workers' Union of Valley View*, 335 Pa. 209, 6 A.2d 775 (1939) (per curiam); *In re Elkland Leather Workers' Ass'n*, 330 Pa. 78, 198 A. 13 (1938) (per curiam); *In re Independent Children's Dress Workers*, 45 Dauphin County Rep. 392 (C.P. 1938).

This line of cases has never been disapproved, although its continuing validity is doubtful under Pennsylvania's new nonprofit corporation statute, which, while retaining the prohibition on purposes "involving pecuniary profit, incidental or otherwise,"¹⁸² specifically allows nonprofit incorporation "for any lawful purpose or purposes, including, but not limited to, . . . professional, commercial, industrial, trade, service or business associations."¹⁸³

Some states have also denied nonprofit incorporation to various organizations established to provide services directly to their members, reasoning that the value of such services constitutes profit or pecuniary gain. In Washington, for example, an organization established by a group of businesses to provide low-cost medical services to their employees was denied nonprofit status on the grounds that

[p]rofit does not necessarily mean a direct return by way of dividends, interest, capital account, or salaries. A saving of expense which would otherwise necessarily be incurred is also a profit to the person benefited. If respondent renders to its incorporators or members, or to businesses in which they are interested and in whose profits they share, a service at a cost lower than that which would otherwise be paid for such service, then respondent's operations result in a profit to its members.¹⁸⁴

In Ohio, this principle has been extended to include not only services rendered directly to members, but also benefits of a more general sort that members might enjoy. Thus, the Supreme Court of Ohio sustained the Secretary of State's refusal to grant a nonprofit corporate charter to a homeowner's association which devoted funds to general community planning and development, citing the "clear purpose to confer both direct and indirect benefits to members of the corporation."¹⁸⁵

It is, indeed, difficult to find cases that clearly hold to the contrary. In spite of the large number of membership organizations in virtually every state that are incorporated as nonprofits, and that provide services that obviously benefit their members, judicial opinions holding that such benefits to members need stand as no

¹⁸² 15 PA. CONS. STAT. ANN. § 102 (Purdon Supp. 1979).

¹⁸³ *Id.* § 7311.

¹⁸⁴ State *ex rel.* Troy v. Lumbermen's Clinic, 186 Wash. 384, 394-95, 58 P.2d 812, 816 (1936).

¹⁸⁵ State *ex rel.* Russell v. Sweeney, 153 Ohio St. 66, 72, 91 N.E.2d 13, 16 (1950). *But see* Snyder v. Chamber of Commerce, 53 Ohio St. 1, 41 N.E. 33 (1895).

impediment to nonprofit incorporation are rare. What seems to be the clearest and most forthright decision of this type appears in a 1922 Delaware case holding that an association of coal shippers could form a nonprofit corporation for the purpose of taking various measures to expedite the sorting and shipping of coal at major East Coast ports.¹⁸⁶ The court reached this result by concluding, in essence, that a nonprofit firm is defined simply by adherence to the nondistribution constraint: "a corporation is for profit when its purpose is . . . to make a profit on the business it does which in reason belongs to it and which if its affairs are administered in good faith would be available for dividends."¹⁸⁷ Were the beneficial services that the corporation rendered to its members tantamount to a distribution of profits? The court thought not, though its reasoning here becomes a bit muddled: "Profit furthermore must be something of a tangible or pecuniary nature. Intangible benefits not capable of measurement in definite terms, though of value to the recipients, cannot be called profits."¹⁸⁸

It is in areas such as this that one feels most acutely the lack of any conception of the proper role of the nonprofit corporation. Not only do none of the cases that deal with the subject at hand base their holding on some such conception, but in fact they even fail to ask what is at stake—that is, who would stand to benefit and who would stand to lose, and how, as a result of a ruling in one direction or the other.

2. A More Reasoned View

There is no reason why a nonprofit corporation should be forbidden to render services to its members, or for that matter make such services its sole *raison d'être*. But the reason for this is not that such services are "intangible" or not capable of measurement in definite terms. Rather, it follows from the nature of the fiduciary function that nonprofits are designed to perform. As was argued in section I, the purpose of establishing an organization as a nonprofit is to assure its patrons that the funds that they pay to it will be devoted in their entirety to financing the services that the organization claims to provide.¹⁸⁹ It follows that the nonprofit form is

¹⁸⁶ *Read v. Tidewater Coal Exch., Inc.*, 13 Del. Ch. 195, 209, 116 A. 898, 904 (1922).

¹⁸⁷ *Id.* 209, 116 A. at 904.

¹⁸⁸ *Id.* 210, 116 A. at 904.

¹⁸⁹ See text following note 6 *supra*.

abused only when a patron's payments are instead used for some other purpose, such as the personal enrichment of those who control the organization (beyond reasonable compensation for services rendered). The mere fact that the organization is providing services that are of benefit to controlling individuals, such as members, is not in itself an indication that such abuse is occurring. Rather, the question is whether such services are being financed in whole or in part by profits gained from the provision of services paid for by other patrons. Some examples may help to make this clear.

Consider, first, a trade association whose members are businesses and businesspersons engaged in a common trade. The purpose of the organization, as in most such organizations, is to collect and distribute information of common interest to its members, to engage in collective advertising to promote their common product, to lobby for legislation favorable to the trade, and so forth. All of these activities are public goods so far as members of the trade are concerned, and therefore, for the reasons suggested in section I, the nonprofit form is well suited to their needs. That is, because it is not easy for a member to see accurately the increment in the organization's services that is financed with the member's individual contribution, the member needs to rely on the nonprofit form to assure that all contributions will be devoted to the services that the organization was formed to provide. The fact that the organization's patrons are all members and thus exercise some control over it—that is, that the organization is a mutual nonprofit rather than an entrepreneurial nonprofit—is presumably simply a response to such considerations as (1) that the entrepreneurial activity necessary to establish such an organization is likely to come only from among members of the industry; (2) that this form gives the organization's patrons even more assurance that their contributions are being used exclusively for their benefit; and (3) that the patrons are relatively easy to organize, being established businesses with an ongoing interest in the affairs of the trade association and with both the means and the opportunity to communicate with each other relatively easily.¹⁰⁰

In such a case, it is absurd to prohibit the association from using the nonprofit corporate form on the ground that it provides services to its members. The whole point of using the nonprofit form in such a situation is precisely to assure its patrons that they will receive the highest quality services possible in return for their contributions to the organization. Denying them the use of the

¹⁰⁰ See Hansmann, *supra* note 2, at 890-91.

nonprofit form would simply handicap them in their endeavor, with no gain whatsoever to anyone else. No one is being abused or deceived. Rather, the purpose of the nonprofit form in such a case is precisely to prevent any opportunity for abuse or deceit.¹⁹¹

Nor does this conclusion depend on the fact that the trade association is providing its members services in the form of public goods that improve the conditions for profitability in the trade as a whole—that is, providing only “indirect” benefits. For example, take the case of a nonprofit day care center controlled by the parents who purchase its services for their children—a commercial mutual nonprofit. The services that such an organization provides are private consumption goods for the members. The nonprofit form is presumably used here, as elsewhere, in large part because it assures the parents that there is nobody who, by virtue of their ownership interest in the organization, has an incentive to minimize the quality of care in order to increase the organization’s profitability. And the mutual rather than the entrepreneurial form for the nonprofit has presumably been chosen, in part, to provide the parents with even further assurance in this regard by giving them the authority to exercise ultimate control over the organization.¹⁹² Again, as in

¹⁹¹ Labor unions and business leagues, if organized as nonprofits, are exempt from federal income taxation. I.R.C. § 501(c)(5), (6). In Bittker & Rahdert, *The Exemption of Nonprofit Organizations from Federal Income Taxation*, 85 YALE L.J. 299, 353-57 (1976), it is suggested that this is inappropriate, because such organizations do not adhere to the statutory provisions requiring, as a condition of exemption, that the net earnings of an organization not inure to the benefit of private persons such as members. Bittker and Rahdert’s reasoning follows the same lines sketched above: because the purpose of such organizations is to assist their members in increasing the profitability of their income-producing activities, the income of these organizations is clearly being used in ways that inure to the benefit of their members.

A more consistent and appropriate view of the non-inurement rule of section 501(c), and the view that has generally been taken by the Internal Revenue Service, see text accompanying notes 330-44 *infra*, is to consider that rule as roughly equivalent to the nondistribution constraint as interpreted in this Article. Thus, labor unions and business leagues should not be denied exemption on the grounds that they are really profit-seeking ventures in violation of the non-inurement rule, just as their activities should not generally be considered in violation of the nondistribution constraint. There might, however, be other reasons for denying tax exemption to organizations of this type: for example, their benefits might not flow to a sufficiently large segment of the public (which may be the thought that actually motivates Bittker and Rahdert’s objections), or, because their close relationship with their membership gives them a ready source of capital, they might not suffer from the capital constraints that appear to offer the strongest justification for corporate income tax exemption for nonprofits. See *Exempted Nonprofit Organizations*, *supra* note 93.

¹⁹² In many cases, patron control over an organization is itself sufficient to protect the patron’s essential interests, and the additional fiduciary constraints of the nonprofit form are therefore unnecessary. In such cases, the cooperative form may be just as convenient and somewhat more flexible than the nonprofit form. See

the preceding example of the trade association, the use of the non-profit form serves to abuse or deceive no one. On the contrary, refusing to permit such organizations to incorporate as nonprofits would simply increase the chances that somebody—in particular, the patrons of the organization—would be exploited.

On the other hand, there are certainly circumstances in which the provision of services that benefit controlling individuals could constitute a violation of the nondistribution constraint, and therefore subvert the nonprofit form. An obvious example would be the case of a director of a nonprofit nursing home who used a substantial fraction of the organization's income to provide himself or herself with extensive personal services such as luxurious free housing, travel, automobiles, club memberships, and so forth, in addition to an already perfectly adequate salary. Nor need the illicit services be something other than the services that the organization was formed to provide. Our nursing home operator, for instance, would presumably be just as much in violation of the nondistribution constraint if, instead of using the organization's income to obtain such unrelated services as personal travel, he or she used it to provide expensive free care at the home for some aging members of his or her family, again in addition to an already adequate salary.

Much the same result can arise when the services are provided to members rather than to officers or directors. For example, suppose that a membership-controlled health maintenance organization were to allow nonmember patrons to use its services, and that admission to membership were not a matter of right for all of the organization's patrons but rather required the acquiescence of the existing members. Suppose further that the organization were to either (1) charge lower fees for members than for nonmembers for the same services, or (2) charge both members and nonmembers the same annual fee, but arrange for superior service for those patrons who are also members. In such a case, the organization would effectively be providing services to nonmembers at a price in excess of cost, and using the profit thus obtained to subsidize services for members. As in the preceding example, such behavior would, except in unusual circumstances to be discussed below, constitute a violation of the nondistribution constraint, and there would be

Hansmann, *supra* note 2, at 891-94; text accompanying notes 267-318 *infra*. But formal control is not always equivalent to actual control, as many shareholders in business corporations are aware, and therefore the additional constraints of the nonprofit form may be of significance to the organization's patrons. This is most obviously true for donative mutual nonprofits, such as the National Audubon Society, but it might also be true for some organizations, such as a day care center, of an essentially commercial character.

good reason to refuse nonprofit status to such an organization. For in such circumstances the organization would be failing to fulfill its fiduciary role, which is to assure all of its patrons that the payments they make are being used exclusively to provide them with health services, and in particular that those who control the organization have no incentive to provide services that are worth less than the amount the patron pays for them.

The essence of the problem, therefore, lies not in providing services that are of value to officers, directors, or members, but rather in financing such services out of profits derived from payments made by other patrons, without the knowledge and consent of those patrons. The latter qualification concerning knowledge and consent is, however, important. For example, an individual who is kindly disposed to the labor movement might make a contribution to a local union that has gone on strike, even though that individual is not a member of the union, and will receive none of the strike benefits that the union will provide to its members with the aid of the contribution. Yet, in this context, although services are being financed for members by means of payments received from nonmember patrons, there is no corruption of the nonprofit form involved. It is precisely the intent of the nonmember contributor in this case to provide services for the members. And the nonprofit form serves the salutary purpose of assuring the contributor that all of his or her contribution will be devoted to providing the intended services.¹⁹³

A more difficult case is presented by organizations that derive profits from serving one class of patrons in order to subsidize another class of patrons, but in which neither class of patrons exercises any control over the organization. Such cross-subsidization is evidently fairly common, for example, in nonprofit hospitals, in which profits derived from services provided to private-room patients and to patients with relatively routine problems may be used

¹⁹³ A related example is provided by United Way. That organization, which solicits donations from the public on behalf of a large number of charitable organizations, is controlled by the organizations to which it distributes the funds it collects. In formal terms, United Way clearly violates the nondistribution constraint, for it distributes virtually all of its net earnings (that is, income in excess of its operating costs) to those who control it. If we are to consider United Way as being legitimately organized and operated as a nonprofit—which appears, on balance, to be a reasonable result—then it must be because we are willing to deviate from a literal application of the nondistribution constraint in situations in which (1) the controlling persons are themselves nonprofit corporations that adhere closely to the nondistribution constraint, and (2) the individuals who contribute to the organization are fully aware of the ultimate use being made of their donations.

to help cover the costs of teaching, research, unusually expensive forms of treatment, and services provided to indigent patients.¹⁹⁴ Yet most hospitals are entrepreneurial nonprofits in which none of the patients exercise any formal control. Is such cross-subsidization therefore inconsistent with the fiduciary role that the nonprofit form is designed to serve?

That the patrons who benefit from cross-subsidization also do not exercise control obviously makes it less troublesome than it would otherwise be. For in this situation, at least, the patrons as a whole are not being exploited. Moreover, because those who control the organization do not benefit directly from such cross-subsidization, they have less incentive to push the cross-subsidization to such an extreme that the patrons who are the source of the subsidy are actually being badly abused. For example, in the case of hospital care, it appears likely that the profits that are the source of the subsidies are derived not from cutting the quality of care provided to a class of patients while still charging them the full price, but rather from simply charging a higher price than is required to cover the cost of the (generally quite adequate) services provided to those patients.

Those who control a nonprofit might, to be sure, still receive considerable indirect benefits from such cross-subsidization. For example, doctors, who exercise substantial formal or informal control over hospital governance, may benefit in several ways from cross-subsidization among classes of patients. For instance, by taxing one class of patients whose demand is fairly inelastic to subsidize treatment for another class of patients whose demand is more elastic (perhaps because of poverty or because the services involved are quite costly in comparison to the benefits derived from them), doctors might manage to increase the overall effective demand for their services, and thus increase their incomes. Or, alternatively, doctors may choose to tax certain classes of patients in order to subsidize services that have more personal appeal to the doctors, such as research or treatment of exotic or difficult cases. Similar concerns might affect hospital administrators. For example, the prestige associated with a hospital administrator's job may increase if his or her hospital has an open heart surgery unit, and this in turn might lead the administrator to place a surcharge on the more lucrative types of treatment in order to subsidize such a unit, which otherwise might not be able to support itself.

¹⁹⁴ See Clark, *supra* note 63, at 1468-69, 1480; Harris, *Pricing Rules for Hospitals*, 10 BELL J. ECON. 224 (1979).

On the other hand, cross-subsidization may serve legitimate purposes as well. For example, it has been argued that cross-subsidization within nonprofit hospitals can be, and perhaps is, used to compensate for distortions and inequities in existing health insurance coverage.¹⁹⁵

Whatever the motivation of those who control the organization involved, such cross-subsidization is arguably more consistent with the fiduciary responsibilities of nonprofits if the patrons who are the source of the subsidy are aware of its existence and have some choice about contributing to it. For example, such choice would exist if the patrons were aware of alternative sources of the same service that did not levy a surcharge on it. Of course, in the case of hospitals, patients probably exercise little effective choice. This is because (1) they commonly delegate this decision to their doctor, (2) third-party payment schemes eliminate most of the incentive for comparative shopping based on price, and (3) as discussed above,¹⁹⁶ only proprietary hospitals are likely to offer patients the possibility of avoiding cross-subsidization, yet, perhaps in part because of legal constraints, they are relatively scarce in many areas.

In the absence of knowledge or effective choice on the part of patrons, those who control a nonprofit should bear the burden of demonstrating that a cross-subsidization scheme is in the overall best interests of patrons as a class, and, in particular, that it has not been undertaken primarily with the object of serving the self-interest of controlling persons. Absent such a showing, cross-subsidization can appropriately be considered inconsistent with the fiduciary obligations of the nonprofit form and therefore enjoined as a violation of the nondistribution constraint. Whether the cross-subsidization currently undertaken by nonprofit hospitals can pass this test remains open to dispute.¹⁹⁷

¹⁹⁵ See Harris, *supra* note 194.

¹⁹⁶ See text accompanying notes 118-42 *supra*.

¹⁹⁷ Professor Clark, after arguing that cross-subsidization in nonprofit hospitals is a serious abuse, proposes that every payor for a nonprofit hospital's services be given standing to seek an injunction against provision of services by that hospital below marginal cost. Clark, *supra* note 63, at 1481-83. Professor Clark evidently does not, however, see this proposed cause of action as being founded on the obligations imposed on hospitals by the nondistribution constraint currently embodied in the nonprofit corporation law, though the thrust of his article as a whole suggests strongly that he feels that such cross-subsidization is inconsistent with whatever fiduciary obligations hospitals may have toward their patients by virtue of their nonprofit form. Rather, Professor Clark appears to propose that his suggested cause of action be expressly created by legislative enactment. If we take the view, suggested in this Article, that cross-subsidization can constitute a violation of the nondistribution constraint, and combine it with the liberalized view of patron standing suggested in the text accompanying notes 345-83 *infra*, we can

Museum gift shops provide another interesting example in this connection. Such shops are commonly operated at a profit, and the returns thus obtained are used to help finance the museum's regular exhibits. In this context, the cross-subsidy is from those who patronize the gift shop to those who view the exhibits. Again, neither class of patrons exercises any appreciable control over the organization. Yet a strong argument exists that there is nothing improper about operating such a profit-making gift shop within the museum's nonprofit corporate entity. The reason is that those who patronize the gift shop undoubtedly know, in general, just what is going on. Moreover, most of the gift shop patrons are probably perfectly happy to be subsidizing the museum's exhibits with their purchases. And finally, there are plenty of other proprietary shops that sell items that are reasonably close substitutes for the merchandise carried by museum shops, and customers can turn to them should they not wish to serve as the source of the museum's internal subsidy.

Thus, such gift shops, like the many other nonprofit operations involving payments from patrons that are part purchase and part contribution, need not be seen as an abuse of the nonprofit corporation's fiduciary role. On the contrary, that such a shop is operated by a nonprofit provides some assurance to the customers that any profit derived from their purchases will be used to help finance the museum rather than go into somebody's pocket.¹⁹⁸

B. *Return to Capital*

The term "profit" is popularly associated with returns to invested capital. Perhaps for this reason, there has sometimes been confusion as to whether or when a nonprofit can pay a return to capital without violating the nondistribution constraint.

There is, in general, no reason why a nonprofit organization should not be permitted to pay a reasonable return on the capital

achieve something like Professor Clark's proposed remedy without need for legislation (although Professor Clark's proposal would presumably condemn a broader range of cross-subsidization practices than would the more flexible rule proposed here).

¹⁹⁸ It does not necessarily follow, however, that the advantageous tax treatment afforded to a nonprofit organization such as a museum should necessarily be extended to its gift shop operation as well. That is a separate question, and to answer it one needs to consider, *inter alia*, the reasons why special tax treatment is provided for the museum itself and the consequences that special tax status for the gift shop will have on competition between it and proprietary shops offering similar wares. Unfortunately, to explore such issues would require a major digression from the matters that are the central focus of this discussion.

that it uses, just as it may pay reasonable salaries in return for labor services and reasonable prices for supplies and equipment. Capital, like these other factors of production, is necessary to produce the organization's services, and must be paid for in the absence of sufficiently generous gifts of capital. The difficulty lies in the need to ensure that the return paid to capital is no more than is necessary to obtain it. In theory, this problem is no different from that of dealing with excessive salaries or prices paid for services and supplies. Yet, in practice, it is often the case that the only way for an unscrupulous operator of a nonprofit to tap truly substantial profits out of the organization is through devices involving capital transactions; inflated salaries and self-dealing supply contracts are often too inflexible and obvious for the purpose.¹⁹⁹ Consequently, restrictions on the permissible returns to capital deserve special attention.

In considering returns to capital, two considerations are of particular importance: first, whether the contributor of capital is a controlling person; and second, whether the rate of return to be paid is variable.

In general, capital contributions by noncontrolling individuals present few problems. Such arrangements usually involve a fixed interest rate, as in the case, for example, of a loan from a commercial bank or a bond issue sold to the public. Also possible are variable-return arrangements in which the organization sells a security, somewhat analogous to nonvoting preferred stock, that entitles its holder to a stated maximum interest rate payable only if the organization's finances permit, and that may or may not provide for accumulation of missed payments. Both New York and Pennsylvania law now provide explicitly for such financing, which the statutes refer to as "subventions."²⁰⁰

The terms of such arrangements presumably need not be carefully regulated, because the managers of a nonprofit have no strong incentive to agree to an interest rate that exceeds what is necessary to attract the needed amount of capital. To be sure, because the managers of a nonprofit have no direct financial stake in the residual earnings of the enterprise, they may be willing to agree to a more

¹⁹⁹ This is not to say, however, that these latter devices cannot occasionally be terribly lucrative. For some examples of the many ways to loot a nonprofit, through capital transactions and otherwise, see M. MENDELSON, *supra* note 153, at 195-212. See also text accompanying notes 209-66 *infra*.

²⁰⁰ N.Y. NOT-FOR-PROFIT CORP. LAW § 504 (McKinney 1970); 15 PA. CONS. STAT. ANN. § 7542 (Purdon Supp. 1979). Unfortunately, as discussed below, these states do not limit subventions to noncontrolling persons. See text accompanying note 208 *infra*.

generous interest rate on borrowed money than necessary, simply to avoid the personal effort involved in seeking out a better deal. But this is a problem of managerial incentives that may be endemic to the nonprofit form, and will affect not just loans, but all of a nonprofit's operations; when one eliminates the profit motive, one must sacrifice the benefits as well as the evils that accompany it.²⁰¹

In theory, one could also imagine a nonprofit selling to a noncontrolling person a variable-return security with no interest ceiling or, what is the same thing, with an interest ceiling so high that the organization's expected earnings would never be sufficiently large to reach it. Such an arrangement would essentially involve a pledge to the securityholders, in return for a contribution of capital, of all of the organization's future net earnings. The securities would therefore have the character of nonvoting common stock. Again, the managers of the corporation would have no incentive to agree to unfavorable terms for the organization in such a security issue; thus, presumably they could be trusted to sell such securities only for the maximum amount that the market would bear.

Yet it is extraordinarily unlikely that such securities would ever be purchased by rational investors. There would obviously be no incentive for the managers of a nonprofit to operate the organization in a manner that would yield any net earnings with which to pay dividends on such securities, because neither the managers nor the organization could benefit by doing so. Rather, the managers would have every incentive to cut prices and raise costs and quality, maximizing the prestige, size, and stability of the organization at the expense of the investors.²⁰² Indeed, if such securities were to be encountered one would naturally be suspicious, particularly about the possibility that the securityholders in fact have some influence on the organization's management.

As it is, state law is generally in conformity with these conclusions regarding money loaned to a nonprofit by noncontrolling persons. The corporation statutes commonly give the organization explicit authority to borrow money and to sell bonds, and leave the

²⁰¹ See Hansmann, *supra* note 2, at 877-79.

²⁰² To be sure, it has been frequently argued, at least since the publication of A. BERLE & G. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932), that common shares in many large publicly held business corporations have the qualities described in this context—namely, a claim to residual earnings, but no effective participation in control. Yet, as others have noted, the management of even large corporations continues to be disciplined, at least to some extent, by the threat that some individual or company will acquire enough of the corporation's stock on the market to take it over and oust the management if they pay too low a return on the securities. See, e.g., Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965).

negotiation of the interest rates on these obligations to the discretion of management.²⁰³ And, of the two states that expressly authorize subventions, one places no limit on the interest that can be paid,²⁰⁴ though the other establishes a ceiling tied to the state's usury rate.²⁰⁵

More difficult problems are presented by capital contributions from controlling persons. A variable-return security without an interest ceiling is, of course, out of the question in this context; it would effectively turn the organization into a proprietary firm, giving the controlling person involved both the means and the incentive to distribute net earnings to himself. Not surprisingly, the existing statutes generally proscribe such an arrangement more or less clearly, at least so far as distributions of current earnings are concerned,²⁰⁶ as opposed to the distributions on dissolution discussed below.²⁰⁷ The subventions provided for in New York and Pennsylvania, however, which essentially have the qualities of variable-return securities, are not confined to noncontrolling persons; indeed, the statutes in both states explicitly provide that such subventions may be held by members of the corporation.²⁰⁸ Because the New York statute places a low ceiling on the maximum interest that can be provided for in a subvention, there appears to be no real chance that in a New York nonprofit corporation the non-distribution constraint will be breached by converting this instrument into the effective equivalent of voting common stock. The

²⁰³ E.g., CAL. CORP. CODE § 5140(i) (West Supp. 1980); N.Y. NOT-FOR-PROFIT CORP. LAW §§ 202(a)(9), 506 (McKinney 1970 & Supp. 1979); MODEL ACT, *supra* note 19, § 5(h).

²⁰⁴ 15 PA. CONS. STAT. ANN. § 7542 (Purdon Supp. 1979).

²⁰⁵ N.Y. NOT-FOR-PROFIT CORP. LAW § 504(d) (McKinney 1970). As suggested below, such a ceiling might be appropriate given that such subventions are not limited in New York (or in Pennsylvania) to noncontrolling persons. See text following note 208 *infra*.

²⁰⁶ For example, § 26 of the Model Act provides that:

A corporation shall not have or issue shares of stock. No dividend shall be paid and no part of the income or profit of a corporation shall be distributed to its members, directors or officers. A corporation may pay compensation in a reasonable amount to its members, directors, or officers for services rendered, may confer benefits upon its members in conformity with its purposes, and upon dissolution or final liquidation may make distributions to its members as permitted by this Act, and no such payment, benefit or distribution shall be deemed to be a dividend or a distribution of income or profit.

MODEL ACT, *supra* note 19, § 26. See also N.Y. NOT-FOR-PROFIT CORP. LAW § 501 (McKinney 1970).

²⁰⁷ See text accompanying notes 241-66 *infra*.

²⁰⁸ N.Y. NOT-FOR-PROFIT CORP. LAW § 504(a) (McKinney 1970); 15 PA. CONS. STAT. ANN. § 7542(a) (Purdon Supp. 1979).

same cannot be said for Pennsylvania, however, which imposes no limit at all on the maximum rate of return on subventions.

Money contributed to a nonprofit by a controlling person at a fixed interest rate offers less opportunity for abuse. Once the interest rate has been set, it makes little difference whether the right to that interest is held by a controlling or a noncontrolling person; both have the right and the means to see that the stated interest, but nothing more than the stated interest, is paid. The problem, obviously, is in setting the interest rate. Because the controlling person is on both sides of the deal, he has the incentive to use his control to establish a more generous interest rate than he would otherwise insist upon as a lender, and thereby tap pure profits from the corporation.

The issues presented by such self-interested capital transactions are much the same as those presented by self-dealing transactions in general, including such transactions as purchases made by a nonprofit from a company in which a controlling person has an interest, or loans made by a nonprofit to members of a controlling person's family. In fact, current law generally does not distinguish among such transactions. Consequently, the following discussion will focus on problems of self-dealing in general.

C. Self-Dealing and Conflicts of Interest

In the law of business corporations, the modern rule is that a transaction between a corporation and one of its directors or officers, or between a corporation and another organization in which one of its directors or officers has an interest, is neither void nor voidable if either (1) the conflict of interest is disclosed to the other members of the board of directors and the transaction is approved by a majority of the disinterested directors; (2) the conflict of interest is disclosed to the shareholders and the transaction is approved by a majority of the disinterested shareholders, or (3) the transaction is "fair" to the corporation.²⁰⁹ The same standard has now been adopted in many jurisdictions, either in the statutory or the decisional law, to apply to nonprofit corporations, the only difference being that in the case of nonprofits, ratification of self-dealing by shareholders is replaced with ratification by members.²¹⁰

²⁰⁹ *E.g.*, DEL. CODE ANN. tit. 8, § 144 (1975); ABA-ALI MODEL BUS. CORP. ACT § 41 (1974). See Marsh, *Are Directors Trustees? Conflict of Interest and Corporate Morality*, 22 BUS. LAW. 35 (1966).

²¹⁰ *E.g.*, Stern v. Lucy Webb Hayes Nat'l Training School for Deaconesses and Missionaries, 381 F. Supp. 1003 (D.D.C. 1974); N.Y. NOT-FOR-PROFIT CORP. LAW § 175 (McKinney 1970).

1. The Differing Needs of Nonprofit and Business Corporations

Whatever may be the case with respect to business corporations,²¹¹ this standard of conduct is too weak for nonprofits. In a business corporation, the fiduciary obligations imposed on the organization's directors, officers, and controlling shareholders are designed to protect noncontrolling shareholders. In a nonprofit, on the other hand, the fiduciary obligations imposed on controlling persons are for the benefit of the organization's patrons—that is, its donors and customers. And the patrons of a nonprofit are generally much less able to look out for themselves than are the shareholders in a business corporation.

To begin with, shareholders have the ability to exercise direct control over their corporation in general, and over its directors in particular, through their voting power. Beyond this, they have available the device of the derivative suit to force corporate managers to account for their malfeasance. And, to make both of these mechanisms more effective, shareholders also have the benefit of the extensive disclosure requirements that have been imposed on business corporations. The patrons of a nonprofit, in contrast, often have no voting power at all. Moreover, as discussed below,²¹² patrons of nonprofits generally lack standing to sue the corporation's directors and officers for breach of their fiduciary duties; rather, the authority to bring such suits is given exclusively to state officials, who seldom make much effort to use it. And finally, nonprofits are seldom obliged to disclose substantial information about their financial affairs, either to patrons or to the state officials nominally responsible for overseeing the organizations.²¹³ Indeed, the Internal Revenue Service has generally been the only effective mechanism for sanctioning self-dealing by the managers of nonprofits, and even that agency has, at least until recently, made only limited efforts in this direction, evidently in part because the sanctions available to it have not been well suited to the task.²¹⁴

Such weakness in the mechanisms available for policing the managers of nonprofits, and especially in the mechanisms directly available to patrons, argues for a stronger, clearer rule of fiduciary conduct for the managers of nonprofit corporations than for the

²¹¹ See Marsh, *supra* note 209, for a suggestion that this standard is too weak even for business corporations.

²¹² See text accompanying notes 319-84 *infra*.

²¹³ See text accompanying notes 385-406 *infra*.

²¹⁴ See text accompanying notes 330-44 *infra*.

managers of business corporations. For if the managers of nonprofits are subject to only minimal oversight, then it is important that they be held to a rule of conduct that both leaves them with few opportunities to indulge their self-interest and is easily policed.

2. A Stricter Rule for Nonprofits

An attractive alternative to the currently prevailing doctrine would be a flat prohibition against all self-dealing transactions involving controlling persons in nonprofit organizations. Such a rule would simply forbid any transaction between a nonprofit organization and any controlling person, or any other organization in which such a person has a financial interest, subject only to necessary exceptions for such things as reasonable salaries and expenses, and the purchase of services from the organization on the same terms as are available to all others with whom it deals.²¹⁵ This is, in essence, the rule that is applied in the law of trusts,²¹⁶ including charitable trusts.²¹⁷ Lest this be thought too restrictive for organizations that are more complex in their structure and activities than is a simple trust, it should be noted that such a flat prohibition on self-dealing was the universal rule in this country even for business corporations until the turn of the century,²¹⁸ and evidently remains the norm for business corporations under British law.²¹⁹ Moreover, under the Tax Reform Act of 1969, a detailed, clear, and workable set of rules along these lines has been promulgated by the Internal Revenue Service and applied to all nonprofits designated as private foundations,²²⁰ a class primarily comprised of those donative nonprofits

²¹⁵ Rules for transactions between the organization and its members, if any, would presumably need to be carefully spelled out. The principles involved are discussed in the text accompanying notes 176-98 *supra* and the text accompanying notes 213-56 *infra*.

²¹⁶ Any transaction between the trust and trustee involving trust property, unless consented to by the beneficiaries, is voidable no matter how reasonable and fair. See 2 A. SCOTT, *THE LAW OF TRUSTS* § 170 (3d ed. 1967 & Supp. 1980) [hereinafter cited as SCOTT ON TRUSTS]. This prohibition extends to dealings between the trust and a third party with whom the trustee has some substantial relationship. See *id.* §§ 170.6, 170.10. Cf. Employee Retirement Income Security Act of 1974 (ERISA), § 404(a)(1), 29 U.S.C. § 1104(a)(1) (1976) (duty of loyalty under ERISA); *id.*, § 406(a)(1), 29 U.S.C. § 1106(a)(1) (1976) (ERISA prohibited-transaction rules).

²¹⁷ See M. FREMONT-SMITH, *FOUNDATIONS AND GOVERNMENT* 136 (1965). That a charitable trust has no beneficiaries able to ratify an otherwise voidable transaction necessarily makes this prohibition against self-dealing absolute. See also note 216 *supra*.

²¹⁸ See Marsh, *supra* note 209, at 36-39.

²¹⁹ E. IVAMY, *TOPHAM AND IVAMY'S COMPANY LAW* 221 (15th ed. 1974).

²²⁰ See I.R.C. § 4941; Treas. Reg. § 53.4941 (1973); notes 330-37 *infra* & accompanying text.

that derive the bulk of their income from a small number of (often controlling) donors. Indeed, under the prompting of regulations adopted by the IRS,²²¹ most states have now incorporated into their nonprofit corporation statutes the same prohibitions against self-dealing for private foundations that appear in the 1969 Act.²²² All that remains to be done is to extend these prohibitions to all other nonprofits as well.

Such a straightforward prohibition of self-dealing could have an enormously salutary effect. At present, much of the questionable activity in the nonprofit sector appears to involve fairly overt forms of self-dealing. An instructive example is provided by a nursing home facility that was constructed in New York by a proprietary real estate firm solely owned by a doctor and his wife. The same couple formed a nonprofit nursing home corporation, establishing themselves as members of the board and also as its salaried administrators, and arranged for this nonprofit organization to lease the facility from the couple's real estate company on extremely lucrative terms.²²³ This arrangement, not unexpectedly, created precisely the kind of unfortunate trade-off between profits and patient care that the nonprofit form is presumably designed to avoid. Although the rental payments per bed in the home were sixty percent higher than the maximum rent agreed on for Medicaid reimbursement purposes by the state health department and the nursing home association, the state health department found dietary expenditures and nursing services to be substantially underbudgeted.²²⁴

At present, such an arrangement is not clearly illegal. To attack the deal under current New York nonprofit corporation law would require a suit by the state attorney general²²⁵ seeking to challenge the lease terms as "unfair" to the corporation. If the lease had been approved by a majority of the nursing home's "dis-

²²¹ I.R.C. § 508(e) provides that a private foundation shall not be exempt from taxation unless its governing instrument includes provisions prohibiting the foundation from engaging in self-dealing as defined in I.R.C. § 4941. Treas. Reg. § 1.508-3(d) (1972) provides that this requirement shall be deemed to have been met if provisions of state law have been enacted which either prohibit such self-dealing directly or treat such restrictions as being contained in the governing instruments of private foundations.

²²² *E.g.*, N.Y. NOT-FOR-PROFIT CORP. LAW § 406 (McKinney Supp. 1979). See H. OLECK, *supra* note 1, at 632-34.

²²³ M. MENDELSON, *supra* note 153, at 203-07.

²²⁴ *Id.*

²²⁵ See N.Y. NOT-FOR-PROFIT CORP. LAW § 112 (McKinney 1970 & Supp. 1979). Generally, private persons have no standing to sue a nonprofit corporation. See note 340 *infra* & accompanying text.

interested" directors,²²⁶ the courts would place the burden of proving unfairness on the state.²²⁷ And given the deference which the courts accord the "business judgment" of the directors,²²⁸ such a suit would be nearly impossible to win.²²⁹ Even if the state were to obtain a ruling that the lease terms were excessive, the remedy might well be simply a judicially mandated lowering of the rental payments to some more customary but still profitable level, and a recapture by the corporation of the "excessive" profits realized by the realty firm.²³⁰ At worst, the individuals involved in the self-dealing would have to settle for a reasonable return on their transaction. Thus, such suits can not be expected to be an effective remedy for self-dealing, nor the threat of them to be much of a deterrent.

In contrast, a simple prohibition against all self-dealing, such as that presently applied to private foundations, would unambiguously forbid transactions of this type altogether.

It might be thought that such a strict prohibition on self-dealing could have the undesirable effect of preventing nonprofits from entering into a variety of transactions that clearly would be to their advantage, and that the present weaker standard is therefore to be preferred. For example, suppose that a nonprofit day care center finds itself badly in need of furnishings on credit. A member of its board of directors happens to own a controlling interest in a local firm that deals in such furnishings. After the center has unsuccessfully sought credit from other suppliers, the director uses his or her influence at his or her firm to obtain the furnishings there, under credit terms that are quite favorable to the day care center. In making this deal the firm and its director are motivated in part by a sense of charity, heightened by their intimate involvement with the affairs of the center, and in part by their conclusion, also derived from involvement with the center, that the center in fact is

²²⁶ Interested directors may be present at the meeting during which the transaction is ratified, *see* N.Y. NOT-FOR-PROFIT LAW § 715(c) (McKinney 1970), and can therefore bring their influence to bear on the disinterested directors.

²²⁷ *See id.* § 715. *Cf.* *Cohen v. Ayers*, 596 F.2d 733, 739-41 (7th Cir. 1979) (interpreting a virtually identical provision in the New York business corporation statute).

²²⁸ *Cf.* *Cohen v. Ayers*, 596 F.2d at 739-40 (discussing the "business judgment" rule in the context of for-profit corporation law).

²²⁹ *Cf.* Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663, 670-84 (1974) (discussing the application of the business judgment rule as formulated by the Delaware courts).

²³⁰ *Cf.* *Mann v. Luke*, 44 N.Y.S.2d 202, *aff'd*, 272 A.D. 19, 68 N.Y.S.2d 313 (1947) (under New York for-profit corporation law, a faithless director must return unfair profits extracted from his corporation).

a solid organization involving less risk than the other merchants in town might have feared. Such a scenario is by no means implausible, and may occur quite commonly. Why adopt a rule that might prohibit such transactions?²³¹

It would appear, however, that most benign transactions of this type could easily be restructured so that they involve no conflict of interest whatever. In the example just described, for instance, the director's firm could, instead of providing the furnishings and credit itself, simply offer to guarantee the center's repayment of credit extended by another merchant, without seeking any reimbursement for the guarantee. Such a guarantee would, in effect, be a simple gift to the center, and therefore would not violate even the strictest of rules proscribing conflicts of interest and self-dealing.²³²

To be sure, some flexibility in the application of such a strict rule would undoubtedly be appropriate. Most importantly, it would probably be best to apply such a rule in its strictest form only prospectively, either by grandfathering transactions entered into prior to the adoption of the rule, or more restrictively, by requiring the explicit sanction of a court of equity for the continuation, after the adoption of the rule, of self-dealing arrangements entered into before the adoption of the rule. It might even be appropriate to provide some latitude in the prospective application of the rule by allowing self-dealing transactions to be entered into if the interested parties can obtain prior consent from a court of equity by showing that prohibition of the transaction would result in substantial disbenefit to the organization's patrons as a whole.

Should the strict rule on self-dealing proposed here prove infeasible, either practically or politically, then at the very least some intermediate rule, stronger than the rule generally imposed on business corporations, should be imposed on nonprofits. One possibility along these lines is the rule embodied in the new California statute applicable to public benefit nonprofits, which provides that a transaction involving self-dealing or a conflict of interest is valid only if the person asserting the validity of the transaction proves that:

²³¹ If the nonprofit involved were a private foundation under the Internal Revenue Code (as a day care center generally would not be), a transaction like this would presumably be in violation of the Code's rules concerning self-dealing if the director in question owned more than a 35% interest in the firm with which the center contracted. See I.R.C. §§ 4941, 4946(a)(1)(B), (F).

²³² See, e.g., I.R.C. § 4941(d)(2)(B), (C) (specifically excluding gifts from the strict prohibition against self-dealing imposed on private foundations).

(A) The corporation entered into the transaction for its own benefit;

(B) The transaction was fair and reasonable as to the corporation at the time the corporation entered into the transaction;

(C) Prior to consummating the transaction or any part thereof the board authorized or approved the transaction in good faith by a vote of a majority of the directors then in office without counting the vote of the interested director or directors, and with knowledge of the material facts concerning the transaction and the director's interest in the transaction. . . . ; and

(D) Prior to authorizing or approving the transaction the board considered and in good faith determined after reasonable investigation under the circumstances that the corporation could not have obtained a more advantageous arrangement with reasonable effort under the circumstances or the corporation in fact could not have obtained a more advantageous arrangement with reasonable effort under the circumstances.²³³

This rule is superior to the rule currently in force in the majority of jurisdictions because, first, the burden of persuasion regarding the fairness of the transaction remains with the party accused of self-dealing, and second, the party attacking the transaction may prevail merely by demonstrating the existence of a more advantageous alternative of which the directors should have been aware.²³⁴ Nonetheless, the difficulty of determining whether a transaction was "fair" or whether an available alternative was more or less "advantageous" militates in favor of the simpler rule of flat prohibition.²³⁵

3. Different Standards for Different Types of Nonprofits

In general, neither the courts nor the statutes distinguish among different types of nonprofit corporations in establishing rules

²³³ CAL. CORP. CODE § 5233(d)(2) (West Supp. 1980).

²³⁴ *Id.*

²³⁵ The rule, found both in trust law, *see* 2 SCOTT ON TRUSTS, *supra* note 216, at § 170.9, and in British corporation law, *see* E. IVAMY, *supra* note 219, at 222, that the strict prohibition against self-dealing can be avoided by express provisions in the entity's governing instrument, would of course be improper for nonprofits, because the individual patrons for whose protection the rule is designed would not in most cases be parties to the adoption of the governing instrument.

of conduct for corporate managers; the same rule is applied to all, including charitable organizations, and, as already noted,²³⁶ it is essentially the same rule that is applied to business corporations.²³⁷ The new California act, however, establishes different standards for managers of mutual benefit nonprofits than for managers of public benefit nonprofits. In particular, whereas public benefit nonprofits are governed by the relatively strict standard quoted above,²³⁸ the managers of mutual benefit nonprofits are governed by a lower standard²³⁹ roughly equivalent to that which is generally applied to business corporations.

This is, as we shall see, only one of the ways in which California, and some other jurisdictions as well, apply different standards to different categories of nonprofits. The rationale for such varying standards, and the problems that they create, will be treated at length below.²⁴⁰

D. *Distribution of Assets on Dissolution*

The nonprofit corporation statutes commonly place few or no limits on the distribution of a corporation's assets in dissolution.²⁴¹ More particularly, in many circumstances, the statutes explicitly recognize the right to have the organization's assets distributed to members. Further, where such authority exists, it is generally unlimited, extending not only to those assets that were originally contributed by the members, but also to assets representing net income that the organization has accumulated.

1. The Potential for Abuse

Such authority for distribution of assets to members on dissolution creates an enormous loophole in the nondistribution constraint, for it means that, if members of a nonprofit organization wish to derive profits from its activities, they need only wait until the organization is dissolved.

To take an extreme example, under such a statute, a group of individuals could presumably form a nonprofit nursing home—or a

²³⁶ See text accompanying notes 209 & 210 *supra*.

²³⁷ See W. CARY & C. BRIGHT, *supra* note 41, at 20-27.

²³⁸ See text accompanying note 233 *supra*.

²³⁹ CAL. CORP. CODE § 7233 (West Supp. 1980).

²⁴⁰ See text accompanying notes 267-318 *infra*.

²⁴¹ For a detailed discussion of representative statutes, see the text accompanying notes 242-66 *infra*.

medical services laboratory, a family counseling service, or a day care center—with themselves as its only voting members, run the organization at a profit for several years by selling services to nonmembers at prices exceeding cost, accumulate the net earnings each year within the organization (perhaps, for the sake of subtlety, by investing in new buildings and equipment, or by paying off debt used to acquire the original buildings and equipment), and then, once a sizable surplus has been accumulated, sell the organization's assets and liquidate the corporation, distributing to themselves the cash that remains.

Moreover, this game could presumably be repeated on a regular basis with the same underlying organization by selling the corporation's assets, at the time of liquidation, to a new nonprofit corporation that is controlled by the same members, and that uses borrowed funds for the acquisition. The result would be an ongoing organization that earns profits and distributes them to the individuals in control of the organization at regular intervals, all within the nonprofit corporate form.

2. Current Statutes

Such an organization would of course be nonprofit in name only. Yet the law in many states seems to countenance precisely this result.

For example, the Model Act places no meaningful restrictions on distributions in dissolution whatever, beyond the ambiguous requirement that assets "held by the corporation subject to limitations permitting their use only for charitable . . . or similar purposes" must be transferred to other organizations "engaged in activities substantially similar to those of the dissolving corporation."²⁴² It is difficult to determine how broad this restriction is intended to be. The most natural reading would confine its application to assets acquired by the corporation subject to explicit donor-imposed limitations on the purposes for which the corporation can use the assets, as in the case of a capital gift to an educational institution that the donor specifies is to be used only for the purpose of endowing a chair of Oriental studies in perpetuity.²⁴³ A somewhat

²⁴² MODEL ACT, *supra* note 19, § 46(c).

²⁴³ A requirement of this nature would probably be imposed by the courts in most states even in the absence of such statutory language. The courts have generally held, often on the basis of vague trust or contract theories, that assets given to a "charitable" nonprofit corporation are subject to donor-imposed restrictions permitting their use for only certain charitable purposes by the corporation. See W. CARY & C. BRICHT, *supra* note 53, at 14-17, 78. Presumably,

broader reading would extend the restriction to assets acquired by the corporation by virtue of donations to the organization—such as simple contributions by members of the public to the March of Dimes—which, while not accompanied by explicit donor-imposed restrictions, presumably were made by the donors with the intention that the donations would be devoted in their entirety to charitable “or similar”²⁴⁴ purposes. Finally, the restriction might be read more broadly yet to apply to all assets held by a nonprofit corporation organized for charitable or similar purposes, however acquired (including assets purchased with the use of net earnings derived from services provided by the organization); such a reading might be supported by the theory that any organization that holds itself out as serving charitable purposes is impressed with a constructive trust, and therefore holds its assets “subject to limitations.”

In any case, the Model Act makes it clear that, except for the foregoing restriction, a nonprofit corporation may provide freely for the distribution of its assets, on dissolution, to its members, or among classes of its members, or, for that matter, to anyone, as specified in its articles of incorporation²⁴⁵ or plan of dissolution.²⁴⁶ Lest there be any doubt that the license established by this provision in the Act is intended to extend to accumulation and distribution schemes of the type described in the nursing home example above,²⁴⁷ the authors of the Act state in the preface that, under the Act,

a corporation may be organized to help its members make profits or to make profits itself through earnings or capital

this means that the restrictions on the use of such assets continue to be binding on the corporation even in dissolution. Thus, these assets must be disposed of consistently with the implied restrictions, such as by turning them over to another organization serving similar purposes. In particular, the assets cannot simply be distributed to controlling individuals such as members of the dissolving corporation.

²⁴⁴ One can, of course, only speculate as to the intended meaning of the “or similar” category of purposes.

²⁴⁵ See MODEL ACT, *supra* note 19, § 46(d).

²⁴⁶ *Id.* § 46(e).

²⁴⁷ See section IV(D)(1) *supra*. It is possible that the nursing home in our example would be classified as a “charitable” organization by the courts, *see* Rev. Rul. 72-124, 1972-1 C.B. 145 (exempting nursing homes from federal taxation as “charitable” organizations even if they are operated as commercial entities rather than nonprofits, so long as certain conditions are met), and therefore would be subject to the vague restrictions that the Model Act imposes on distributions of assets held subject to limitations for charitable purposes. If, on the other hand, the organization were, say, a family counseling service or a medical services laboratory, such a categorization is less likely. Moreover, if the profit motive of the managers of the nursing home in the example were made known, it is unlikely that the courts would deem the organization charitable (on the basis that the motivation of those who operate it is obviously not charitable), and therefore, paradoxically, the organization, under the Model Act, would be freed of limitations on distributions.

gains for eventual distribution to its members in liquidation, subject of course to any charitable restriction. But the Act does not contemplate . . . a corporation to make profits for current distribution to its members.²⁴⁸

In other words, if you wish to form a for-profit corporation under the Model Nonprofit Corporation Act you are free to do so; you need only be a bit patient about taking your profits home.

Most states have taken an approach to terminating distributions similar to that found in the Model Act (indeed, many states have adopted the Model Act provision verbatim).²⁴⁹ Thus, the right of a nonprofit to distribute its assets on dissolution to whomever it pleases, and, in particular, to its members, is generally recognized, subject only to an exception, of greater or lesser breadth and clarity, for organizations of a charitable nature.²⁵⁰

The New York statute follows this general pattern. It provides, with an ambiguity quite similar to that found in the Model Act,²⁵¹ that "[a]ssets received and held by the corporation for a purpose specified as Type B"²⁵² must be distributed to other organizations "engaged in activities substantially similar to those of the dissolved corporation";²⁵³ otherwise, assets may be distributed in dissolution as the corporation chooses, and, in particular, may be divided up in any way among the organization's members.²⁵⁴ Thus, organizations of types A and C, and perhaps to some extent organizations of type B as well, are free to do with their assets as they wish.²⁵⁵ To this slight distinction among organizations concerning the authority to distribute, there is added, under the New York statute, a distinction concerning procedure: type B and C nonprofits

²⁴⁸ MODEL ACT, *supra* note 19, at ix.

The draftsmen do maintain, however, that such a profit-making plan would be permissible only under the alternative purposes clause of the Act. *Id.* See text accompanying notes 71-84 *supra*.

²⁴⁹ See, e.g., ALA. CODE § 10-3-161 (1975); GA. CODE ANN. § 22-3103 (1977); MINN. STAT. ANN. § 317.57 (West 1969); OR. REV. STAT. § 61.530 (1979); WASH. REV. CODE ANN. § 24.03.225 (1969).

²⁵⁰ See text accompanying notes 242-44 *supra*.

²⁵¹ See note 255 *infra*.

²⁵² See text accompanying notes 86-101 *supra*.

²⁵³ N.Y. NOT-FOR-PROFIT CORP. LAW § 1005(3)(A) (McKinney 1970).

²⁵⁴ *Id.* § 1005(3)(B).

²⁵⁵ The commentary to the New York statute does not clarify what is meant by assets "held . . . for a purpose specified as Type B." Presumably this phrase is subject to much the same range of interpretations suggested above, see text accompanying notes 243-46 *supra*, for the similar Model Act provision. In particular, it may or may not be intended to extend to all assets held by type B nonprofits.

must secure the approval of a judge for their plan of distribution, while type A nonprofits generally need not.²⁵⁶

The new California act, like the New York statute, uses its statutory categorization of nonprofit types to apply and refine the dual approach to terminating distributions found in other states, explicitly extending to all mutual nonprofits the authority to make distributions to members, while clearly denying to public benefit nonprofits the authority to make distributions to any controlling person.²⁵⁷

The license provided by the statutes in this respect is further enhanced by their loose use of the term "member." The New York statute and the Model Act, for example, offer no meaningful definition of "member" at all, but instead provide that a corporation's articles or bylaws may designate anybody or nobody as members, or may designate different classes of members, and may freely specify the rights, if any, of the corporation's members or classes of members.²⁵⁸ The California act is a bit more carefully drawn in this regard, defining a member, essentially, as anyone entitled to vote in elections either for the corporation's board of directors or for certain fundamental corporate changes.²⁵⁹ Nevertheless, nothing in the California statute stands in the way of the nursing home scheme described above,²⁶⁰ because voting rights, and therefore membership, can be granted to anyone that the incorporators designate.²⁶¹

3. The Source of the Problem

A full analysis of the considerations that have led most states to provide that nonprofit corporations, or some large subset of them,

²⁵⁶ N.Y. NOT-FOR-PROFIT CORP. LAW § 1003(b)(2) (McKinney Supp. 1979). Even a type A or D nonprofit, however, will require judicial approval for its plan of dissolution if it "holds assets . . . legally required to be used for a particular purpose." *Id.*

²⁵⁷ The manner in which the California statute accomplishes this is somewhat oblique. In the definitional section of the statute, distribution is defined to include "distribution of any gains, profits or dividends to any member." CAL. CORP. CODE § 5049 (West Supp. 1980) (emphasis added). The part of the statute dealing with public benefit nonprofits mandates that "[n]o corporation shall make any distribution," *id.* § 5410, but the corresponding provision in the mutual nonprofits section is not so absolute: "no corporation shall make any distribution except upon dissolution." *Id.* § 7411(a). See also *id.* § 8717 (method of dissolution).

²⁵⁸ N.Y. NOT-FOR-PROFIT CORP. LAW §§ 102(9), 601 (McKinney 1970 & Supp. 1979); MODEL ACT, *supra* note 19, §§ 2(f), 11.

²⁵⁹ CAL. CORP. CODE § 5056(a) (West Supp. 1980).

²⁶⁰ See section IV(D)(1) *supra*.

²⁶¹ Moreover, the California statute provides that the corporation's bylaws may also confer some or all of the rights of members on any person who does not have voting rights. See CAL. CORP. CODE § 5056(b) (West Supp. 1980).

may distribute their assets on dissolution to controlling individuals such as members must await the discussion below of the confused efforts that the law has made to accommodate the perceived needs of commercial nonprofits and of membership organizations.²⁶² For the moment I shall anticipate that discussion with the observation that all such provisions for distribution of net earnings to controlling persons on dissolution appear misguided. So long as such authority exists, the controlling individuals involved can lawfully play accumulation and distribution games such as that in our nursing home example—which is to say that they can, and have an incentive to, operate the enterprise as a proprietary business. Such an organization is obviously unsuited to the fiduciary roles for which, as argued above, the nonprofit form has evolved, and which it should properly be designed to serve. To call such an organization “nonprofit” is to deprive that term of its essential meaning.²⁶³

4. What Constraints Should Be Imposed on Terminating Distributions?

If, on dissolution, a nonprofit with net assets is prohibited from distributing those assets to any controlling person, then it must, of course, find some other recipient for them. It remains to ask, then, whether any further restrictions should be placed on this choice.

One alternative is to leave the decision entirely to the discretion of the organization itself, as provided for in the organization's articles and bylaws, subject only to the nondistribution constraint. This is the approach taken, for example, in the provisions of the California statute applicable to public benefit nonprofits.²⁶⁴ The other obvious alternative is to apply a more restrictive rule, analogous to the *cy pres* rule in trust law,²⁶⁵ requiring that the organiza-

²⁶² See text accompanying notes 267-318 *infra*.

²⁶³ Here, as elsewhere, the Internal Revenue Code is more carefully and restrictively drawn than the state corporation statutes. For at least some types of organizations, tax exemption is available only if the organization's assets are irrevocably dedicated to an exempt purpose. This condition is deemed not to be met if either state law or the organization's articles would allow the organization's assets to be distributed to members on dissolution. See Treas. Reg. § 1.501(c)(3)-1(b)(4) (1959).

²⁶⁴ CAL. CORP. CODE § 6716(a) (West Supp. 1980). Note, however, that the only organizations that must be formed as public benefit nonprofits rather than as mutual benefit nonprofits are apparently those whose assets are, by virtue of decisional law in California that predates the new statute, impressed with a constructive trust for charitable purposes, and therefore subject to a *cy pres*-like rule that governs any effort to alter the purposes to which they are committed. See note 110 *supra* & accompanying text.

²⁶⁵ See note 269 *infra* & accompanying text.

tion's net assets on dissolution be contributed to other organizations engaged in similar activities. Both the Model Act and the New York statute take this latter approach in those cases in which they impose limitations on distributions.²⁶⁶

Both of these approaches have their redeeming virtues. When a patron gives money to a nonprofit, it is presumably with the intention that the funds will be used to finance services of the sort that the organization was formed to provide. Or, put differently, the implicit contract that a nonprofit makes with its patrons is not just that the patrons' funds will not be used for the personal profit of those who control the organization, but more particularly that those funds will be dedicated to the organization's chartered purposes. If the organization could, on dissolution, direct those funds, or assets purchased with them, to some entirely different use, that implicit contract would then be broken and the patrons' intention would be frustrated.

On the other hand, the dissolution of a nonprofit will often occur because its services are no longer in need. And in such situations, it could be a considerable waste to seek to continue expending the organization's remaining funds for the same unproductive purposes, rather than rededicating them to some different, but more useful purpose.

On balance, the less restrictive approach probably has most to recommend it, although much the same result can probably be reached as well by taking a liberal view of the "similar purpose" requirement under the narrower approach.

V. SHOULD THERE BE DIFFERENT CATEGORIES OF NONPROFITS?

As the preceding discussion suggests, the statutory and decisional law often applies different standards of conduct to different types of nonprofits. Moreover, this is a tendency that is evidently on the rise, finding its clearest embodiment in the recently enacted New York and California statutes with their explicit categorizations of nonprofits according to purposes.

A. *The Considerations Motivating Categorization*

This development, though understandable, is unfortunate. To see how it has come about, and what is at stake, it helps to con-

²⁶⁶ See text accompanying notes 242 & 253 *supra*.

sider briefly the evolution of nonprofit organizations and of the statutes that govern them.

1. Charitable Organizations

With respect to organizations having purposes of the type that traditionally have been classified as charitable, the nonprofit corporation statutes, and the judicial interpretation of those statutes, have obviously been strongly influenced by the law of charitable trusts.

Organizations with charitable purposes were commonly formed as charitable trusts before the advent of the general nonprofit corporation statutes.²⁶⁷ Trustees of charitable trusts have always been subject to a strict rule against self-dealing and conflicts of interest, as befits their status as fiduciaries.²⁶⁸ Further, the assets of a charitable trust are irrevocably dedicated to the purposes of that trust. If those purposes at some point become impracticable, the trustees may receive permission, via the doctrine of *cy pres*, to devote the assets to some other purpose of similar character; but at no point are the trustees of a charitable trust free to dissolve the trust and simply appropriate the assets for themselves.²⁶⁹

Now that organizations with charitable purposes are commonly formed as nonprofit corporations rather than as charitable trusts, the law in many states has transferred to such organizations some of the same fiduciary standards that would be applied if they were formally established as trusts. Thus, most states impose restrictions of some form on terminating distributions by nonprofit corporations organized for charitable purposes, typically providing that some or all of such assets may not be distributed to members, and often requiring further that the assets be turned over to another organization pursuing similar purposes. In particular, the recent New York and California statutes, as well as the Model Act, apply rules of this sort.²⁷⁰

In developing rules of conduct concerning self-dealing and conflicts of interest on the part of corporate managers, however, the courts and the legislatures have been less ready to apply to nonprofit corporations the standards developed for charitable trusts,

²⁶⁷ Although the nonprofit corporation statutes are the product of the nineteenth century, the law of charitable trusts was well developed by the beginning of the seventeenth century. Charities were sometimes incorporated by special legislative acts prior to the nineteenth century, but often such corporations were considered simply trustees of charitable trusts. See M. FREMONT-SMITH, *supra* note 217, at 40-43.

²⁶⁸ See text accompanying notes 215-17 *supra*.

²⁶⁹ See BOCERT ON TRUSTS, *supra* note 39, at § 399.

²⁷⁰ See text accompanying notes 242-61 *supra*.

even when the organization is dedicated to charitable purposes.²⁷¹ Still, nonprofit corporations serving charitable purposes are sometimes singled out for more rigorous regulation than other nonprofits. Most notable in this regard is the new California act, with its especially demanding standards for the managers of public benefit nonprofits.²⁷²

2. Social Clubs and Other Mutual Nonprofits

There are other types of organizations that have commonly been formed as nonprofit corporations, but that do not serve purposes falling within the traditional concept of charity, and for which relatively relaxed fiduciary standards have generally appeared appropriate. This category includes, in particular, social clubs and various similar membership organizations. Typically, these organizations would be classified as commercial mutual nonprofits; their patrons are essentially customers who purchase services for their personal consumption from the organization for a fee, and control over the organization is lodged in their patrons, who comprise the organization's voting members.

Interestingly, although these organizations commonly incorporate as nonprofits, little evidence exists that the services they provide are strong examples of contract failure. For the most part, these services, consisting of such items as food, drink, and recreational facilities, are simple and easy for the consumer to evaluate. And, because these services are consumed directly by the patron, rather than by a third party, plenty of opportunity exists for the patron to police their quality. Further, because the patrons, as members, exercise direct control over the affairs of the organization, they have an additional means of assuring that they are never exploited by the organization. Thus, organizations such as social clubs are evidently an exception to the contract failure theory of the role of nonprofits outlined in section I. Social clubs—and similar commercial mutual nonprofits such as automobile service clubs—have far more in common with consumer cooperatives than they do with traditional charities and other nonprofits that provide services in which contract failure is an obvious problem.²⁷³

²⁷¹ See, e.g., *Stern v. Lucy Webb Hayes Nat'l Training School for Deaconesses & Missionaries*, 381 F. Supp. 1003, 1013-14 (D.D.C. 1974).

²⁷² See text accompanying notes 209 & 210 and 236-40 *supra*.

²⁷³ See Hansmann, *supra* note 2, at 892-94; Hansmann, *Externalities, Exclusivity, Stratification, and Cooperation: A Theory of Associative Organizations* (1978) (Working Paper No. 807, Institution for Social and Policy Studies, Yale University) [hereinafter cited as *Externalities*].

Why do these organizations incorporate as nonprofits rather than as cooperatives? One reason is that the cooperative corporation statutes often place narrow limitations on the purposes for which cooperatives may be formed, restricting them to activities such as agriculture or housing, and making no provision for such purposes as social clubs.²⁷⁴ Further, clubs often do not have a strong need for the full financial flexibility afforded by the cooperative corporate form, such as the power to make regular cash distributions to patrons. Finally, to the extent that clubs do need greater flexibility in managing their affairs than would be appropriate for other nonprofits, such as charities, the nonprofit corporation law has generally been adjusted to meet these needs.

Just what powers are appropriate for social clubs and similar organizations? Owing to the absence of contract failure, and because the patrons, as members, have direct control over the organization's management, social clubs have little need for the high standards of fiduciary conduct that are appropriate in donative entrepreneurial nonprofits such as traditional charities. For the same reasons, and because most of the assets held by social clubs are commonly derived either from capital contributions made by their members or from accumulated earnings from transactions with members, there is good reason to grant such organizations the right to distribute their assets to their members on dissolution.

As discussed above, the statutory or decisional law in most states makes provision, in one way or another, for social clubs and other similar nonprofits to take advantage of permissive rules of precisely this sort.²⁷⁵ Indeed, such flexibility is generally granted to a far larger class of nonprofits than private membership organizations alone. The prevailing practice is to grant freely to all nonprofits that are not charitable, and perhaps as well to some that are, the right to distribute assets to members on dissolution without restriction,²⁷⁶ and to extend to all nonprofits, not only clubs, the generally low standards of fiduciary conduct for corporate managers that have been developed for business corporations.²⁷⁷

The recent California and New York statutes are somewhat more discriminating. Both statutes seek to place organizations such as social clubs in a separate category governed by a special set of standards. In the California statute, this function is served by the

²⁷⁴ *E.g.*, MO. ANN. STAT. § 357.010 (Vernon 1966); N.Y. COOP. CORP. LAW § 13 (McKinney 1951). See Hansmann, *supra* note 2, at 893.

²⁷⁵ See text accompanying notes 238 & 239 and 196-210 *supra*.

²⁷⁶ See text accompanying notes 242-49 *supra*.

²⁷⁷ See text accompanying notes 209 & 210 *supra*.

provisions for mutual benefit nonprofits, as the name suggests. The following comments regarding the statutory classification, offered by one of the authors of the California act, make clear that it was precisely with such entities as social clubs in mind that California's twofold classification for nonreligious nonprofits was created:

We [the authors of the statute] became persuaded . . . that the nonprofit world in fact did divide into two categories which likely were quite different in ways broadly relevant to rules contained in a corporations code. The two categories are charitable, or public benefit corporations, and noncharitable, or mutual benefit corporations. MasterCharge, the Berkeley Tennis Club, and the AAA are mutual benefit corporations—for the mutual benefit of their members. The members are its owners. They are entitled to its assets upon dissolution, and they ought also to be the ultimate authority during its life as to its purposes, scope of activities, or composition of its management. They reasonably may have the authority to ratify self-dealing transactions by the board of directors, just as in the business corporation, since it is only their interest which is at stake.²⁷⁸

In keeping with this conception of the role of the mutual benefit category, mutual benefit nonprofits are given explicit authority to distribute assets to members on dissolution, a power that is denied to public benefit nonprofits.²⁷⁹ Similarly, the standards applicable to self-dealing and conflicts of interest involving managers of mutual benefit nonprofits, which are delineated in the statute, are notably more lenient than those that are established for public benefit nonprofits.²⁸⁰

In the New York statute, the category of type A nonprofits was evidently created with social clubs and similar organizations in mind.²⁸¹ Of the three primary statutory types, type A is subjected to the least restrictive standards. For example, type A nonprofits, as opposed to type B nonprofits, are given permission to distribute assets to members on dissolution and, as opposed to both type B and type C nonprofits, need not seek judicial approval for a terminating distribution,²⁸² are not subject to judicial visitation and in-

²⁷⁸ Ellman, *On Developing a Law of Nonprofit Corporations*, 1979 ARIZ. ST. L.J. 153, 154. See Hone, *supra* note 72a.

²⁷⁹ See text accompanying note 257 *supra*.

²⁸⁰ See text accompanying note 210 *supra*.

²⁸¹ See text accompanying note 94 *supra*.

²⁸² See text accompanying notes 255 & 256 *supra*.

spection,²⁸³ and are free of the exercise, by the attorney general, of certain special enforcement powers.²⁸⁴

3. Commercial Entrepreneurial Nonprofits

Until recently, most nonprofit corporations could be roughly classified either, on the one hand, as charities, or, on the other hand, as membership organizations that served almost exclusively the interests of their own members. Thus, it was sufficient for the courts and for the legislatures to consider the needs of only these two broad types of organizations in developing doctrine concerning the application of the nondistribution constraint, and, in particular, concerning such matters as self-dealing on the part of corporate managers, or the distribution of assets on dissolution.

In recent years, however, there have developed substantial numbers of nonprofits, commonly of a commercial entrepreneurial type, that do not fit comfortably into either of these categories. This new class of nonprofits includes day care centers, nursing homes, performing arts groups, counseling services, contract research firms, publications, and various other kinds of service organizations.

In some cases, the legal concept of charity has been broadened to include organizations of this type. For example, nonprofit hospitals and nursing homes qualify as charities for federal income tax purposes even when they provide no subsidized care for the poor, but rather operate strictly as commercial nonprofits that provide service only to those who can pay.²⁸⁵

To the extent, however, that the newer types of commercial nonprofits have not been assimilated in the charity category, they are commonly treated with much the same leniency that is typically accorded social clubs and related membership organizations. Thus, under the California statute, such organizations are lumped together with clubs and other mutual nonprofits in the category of mutual benefit nonprofits, with its minimally restrictive standards concerning fiduciary duties and terminating distributions.²⁸⁶ Similarly, the

²⁸³ N.Y. NOT-FOR-PROFIT CORP. LAW § 814 (McKinney 1970).

²⁸⁴ *Id.* § 112(7)-112(9).

²⁸⁵ See Rev. Rul. 69-545, 1969-2 C.B. 117 (hospitals), *upheld in* Eastern Ky. Welfare Rights Organization v. Simon, 506 F.2d 1278, 1286-90 (D.C. Cir. 1974), *vacated and remanded on other grounds*, 426 U.S. 26 (1976) (concept of "charity" should be revised to reflect increasingly commercial nature of hospital care); Rev. Rul. 72-124, 1972-1 C.B. 145 (nursing homes).

²⁸⁶ Perhaps the notion of a "public" purpose will be sufficiently broadly interpreted under the California Act to permit many types of noncharitable commercial nonprofits to form as public benefit nonprofits. But because it appears that only

Model Act applies the same minimal standards to commercial nonprofits as it does to clubs and other mutual nonprofits, confining exclusively to charities its few restrictions on distributions of assets. The New York statute, in turn, is somewhat more refined in its classification, in that it actually contains a separate category, designated as type C, evidently intended precisely to include the newer forms of commercial nonprofits.²⁸⁷ Type C nonprofits are subjected to standards intermediate between those of type A and type B, being permitted, like type A, to distribute assets to members, but, like type B, requiring judicial approval for such distributions.²⁸⁸

Why has the nonprofit corporation law, and particularly the newer statutes, taken such a permissive approach to commercial nonprofits? An important reason, perhaps, is that such organizations appear in many ways similar to business firms: commercial nonprofits often provide services similar to those provided by for-profit firms; their income, as with for-profit firms, comes largely or entirely from the sale of the goods and services they produce; and frequently they operate in direct competition with for-profit firms. It may therefore have seemed to those who drafted the nonprofit corporation statutes that such commercial nonprofits should be treated somewhat as if they *are* for-profit firms, and, in particular, that they should be given some of the same license to manage their affairs that is typically provided by the business corporation statutes, rather than being held to the stricter fiduciary standards that are sometimes imposed on charities.²⁸⁹

B. *The Proper Treatment of Commercial Entrepreneurial Nonprofits*

It immediately follows from what has been said in section I concerning the role of nonprofits that it is a serious mistake to apply the nondistribution constraint less rigorously to commercial entrepreneurial nonprofits than to donative nonprofits such as

charitable organizations must form as public benefit rather than as mutual benefit nonprofits, noncharitable commercial nonprofits will presumably retain the right to form, if they wish, under the less strictly regulated mutual benefit provisions. See text accompanying notes 103-10 *supra*.

²⁸⁷ See text accompanying notes 97-101 *supra*.

²⁸⁸ See text accompanying notes 251-56 *supra*.

²⁸⁹ This is suggested, for example, by the use of the term "business purposes" in connection with the definition of type C nonprofits in the New York statute. There is also a hint of such reasoning in Leshner, *The Non-Profit Corporation—A Neglected Stepchild Comes of Age*, 22 BUS. LAW. 951 (1967), which argues that different types of nonprofits have different needs, and that the nonprofit corporation law should be shaped accordingly.

charities. Commercial nonprofits serve a fiduciary role quite analogous to that served by the more traditional donative organizations. In a nonprofit nursing home or family counseling service, just as in the case of CARE or the March of Dimes, patrons need to be able to rely on the nondistribution constraint for assurance that the organization is providing the best service possible with their funds. Thus, it is a mistake to conclude that, because commercial nonprofits in some respects look similar to their proprietary counterparts, the management of commercial nonprofits should be given some of the same license that is given to the management of business corporations. Rather, the essential role of a commercial nonprofit is precisely to provide patrons with an alternative to for-profit suppliers, and, in particular, an alternative in which the patrons are protected by higher fiduciary standards. Obviously, nonprofit firms can provide such an alternative only if they are held to a much higher standard of fiduciary conduct toward their patrons than are their proprietary counterparts.

C. The Proper Treatment of Mutual Nonprofits

In contrast to commercial entrepreneurial nonprofits, some organizations that are commonly formed as mutual nonprofits, and in particular commercial mutual nonprofits such as country clubs, do not need to be subject to the high fiduciary standards that are appropriate for entrepreneurial nonprofits. As noted above,²⁹⁰ commercial mutual nonprofits generally have much more in common with consumer cooperatives than they do with other types of nonprofits. Typically, the patron-members of such organizations are in a good position to look after their own interests, and might stand to benefit in many cases from the greater flexibility afforded by a less rigid application of the nondistribution constraint.

Current efforts to deal with such private membership organizations by creating a separate and more loosely regulated category for them within the nonprofit corporation statutes, however, constitute poor policy. A far superior approach would be to provide for the formation of such organizations under the cooperative corporation statutes, and at the same time to reform the nonprofit corporation law to provide for only a single class of nonprofit corporations that would all be held to a strictly defined nondistribution constraint. Because cooperative corporation statutes are generally designed to provide precisely the type of organizational features

²⁹⁰ See text accompanying notes 273-82 *supra*.

that are needed by social clubs and similar organizations—such as control by patron-members and the right to make distributions to members on appropriate occasions²⁹¹—this alternative approach should serve their interests well.

Such an approach has a number of other important advantages as well.

1. Avoiding the Necessity for Ambiguous Classifications

To begin with, this approach avoids all of the ambiguities that characterize the current efforts to define different categories of nonprofits that are subject to different standards.

We have already seen that the efforts, in New York and California, to develop a statutory classification of those mutual nonprofits that are to be subject to more lenient standards are awkward and ambiguous, and do a highly imperfect job of demarcating precisely those organizations for which such loosened standards are appropriate.²⁹² Some of the difficulties with these statutes arise from their attempt to define the relevant category in terms of the purposes served by the organizations in question.²⁹³ As a first approximation, such a category should be confined to strictly mutual nonprofits—that is, nonprofits that derive their assets and income almost exclusively from transactions with their voting members. Otherwise, an opportunity exists for members to take advantage of the reduced standards of fiduciary conduct to exploit nonmembers who unwittingly patronize the organization in the belief that its nonprofit status provides them with some form of protection.

Yet, even an effort to confine this permissive category to mutual nonprofits would leave it too broadly defined, because there are many mutual nonprofits for which stricter standards are appropriate. This is most obviously true of donative mutual nonprofits, such as Common Cause and the National Audubon Society. The patrons of these organizations, though voting members, have little more opportunity to police the performance of the organizations' managers than do the patrons of a donative entrepreneurial nonprofit such as CARE. Nor do such patrons have any particular need

²⁹¹ See, e.g., N.Y. COOP. CORP. LAW §§ 44 (voting), 46 (proportionate voting), 5 (dividend distributions, incorporating by reference the provision of the for-profit corporation statute governing dividend distributions), 17 (distributions at dissolution) (McKinney Supp. 1979). This is not to imply, however, that a social club could be organized as a cooperative under New York law. See *id.* § 13.

²⁹² See text accompanying notes 94-96 *supra* & notes 107-14 *supra*.

²⁹³ See *id.*

for the flexibility that a less restrictive application of the nondistribution constraint would bring; for example, a distribution of assets on dissolution to members in such an organization would serve little purpose, and would simply raise the possibility that those who were members at the time of the organization's dissolution would profit at the expense of those who had been members, and had made contributions, in earlier years.²⁹⁴

Reduced fiduciary duties to patrons are therefore appropriate, if at all, only for commercial mutual nonprofits. But even within this category there are likely to be cases in which a strict application of the nondistribution constraint is appropriate. It is questionable whether the management of a nonprofit nursing home, for example, should be permitted considerably more freedom to engage in self-dealing merely because the corporation's charter grants nominal voting control over the corporation to its enfeebled patients.

In short, although it would be relatively easy to improve on the existing statutes in defining a class of organizations for which a weakened form of the nondistribution constraint appears appropriate, it would be extremely difficult to construct a definition that would be truly workable. Much can be said, therefore, for designing the nonprofit corporation statutes in a manner that avoids the need for such classification.

2. Avoiding Confusion on the Part of Patrons

The awkwardness involved in defining the appropriate categories, however, is by no means the most serious objection to making special provision for social clubs and other such membership organizations under the nonprofit corporation statutes. Much more important is the fact that any such attempt to define different categories of nonprofits that are subject to substantially different standards of fiduciary responsibility toward their patrons must necessarily lead to confusion in the minds of patrons and potential patrons as to just what it means for an organization to be "nonprofit." Such confusion, in turn, will undermine the effectiveness of the nonprofit form in general.

For all types of organizations other than the relatively narrow class of membership organizations in question here, the essential

²⁹⁴ Compare *Lynch v. Spilman*, 67 Cal. 2d 251, 431 P.2d 636, 62 Cal. Rptr. 12 (1967), in which the Supreme Court of California evidenced its willingness to countenance the efforts of a small number of individuals, who constituted the membership of a nonprofit corporation at the time of dissolution, to distribute to themselves the organization's substantial assets, seemingly at the expense of those who had been members in previous years and perhaps even at the expense of individuals who had made contributions intended to be used for charitable purposes.

role of the nonprofit corporate form is to serve as a response to contract failure. If, for such organizations, the nonprofit form is to serve this function well, it is important not only that the organizations in question be subjected to a rigorous nondistribution constraint, but also that patrons understand that they can rely upon this. In other words, it is important that an organization be able to communicate to potential patrons, simply by informing them that it is nonprofit, that it is pledged to behave toward them with notably higher fiduciary standards than is the case with a proprietary firm.

If, however, the term "nonprofit" means different things for different organizations, then it can no longer serve this function. Both the California and New York statutes provide clear illustrations of this. Neither requires that a nonprofit corporation make known to prospective patrons the category of nonprofit to which it belongs.²⁹⁵ Consequently, a nonprofit corporation may simply hold itself out to the public, without qualification, as being "nonprofit" or "a nonprofit corporation." Imagine, for the sake of illustration, that an organization—say, a family counselling service incorporated under the California statute—does just this. What is a prospective patron of the organization—who is perhaps considering making a contribution, or becoming a client—to infer from such a declaration of nonprofit status, even in the unlikely case that he or she is familiar with the California nonprofit corporation statute? Perhaps the organization is a public benefit nonprofit corporation, and thus the managers of the organization are subject to severe constraints on their capacity to operate the organization for their own financial interest. Or perhaps the organization is merely a mutual benefit nonprofit, and the managers of the organization, without

²⁹⁵ A New York nonprofit corporation must file a certificate declaring its statutory type, N.Y. NOT-FOR-PROFIT CORP. LAW § 113 (McKinney Supp. 1979), but it need not disclose this declaration of type to its patrons or to the public.

The California act requires that a nonprofit declare in its articles of incorporation whether it is a public benefit or a mutual benefit nonprofit. CAL. CORP. CODE §§ 5130, 7130 (West Supp. 1980). There is no further requirement that a corporation give notice to the public of its statutory type, however, beyond a directive that mutual benefit nonprofits, if they choose to issue membership certificates, must state on the certificates that "[t]he corporation is a nonprofit mutual benefit corporation which may not make distribution to its members except upon dissolution, or, if the articles so provide, that it may not make distributions to its members during its life or upon dissolution." *Id.* § 7313(b)(1). Presumably the purpose of this disclosure is to prevent prospective purchasers of memberships in mutual benefit nonprofits from believing that the membership certificate carries with it the full rights of an ordinary share of stock, including the right to current distributions. Thus, in this context, disclosure is aimed at preventing the defrauding of investors rather than patrons, which again shows the strong influence of the image of the business corporation model on the drafting of this and other modern nonprofit corporation statutes.

being in obvious violation of the nonprofit corporation law, have arranged for the organization to rent its quarters at an exorbitant rate from a for-profit corporation that is owned by some of the officers, or have even begun playing the accumulation and distribution game described earlier.²⁹⁶ Knowing only that the organization is "nonprofit," the prospective patron has no way to tell.

Of course, if the organization has been formed as a public benefit nonprofit, the managers of the organization are presumably free to advertise that fact in order to inspire trust in potential patrons. But because the term "public benefit" and the category of nonprofits it denotes are unique to California, and because few nonlawyer patrons can be expected to comprehend quickly the intricacies of California's nonprofit corporation law, such an effort on the part of the corporation to distinguish itself from other legal types of California nonprofits appears unlikely to be particularly effective. Indeed, even if the California statute were to be amended to require all nonprofits to qualify the term "nonprofit" with the term "public benefit" or "mutual benefit" whenever it is used by an organization, it would undoubtedly be a long time before the public came to grips with the distinction—and this would presumably be true even if the mutual benefit category were much more narrowly and coherently defined than it is presently.

In short, so far as the public is concerned, the establishment of such a categorization of nonprofits is likely just to breed confusion. Some individuals, unaware of the distinction, may encounter abuse at the hands of mutual benefit nonprofits in which they have unwittingly placed the kind of trust that is appropriate only for organizations in the public benefit category. Other individuals, aware that the term "nonprofit" is not always a guarantee of high standards of fiduciary conduct, may come to be suspicious of nonprofits of all types, including those that are in fact public benefit nonprofits. And, so far as nonprofit organizations themselves are concerned, there will always be an incentive to adopt the less rigorous mutual benefit category wherever there is a choice, because patrons will generally be unaware of the difference (or, if they are, will suspect the worst), and there will therefore be no point in imposing on the organization the burden of higher legal standards of conduct, no matter what may be the designs of those who control the organization. Thus, a kind of Gresham's Law can be expected to lead the mutual benefit form to supplant the public benefit form.²⁹⁷

²⁹⁶ See section IV(D)(1) *supra*.

²⁹⁷ To be sure, organizations whose purposes are exclusively or almost exclusively charitable arguably do not have the option of forming as mutual benefit

The likely consequence of all this is that the nonprofit form will be notably weakened in its essential role as a means by which an organization can communicate to potential patrons that it is committed to higher fiduciary standards than are its proprietary counterparts, and that therefore it may serve them better in circumstances characterized by contract failure.

3. Providing for Current Distributions

At present, as we have seen,²⁹⁸ commercial mutual nonprofits—and many other types of nonprofits as well—are typically given the power to distribute their assets, including accumulated profits, to members on dissolution. All of the leading statutes, however, more or less clearly prohibit current distributions of profits to members of nonprofit corporations, regardless of the category of nonprofit involved.²⁹⁹ Cooperative corporations, on the other hand, generally have the power to make current, as well as terminating, distributions of net earnings to their members.³⁰⁰

Under the revision of the nonprofit corporation statutes that I am proposing, there would no longer be a category of organizations that are empowered to make terminating distributions but not current distributions to members. Rather, there would exist, on the one hand, the option of forming an organization under the nonprofit corporation statute, in which case neither current nor terminating distributions of profits to members (or any other controlling persons) would be permitted, or, on the other hand, the option of forming the organization under the cooperative corporation statute, in which case the organization would have the power to make both terminating and current distributions of profits to members.

This is not, however, a liability, for there appears to be no need for a category of organizations that is barred from making

nonprofits under the California statute. See note 110 *supra* & accompanying text. Tax considerations might also leave an organization no attractive alternative to forming as a public benefit nonprofit. For example, to qualify for an exemption under I.R.C. § 501(c)(3), a nonprofit in California would presumably need to have a provision in its articles of incorporation dedicating its assets to an exempt purpose, and, in particular, prohibiting any distribution of assets to members on dissolution. See Treas. Reg. § 1.501(c)(3)-1(b)(4) (1959). Such a provision would preclude the organization from incorporating as a mutual benefit nonprofit. See CAL. CORP. CODE § 7111 (West Supp. 1980).

²⁹⁸ See text accompanying notes 242-61 *supra*.

²⁹⁹ Except, perhaps, for the New York statute in its provision for type D nonprofits. See text accompanying notes 87-90 *supra*.

³⁰⁰ See, e.g., WIS. STAT. ANN. § 185.45 (West 1957).

current, but not terminating, distributions of profits to members. The capacity to make distributions on dissolution provides sufficient opportunity to tap profits out of an organization to make the nondistribution constraint essentially meaningless in terms of the protection it affords patrons.³⁰¹ As a consequence, this power is appropriate only for commercial mutual organizations, in which the patrons are in a position to look out for themselves, and in which they may gain from the flexibility that this right provides. But, if the member-patrons in such organizations are able to protect their interests with respect to terminating distributions, why can they not also protect their interests with respect to current distributions? It is not obvious that there is anything about the power to make current distributions that is any more threatening to the interests of member-patrons than the power to make terminating distributions.

Moreover, if the members of an organization find it convenient to be able to make terminating distributions to themselves, they are also likely to find it convenient to make current distributions. Consider, for example, a country club incorporated as a nonprofit. Suppose that, in order to provide the capital that the club needs, new members are required to make a substantial capital contribution. On leaving the club, it might be reasonable to permit the member to have this capital contribution returned. If such a payment to a terminating member does not exceed the original contribution, arguably it would not violate the nondistribution constraint. But suppose that the club's assets had increased significantly in value in the interim, perhaps owing to development in the surrounding community, or perhaps owing to improvements financed through annual operating surpluses (representing an excess in members' fees and payments for services over annual expenses). Would it not then be proper to make a payment to the departing member roughly proportionate to his or her current share in the firm's assets? Disallowing such a payment would essentially involve a transfer of part of the departing patron's share in those assets to the other, remaining members—ultimately to be realized by that group of individuals who are members at the time of dissolution. A payment of this sort, however, presumably would be, and certainly should be, interpreted as a violation of the nondistribution constraint as it applies to current distributions.³⁰²

³⁰¹ See section IV(D)(1) *supra*.

³⁰² The capacity of a member to extract a pro rata share of an ongoing organization's assets on withdrawal is facilitated by the California statute which provides that memberships in mutual benefit nonprofits can be made salable. See

In short, an organization either needs the power to make distributions to its member-patrons or it does not. It makes little sense to permit an organization to make such distributions on some occasions and not on others. And, if an organization is to have the power to make distributions to its member-patrons, the cooperative corporation statutes are well designed to provide it.³⁰³

4. Providing Adequate Safeguards for Distributions

Well-drafted cooperative corporation statutes are much better designed not only to permit, but also to place appropriate controls on, distributions to members. The leading nonprofit statutes all simply permit distributions to "members" on dissolution, without, as we have noted, placing substantial restrictions on what constitutes a "member." Indeed, the New York statute and the Model Act provide no meaningful definition of "member" at all, but simply let each organization define its membership, if any, as it chooses.³⁰⁴ And the new California act is only slightly more careful in this regard, defining a member as any person who, by virtue of the organization's articles or bylaws, has voting rights in the organization.³⁰⁵

More particularly, these statutes impose no requirement that distributions on dissolution go only to members who are also patrons, much less impose safeguards to prevent patrons who are members from exploiting nonmember patrons through such a distribution. Indeed, as we have seen, under these statutes it would apparently be perfectly lawful for the managers of an entrepreneurial nonprofit to define themselves as its members, and then to dissolve the organization when they choose and to divert its assets

CAL. CORP. CODE § 7320 (West Supp. 1980). This, of course, is simply a step toward legalizing current distributions, as well as terminating distributions. Under this statutory scheme, individuals who want to extract their shares of the accumulated profits out of an organization prior to its dissolution need only sell their memberships in the organization, with its accompanying claim (in dissolution) on the organization's accumulated earnings, to another individual; the price received will reflect (among other things) the value of those accumulated earnings.

³⁰³ If the members of the organization, for whatever reasons, wish to have the organization structured so that it has the authority to make distributions to members on dissolution but not currently, they are apparently free to do so under the cooperative statutes in many states. See, e.g., N.Y. COOP. CORP. LAW §§ 14(h), 17 (McKinney 1951 & Supp. 1979). In some states, however, the cooperative statutes place limits on the corporation's power to accumulate earnings, requiring instead that most net earnings be distributed annually. See, e.g., WIS. STAT. ANN. § 185.45 (West 1957).

³⁰⁴ See note 258 *supra* & accompanying text.

³⁰⁵ See note 259 *supra* & accompanying text.

to themselves.³⁰⁶ Of course, the authors of these statutes presumably had no such thing in mind; ³⁰⁷ rather, they were probably thinking of organizations in which the membership consists only of patrons—as in a typical country club or trade association—so that a terminating distribution would be more or less just a return of the assets plus accumulated earnings to the people who had contributed the assets. Yet none of the statutes require that members in general, or even the members who participate in a terminating distribution, also be patrons.

The cooperative statutes are generally much more carefully drawn in this regard, for they typically confine distributions, whether on dissolution or otherwise, to the organization's patrons.³⁰⁸ Moreover, these statutes often contain provisions to ensure that such distributions will not become a means by which one class of patrons exploits another—for example, by requiring that distributions be made in proportion to each individual's patronage,³⁰⁹ or even that such distributions be made to all patrons who can be identified regardless of whether they are members.³¹⁰ Thus, although the cooperative corporation statutes provide more occasions for distributions than do the nonprofit corporation statutes, they actually provide more protection for patrons when such distributions take place. This, therefore, is yet another reason why mutual organizations that desire the power to make distributions, even if only on dissolution, should be formed under the cooperative statutes rather than under the nonprofit statutes.

5. Reforming the Cooperative Corporation Statutes

To implement the reforms just suggested would not only require some changes in the nonprofit corporation statutes—notably eliminating the right to distribute net assets to members and estab-

³⁰⁶ See text accompanying notes 258-61 *supra*.

³⁰⁷ Although perhaps the authors of the Model Act did have something like this in mind. See text accompanying notes 83 & 84 *supra*.

³⁰⁸ See, e.g., IOWA CODE ANN. §§ 499.2, 499.30 (West 1949 & Supp. 1980); MICH. COMP. LAWS ANN. §§ 450.99, 450.106 (1973 & Supp. 1980); WIS. STAT. ANN. § 185.45 (West 1957). Distributions to investors (who need not be patrons) are also generally permitted, however, up to a statutorily prescribed maximum rate of return. See, e.g., IOWA CODE ANN. §§ 499.23, 499.24 (West 1949 & Supp. 1980); MICH. COMP. LAWS ANN. § 450.106 (Supp. 1980); WIS. STAT. ANN. §§ 185.21(1)(c), 185.45(2)(c) (West 1957 & Supp. 1980). See generally Hansmann, *supra* note 2, at 889-90.

³⁰⁹ See, e.g., IOWA CODE ANN. §§ 499.2, 499.30 (West 1949 & Supp. 1980); OR. REV. STAT. § 62.415(1) (1979); WIS. STAT. ANN. § 185.45(3)(b) (West 1957).

³¹⁰ See, e.g., WIS. STAT. ANN. § 185.45(3) (West 1957).

lishing stricter standards against self-dealing—but would also require some modification of the cooperative corporation statutes in many states. In particular, many state cooperative corporation statutes, like the nonprofit statutes, contain restrictions on the purposes for which a cooperative corporation can be formed, typically confining such organizations to agricultural pursuits, housing, operation of public utilities, and so forth.³¹¹ In many cases, these restrictions, on their face, would preclude formation of cooperatives for the purposes with which we are concerned here, such as social clubs and trade associations. Thus, the purposes limitations in the cooperative statutes would have to be loosened. Yet this is not a serious objection, since the restrictions on purposes that appear in the cooperative statutes seem to have even less justification than those that appear in the nonprofit statutes,³¹² and it would be wise to eliminate them in any case.

Beyond this, many of the cooperative corporation statutes are simply not well-drafted, being either too vague or too specific about the rights of patrons, members, and investors,³¹³ or containing arbitrary restrictions on such things as the permissible life span of the organization.³¹⁴ Again, such difficulties in the cooperative statutes should be rectified in any case, regardless of what is done with the nonprofit statutes. The reform of the nonprofit corporation statutes can therefore serve the further function of providing a helpful stimulus to a long overdue reform of the cooperative corporation statutes as well.³¹⁵

³¹¹ See, e.g., MO. ANN. STAT. § 357.010 (Vernon 1966); N.Y. COOP. CORP. LAW § 13 (McKinney 1951).

³¹² There is almost no form of enterprise that, in the appropriate circumstances, might not usefully be organized as either a producers' or a consumers' cooperative, including, for example, a shoe store (see text following note 38 *supra*). Moreover, so long as the applicable cooperative corporation statute is well designed, so that an ordinary investor-controlled business firm cannot set itself up under the guise of a cooperative, there is unlikely to be substantial opportunity to use the cooperative form as a means of deceiving and abusing either patrons or investors, regardless of the type of activity involved.

³¹³ Some states have no general cooperative corporation statute at all. For example, the Idaho statutes make provision only for the formation of cooperative agricultural marketing associations. IDAHO CODE §§ 22-2601 to 2628 (1977 & Supp. 1979).

³¹⁴ E.g., ARK. STAT. ANN. § 64-1504 (1966) (cooperative corporations limited to 50 year duration); PA. STAT. ANN. tit. 15, § 12003 (X) (Purdon 1967) (cooperative corporations limited to 30 year duration).

³¹⁵ In considering the need for such a simultaneous rationalization of the nonprofit and cooperative corporation statutes, we should keep in mind, too, that the prevailing confusion between these two organizational forms has not been confined to such understandable cases as social clubs. Often the nonprofit statutes are used to form organizations that belong even more clearly in the cooperative class. For example, as we saw in section II, the purposes clause of the Illinois statute

D. *The Three Types of Corporations*

In sum, I am suggesting that only three fundamental types of corporation need to be provided for in the general corporation statutes, each of which is characterized by a different relationship between the organization and its patrons. First, for those situations in which simple individual contracts provide an adequate means by which patrons can police the producer's price and performance, there is the business corporation. Second, for situations—such as those involving natural monopoly³¹⁶—in which simple contractual devices are inadequate to protect the interests of patrons, but in which direct patron control over the organization is sufficient for this purpose, there is the cooperative corporation. And third, for situations—such as those characterized by contract failure—in which neither simple contractual devices nor direct patron control provide adequate and workable means by which patrons can police producers, there is the nonprofit corporation.

Each of these corporate types should be covered by a separate statute and designated by a clear label. Because these corporate types represent, in a sense, ascending levels of protection for the patron, efforts to permit the less constrained corporate types to be formed under the more restrictive statutes will only confuse the purpose of these statutes and hamper their ability to function as they should. In particular, any adjustment to a nonprofit statute that permits organizations to be formed under it that are essentially cooperatives undermines the effectiveness of the nonprofit statute, just as adjusting a cooperative statute so that it can also accommodate ordinary joint-stock companies would severely weaken the cooperative statute, and would deprive the term "cooperative" of any coherent meaning.

Once the essential structural features of the corporations that can be formed under each of these types of statutes has been clarified, there should be no need to restrict the purposes for which organizations can be formed under any of them. A shoe store, a country club, a health maintenance organization, or an organization that provides low-cost housing for the poor subsidized by private contributions should all have the option of adopting any of the three different corporate forms. So long as the different corpo-

makes explicit provision for the formation under it of various types of public utilities organizations "on a cooperative basis." See note 14 *supra* & accompanying text.

³¹⁶ Even social clubs—which, as noted at text accompanying notes 273-82 *supra*, have rather more in common with cooperatives than they do with other nonprofits—seem, in a sense, to involve problems of natural monopoly. See Hansmann, *supra* note 2, at 892-94; *Externalities*, *supra* note 273.

rate forms are well defined and clearly differentiated, individuals who deal with an organization—whether as patrons, investors, officers, or employees—will be in a position to know, by virtue of the type of corporation involved, roughly what to expect of it, and what it expects of them.

E. More Modest Reforms

The reforms suggested above are by no means revolutionary. Nevertheless, there would be problems to overcome.

First, there would be the necessity for changes in the cooperative statutes as well as in the nonprofit statutes. Moreover, people would need to become accustomed to applying the term “cooperative” to social clubs and other mutual organizations that have not traditionally been thought of as such, but that, under this proposal, would have to incorporate as cooperatives if they wished to have more freedom than the strict nonprofit form recommended here would allow. Finally, there would be the problem of dealing with cooperative-type organizations that already have charters under the older and looser nonprofit corporation statutes. Presumably, it would be necessary either to require that they revise their articles of incorporation to conform to the newer, more restrictive terms of the nonprofit statute (or, more simply, just impose the new standards on all existing nonprofit corporations by the direct operation of the statute, as do the new rules for private foundations established by the Tax Reform Act of 1969³¹⁷), or to require that they reincorporate under the cooperative statute.

None of these difficulties is particularly serious, and they are significantly overshadowed by the benefits to be expected from reform. Nevertheless, even such minor obstacles as these, together with simple inertia and conservatism, can be expected in many cases to hinder the adoption of the proposed statutory revisions. Consequently, it is worthwhile to consider some more modest reforms that can be implemented with less effort.

One such compromise approach would involve the creation of a separate statutory category for those cooperative-type organizations that have in the past commonly been formed as nonprofits. This would be similar to the approach taken in the new California statute, except for a few important changes.

First, the organizations in the new category should not be labeled “nonprofit,” but rather should be given a distinct title,

³¹⁷ See notes 221 & 222 *supra* & accompanying text.

such as "membership corporation,"³¹⁸ "mutual corporation," or "mutual benefit corporation," in order to prevent confusion with true nonprofits.

Second, all limitations on the purposes for which true nonprofits—that is, those that are subject to relatively strict fiduciary standards—can be formed should be eliminated, as should any restrictions on the purposes for which membership corporations can be formed.

Third, the right of membership corporations to distribute assets to members on dissolution should be limited to members who are also patrons. Moreover, protective provisions should be adopted to prevent such distributions from benefiting one group of patrons at the expense of others. For example, such a distribution might be permitted only for those corporations that either offer membership to all patrons on equal terms or derive only an insubstantial portion of their income from nonmember patrons.

Even this approach, of course, would require a substantial amount of new legislation in any state that adopted it, and such action might be a long time coming. Interim reforms that are even simpler and less controversial are therefore worth mentioning. One such reform would be a revision of the provisions in the existing nonprofit statutes that govern distributions of assets on dissolution, so that these provisions authorize such distributions to members only when those members are also patrons, and only when the contemplated distribution will not unreasonably benefit one group of patrons at the expense of another. Indeed, in many states, the existing statutory provisions governing distributions on dissolution are so vague that a court could reasonably apply—and should apply—criteria such as these as a gloss on the language of the statute, supported by the perfectly reasonable argument, which has been made throughout this Article, that without such a gloss, the statute as a whole makes no sense. Similarly, the existing statutes can be revised to place much more stringent constraints on self-dealing for at least those nonprofits other than commercial mutual nonprofits. Again, even in the absence of such statutory revision, the courts can exercise their considerable discretion, relying on the vague language of most of the statutes, to impose such standards on their own.

³¹⁸ Interestingly, the term "membership corporation" used to be applied in New York to nonprofits of all forms. See *Membership Corporations Law*, ch. 722, § 2, 1926 N.Y. Laws 1308, 1309 (1926) (repealed by *Not-For-Profit Corporation Law*, ch. 1066, § 2, 1969 N.Y. Laws 2683, 2850 (1969) (current version at N.Y. *NOT-FOR-PROFIT CORP. LAW* §§ 101-1515 (McKinney 1970 & Supp. 1979))).

VI. POLICING THE NONDISTRIBUTION CONSTRAINT

Promulgating appropriate rules of conduct for the managers of nonprofit organizations is only the first step; it is also necessary to provide for the enforcement of those rules. Unfortunately, to date the law has been even more deficient in the latter respect than it has been in the former.

A. *Enforcement by the State Attorney General*

Virtually all states authorize the attorney general, either by common law or by statute, to ensure that the managers of charitable organizations fulfill their fiduciary obligations.³¹⁹ This authority commonly extends not only to charitable trusts, but also to charities organized as nonprofit corporations. The extent of the attorney general's powers to police the affairs of nonprofit corporations that do not fall within the vague category of "charities" is less clearly established, although some such authority can presumably be based on the provisions found in most nonprofit corporation statutes that permit the attorney general to bring an action to dissolve a corporation for exceeding or abusing its corporate powers.³²⁰

Here, as elsewhere in the organizational law, it is difficult to discern any good reason for distinguishing between nonprofits that are classed as charities and those that are not. As argued above,³²¹ all types of nonprofits play, or should play, an important role as fiduciaries vis-a-vis their patrons. Moreover, patrons of all types of nonprofits are commonly in a poor position to ensure that this fiduciary role is being well-performed—which, of course, is why the patrons turn to a fiduciary institution in the first place. Indeed, as discussed below, the law generally denies the patrons of a nonprofit even the right to bring suit against a nonprofit or its managers for breach of the fiduciary duties owed to the organization's patrons, and this is as much or more the case for patrons of noncharitable nonprofits as for patrons of charities.³²² Oversight by state authorities can therefore serve an important purpose throughout the nonprofit sector, and not just in those areas that have come to be

³¹⁹ See Office of the Ohio Attorney General, *The Status of State Regulation of Charitable Trusts, Foundations, and Solicitations*, in 5 COMMISSION ON PRIVATE PHILANTHROPY AND PUBLIC NEEDS, RESEARCH PAPERS 2705, 2710-25 (1977) [hereinafter cited as *Status of State Regulation*].

³²⁰ E.g., MODEL ACT, *supra* note 19, § 51. See M. FREMONT-SMITH, *supra* note 217, at 200.

³²¹ See text accompanying notes 6-8 *supra*.

³²² See text accompanying notes 145-56 *infra*.

classified as charitable. It should be made clear, either by statute or through the decisional law, that the attorney general's authority to police the affairs of nonprofits extends equally to all nonprofit organizations.

Unfortunately, in most states there has been little effort to exercise even the substantial powers that the attorney general already has. Commonly, little or no staff in the attorney general's office is assigned to look after the affairs of nonprofits,³²³ and no effective system of financial reporting by nonprofits exists in any state.³²⁴ Moreover, among the few states that make some organized effort in this area, policing often is largely confined to charitable trusts.³²⁵ This sad state of affairs has, at various times, been prominently noted and loudly bemoaned,³²⁶ but with little effect.

Perhaps part of the reason for such inactivity on the part of state authorities has been that the fiduciary standards imposed on nonprofit corporations by state law have generally been so low and so ambiguous³²⁷ that there has been little point in attacking any but the most grotesque cases of fraud.³²⁸ And perhaps, too, this relaxed attitude toward nonprofits has derived from a lack of understanding of the role played by nonprofits, and of the importance of high fiduciary standards in assuring that this role is performed effectively. If so, perhaps the suggestions made above for more rigorous fiduciary standards, and the observations offered here and elsewhere³²⁹ concerning the general role of nonprofits, will help fuel the movement for more vigorous enforcement efforts by state authorities. In the meantime, however, it may be well to look elsewhere for effective means of policing the nonprofit sector.

B. Enforcement by the Internal Revenue Service

For those nonprofit organizations that are exempt from the federal corporate income tax, a class that includes most substantial

³²³ *Status of State Regulation*, *supra* note 319, at 2726-33.

³²⁴ See text accompanying notes 319-84 *infra*.

³²⁵ See Beeney, *Effectiveness of States Policing Non-Profits* (Oct. 3, 1977) (unpublished memorandum prepared for the author, reporting results of a telephone survey of enforcement activities in selected states).

³²⁶ M. FREMONT-SMITH, *supra* note 217, at 194-318; *Status of State Regulation*, *supra* note 319; Karst, *The Efficiency of the Charitable Dollar: An Unfulfilled State Responsibility*, 73 HARV. L. REV. 433 (1960); Comm. on Charitable Trusts & Foundations of the ABA Section of Real Property, Probate & Trust Law, *Report*, 100 TR. & EST. 895 (1961).

³²⁷ See text accompanying notes 176-266 *supra*.

³²⁸ See text accompanying note 223 *supra*. This may also partially explain why charitable trusts, which are generally subject to clearer and more rigorous fiduciary standards, are a more popular target of enforcement efforts.

³²⁹ See Hansmann, *supra* note 2.

nonprofits, the Internal Revenue Service constitutes another mechanism for ensuring that the managers of nonprofit organizations adhere to their fiduciary duties.

The Internal Revenue Code explicitly imposes its own non-distribution constraint on exempt organizations, limiting exemption in most cases to organizations "no part of the net earnings of which inures to the benefit of any private shareholder or individual."³³⁰ As noted earlier, for private foundations, this general "non-inurement" rule is supplemented by an extensive and detailed set of prohibitions against self-dealing by foundation managers and other controlling persons.³³¹ In addition, a slightly weaker set of prohibitions against self-dealing is explicitly applied to another small class of exempt organizations comprising certain trusts and unemployment benefit plans.³³²

Violation of the strict statutory standards of conduct applied to private foundations makes the individuals involved, including foundation managers, subject to a special "excise tax,"³³³ which is in effect a fine that is proportionate to the size of the prohibited transactions.³³⁴ The very existence of such strict and clear rules, supported by severe sanctions and backed by at least a moderate IRS enforcement effort,³³⁵ may have had a salutary effect on the

³³⁰ This language, or its equivalent, appears in the definition of most of the 21 categories of exempt organizations provided for in the Internal Revenue Code, and is implicit in most of the others, except for those covering organizations formed on a cooperative basis. See I.R.C. § 501(c). See P. TREUSCH & N. SUGARMAN, *supra* note 34, at 129-40.

Treasury regulations define "private shareholder or individual" as referring to "persons having a personal and private interest in the activities of the organization," Treas. Reg. § 1.501(a)-(1)(c) (1958), which is presumably a vague effort to denote that class of persons that has been referred to in this Article as "controlling persons."

³³¹ See text accompanying notes 220-22 *supra*.

³³² See I.R.C. § 503.

³³³ Treas. Reg. § 53.4941(a)-1(a)(1) (1973).

³³⁴ I.R.C. § 4941. Both the foundation manager and the entity on the other side of the deal, the so-called "disqualified person," see *id.* § 4946(a)(1), are subject to the tax, equal to 2.5% and 5%, respectively, of the transaction amount. *Id.* § 4941(a)(1) (disqualified person); *id.* § 4941(a)(2) (foundation manager). Further, if the transaction is not "corrected," preferably by rescission, see *id.* § 4941(e)(3), within the "correction period," see *id.* § 4941(e)(4), then the foundation manager and disqualified person are liable for further taxes of 50% and 200%, respectively, of the transaction amount. *Id.* § 4941(b)(1) (disqualified person); *id.* § 4941(b)(2) (foundation manager).

³³⁵ After the Tax Reform Act of 1969, the IRS established a program of auditing all private foundations at least once every five years, with the largest and most complex being audited once every two years. *Private Foundations: Hearings on the Role of Private Foundations in Today's Society and a Review of the Impact of Charitable Provisions of the Tax Reform Act of 1969 on the Support and Operation of Private Foundations Before the Subcomm. on Foundations of the Senate*

fiduciary behavior of those who control the affairs of private foundations.³³⁶ Most exempt nonprofits, however, including the great bulk of operating nonprofits such as schools and hospitals, are not covered by special rules such as those applied to private foundations. Rather, for these organizations, the simple non-inurement language quoted above represents the only express statutory statement of the limits to which a nonprofit can serve the self-interest of controlling persons. And, as many observers, including the IRS itself, agree, the IRS has never been terribly zealous in enforcing this general non-inurement provision.³³⁷

One reason for the limited effort at policing is presumably the vagueness of the statutory language. That language, unlike the provisions applicable to private foundations, does not explicitly forbid self-dealing per se. Consequently, it has been interpreted to forbid only those acts of self-dealing that actually involve excessive payments to the controlling persons involved.³³⁸ All but the most obvious cases of profiteering therefore involve messy factual issues concerning the reasonableness of compensation. Another disincentive to active enforcement lies in the nature of the available remedies. Withdrawal of exemption, which is the principal threat that the IRS can offer in such cases, will often hurt rather than help those innocent individuals whom the organization is designed to serve. And finally, in all but the most flagrant cases, little revenue can be gained from attacking self-dealing transactions, and revenue is the main goal of the IRS.

Considerably more effective policing by the IRS in this area might result if the special rules established for private foundations in the Tax Reform Act of 1969, including, in particular, the strict and clear prohibitions against self-dealing and the special monetary sanctions created by that Act, were extended to cover all tax-exempt

Comm. on Finance, 93d Cong., 2 Sess. 113 (1974) [hereinafter cited as *1974 Hearings*] (background paper submitted by Donald C. Alexander, Comm'r of the IRS).

³³⁶ See *Private Foundations: Hearings on the Role of Private Foundations in Today's Society and a Review of the Impact of Charitable Provisions of the Tax Reform Act of 1969 on the Support and Operation of Private Foundations Before the Subcomm. on Foundations of the Senate Comm. on Finance*, 93d Cong., 1st Sess. 195 (1973) [hereinafter cited as *1973 Hearings*] (statement of Malcolm Sein, Esq., former staff member in the Office of the Ass't Sec'y of the Treasury for the Tax Policy).

³³⁷ For example, although substantially all private foundations were audited in the period 1969 to 1974, only 9,000 of the total 80,000 public charities filing returns during that same period were audited. *1974 Hearings*, *supra* note 335, at 115 (background paper submitted by Donald C. Alexander, Comm'r of the IRS). See also *1973 Hearings*, *supra* note 336, at 272 (statement of Sheldon Cohen, former Comm'r of the IRS).

³³⁸ See TREUSCH & SUGARMAN, *supra* note 34, at 133.

nonprofits. As already suggested, the extension of such high fiduciary standards to all nonprofits would be a salutary development.³³⁹ Yet substantial considerations weigh against relying primarily on the federal taxing authorities to establish and enforce rules of fiduciary conduct for the managers of nonprofit organizations.

First, many nonprofit organizations, because of the purposes they serve, do not qualify for exemption regardless of whether they adhere strictly to high fiduciary standards, and these nonprofits would be unaffected by any requirements established as a condition for exemption.³⁴⁰ Thus, even the most vigorous policing by the IRS could never ensure that all nonprofits adhere closely to the nondistribution constraint.

More important, however, federal revenue agents have, at best, only an indirect interest in policing fiduciary behavior in nonprofits. The primary rationale for the nondistribution constraint is to protect a nonprofit's patrons, and enforcement of that constraint is therefore for their benefit. But the federal income tax is not levied and collected primarily for the sake of promoting honesty and fair dealing among individuals in their transactions with each other, but rather to produce revenues to finance the government. To be sure, the IRS must necessarily police transactions of all sorts to ensure that those upon whom taxes are levied actually pay them. But strict enforcement of the nondistribution constraint among tax-exempt nonprofits will generally not lead to an increase in federal revenues; rather, it will simply ensure that less of a nonprofit's income goes to its managers and more goes to further the purposes for which the patrons have contributed their funds. Burdening the revenue system with such nontax objectives threatens to confuse its mission and dilute its effectiveness.

The establishment and enforcement of rules of conduct for the managers of nonprofit organizations is a responsibility that is most appropriately entrusted to that body of law that is specifically designed to govern the general affairs of private organizations, in particular the law of corporations and trusts. The incongruity of using the tax law for this purpose is nowhere better illustrated than in the special Internal Revenue Code rules for private foundations. Those statutory provisions, together with their accompanying regulations, essentially constitute a detailed corporation statute for foundations.

³³⁹ See text accompanying notes 215-32 *supra*.

³⁴⁰ For example, automobile service clubs, though formed as nonprofit corporations, are not exempt. *Chattanooga Auto. Club v. Commissioner*, 182 F.2d 551 (6th Cir. 1950); G.C.M. 23688, 1943 I.R.B. 283, *as modified by* Rev. Rul. 69-635, 1969-2 C.B. 126.

This fact is explicitly recognized in the Treasury Regulations, which essentially force the states to incorporate large sections of the federal statutory provisions verbatim into their nonprofit corporation statutes.³⁴¹ It is also reflected in the elaborate system of special fines (denominated "excise taxes") that has been legislated to ensure compliance with the private foundation rules,³⁴² and that represents an unusual exception to the normal system of penalties that is used to secure compliance with virtually all other provisions of the tax code.

To be sure, federal tax law does effectively make the government a patron of many nonprofits, and to this extent the government has an interest in policing the behavior of nonprofits that is much like that of any other patron. The degree of this interest varies considerably, however, among different types of nonprofits, and often is not closely correlated with the interest of the public at large in the fiduciary integrity of the organizations in question. For the limited group of organizations that both qualify for the charitable deduction³⁴³ and receive considerable donative support, the government is in effect a substantial contributor. Moreover, for those organizations within this group that are categorized as private foundations, the government is often the only contributor that does not exercise direct control over the organization, and therefore the only patron that is likely to be abused by a breach of fiduciary duty on the part of the organization's managers. This therefore provides a rationale for the particularly close IRS scrutiny of private foundations that is now provided for in the tax code. By the same reasoning, however, members of the public at large have virtually no stake in the probity of private foundations—aside from the tax avoidance issue—because they are not among its patrons.

On the other hand, the federal interest in the behavior of organizations that are merely exempt, but do not qualify for the deduction, is fairly modest. Although exemption for nonprofits can be viewed as a contribution of the amount of tax that would otherwise be due,³⁴⁴ the potential corporate income tax liabilities of

³⁴¹ See text accompanying notes 221 & 222 *supra*.

³⁴² See notes 333 & 334 *supra* & accompanying text.

³⁴³ I.R.C. § 170 permits individuals to deduct from their taxable income amounts that they contribute to nonprofit organizations (principally charities) that fall within a group designated by that section of the Code. This group is in turn a subset of the class of nonprofits, defined in I.R.C. § 501(c), that is exempt from the taxes levied on for-profit corporations.

³⁴⁴ *But see* Bittker & Rahdert, *supra* note 191; *Exempted Nonprofit Organizations*, *supra* note 93.

most nonprofits are probably so small that this is a relatively insignificant source of financial support. Yet organizations in this class may often be in a position seriously to defraud private patrons.

It may be that all efforts to assure adequate policing of the nondistribution constraint through reform of state corporation law and its associated enforcement mechanisms will ultimately prove unavailing, and that there will therefore be no place to turn for such policing other than to the federal taxing authorities. As it is, however, there still remain natural agents for enforcement at the state level that have been largely untried—namely individual patrons.

C. *Enforcement by Patrons*

Because the nondistribution constraint under which a nonprofit corporation operates is for the protection of the organization's patrons, it seems natural to provide for patrons to participate in the enforcement of that constraint by giving them a cause of action against anyone who violates it. As it is, however, the nearly universal rule is that patrons generally have no standing to bring such a suit.

1. Current Doctrine

The doctrine in this area is largely judge made. The nonprofit corporation statutes, including the Model Act, are, with a few exceptions to be discussed below,³⁴⁵ generally silent on the subject. The courts have borrowed the rules on standing largely from the law of charitable trusts; both the courts and the commentators for the most part continue to speak in terms of standing to sue "charities" rather than nonprofit corporations.³⁴⁶ Although this might suggest that a different rule of standing would be applied in the case of a nonprofit corporation that does not qualify as charitable, the courts apparently do not pay much attention to the distinction, and apply the same doctrine to any nonprofit corporation or charitable trust.³⁴⁷

The general rule is that, in the case of a breach of fiduciary duty by a nonprofit or its officers or directors, only the attorney

³⁴⁵ See text accompanying notes 355 & 356 and 378-84 *infra*.

³⁴⁶ See M. FREMONT-SMITH, *supra* note 217, at 202-08; Karst, *supra* note 326, at 433 n.2, 445-60.

³⁴⁷ See *Wiegand v. Barnes Foundation*, 374 Pa. 149, 97 A.2d 81 (1953).

general has standing to bring suit.³⁴⁸ In particular, the courts have explicitly denied standing to the two groups most likely to take an interest in the affairs of a charitable organization—the organization's donors and beneficiaries.

At one time, founding donors were granted a right of "visitation" over a charity, which permitted them to inspect the charity's affairs and ensure that the managers of the charity were fulfilling their obligations. This right, which was evidently recognized well into the nineteenth century, appears to have fallen into disuse and disfavor in more recent times, and its status is now doubtful.³⁴⁹ In any case, it is clearly established that donors who are not founders have no standing.³⁵⁰ A reason sometimes given for this is that the gift to the charity is absolute, and leaves no remaining right in the hands of the donor.³⁵¹ Another common justification is that standing for donors would lead to excessive litigation.³⁵²

Although the courts appear more willing to concede that beneficiaries and potential beneficiaries of a charity have an interest in its enforcement, standing for this group is also generally denied, largely on the ground of avoiding "vexatious" and "harassing" litigation.³⁵³ A related justification is that the beneficiaries of a charity constitute a large and indefinite group, and it is difficult to determine which individuals clearly come within that group.³⁵⁴

There are, to be sure, some exceptions to the general denial of standing to beneficiaries. In particular, courts have sometimes been willing to grant standing to individuals who have a "special interest." A commonly cited example is the case of a charitable trust created for the benefit of the minister of a church; in this context, the current minister is considered to have a special interest sufficient to justify standing to sue for enforcement of the

³⁴⁸ *Id.* See BOGERT ON TRUSTS, *supra* note 39, at §§ 411, 414 (2d ed. 1964 & Supp. 1980); M. FREMONT-SMITH, *supra* note 217, at 198-202; Karst, *supra* note 326, at 445-49.

³⁴⁹ See BOGERT ON TRUSTS, *supra* note 39, at § 416; Karst, *supra* note 326, at 446.

³⁵⁰ See CHARITABLE FOUNDATIONS, *supra* note 57, at § 717; Karst, *supra* note 326, at 445-46.

³⁵¹ See BOGERT ON TRUSTS, *supra* note 39, at § 415, at 348-49; CHARITABLE FOUNDATIONS, *supra* note 57, at § 717.

³⁵² See Karst, *supra* note 326, at 447.

³⁵³ BOGERT ON TRUSTS, *supra* note 39, at § 411, at 324, at § 414, at 340 (2d ed. 1964 & Supp. 1980); CHARITABLE FOUNDATIONS, *supra* note 57, at § 720; M. FREMONT-SMITH, *supra* note 217, at 200; 4 SCOTT ON TRUSTS, *supra* note 216, at § 391; Karst, *supra* note 326, at 449.

³⁵⁴ See BOGERT ON TRUSTS, *supra* note 39, at § 411, at 324 (2d ed. 1964 & Supp. 1980).

trust.³⁵⁵ This exception, which has not been very well defined, has, however, usually been narrowly construed.³⁵⁶

This restrictive attitude toward standing has received general approval from the commentators, including some who have been quite critical of the sorry state of enforcement of the fiduciary responsibilities of nonprofits and their managers.³⁵⁷ These commentators, like the courts, all invoke the specter of "harassment," and either argue that the attorney general is an adequate agent for enforcement, or that if he is not, then the appropriate remedy is to expand the capabilities of his office so that he will be (or to create a new state agency, such as a state board of charities, that will undertake the task ³⁵⁸).

2. The Case for Patron Standing

Unfortunately, there is no reason to believe that the attorney general, or any other agency, will become an adequate instrument of enforcement in most states in the foreseeable future. Efforts at reform in this direction have been underway for forty years,³⁵⁹ and there is still rather little to show for them. In the meantime, patrons should at least be given the opportunity to try to look out for themselves.

I refer here to enforcement by "patrons" rather than by donors and beneficiaries for the same reasons that I have been concerned with patrons as a class throughout—namely, because this is a more useful analytic category when dealing with nonprofits in general. It is easy and perhaps useful to divide the interested parties into donors and beneficiaries when analyzing simple charitable trusts. But once the full range of nonprofit corporations is considered, this categorization breaks down, because we encounter many individuals whose relationship to a given nonprofit is essentially that of a purchaser of services, and as such has something in common with the interests of both donors and beneficiaries. In such cases, the interests of customers appear to have most in common with those of

³⁵⁵ See RESTATEMENT (SECOND) OF TRUSTS § 391 (1959); CHARITABLE FOUNDATIONS, *supra* note 57, at § 719, at 562-63.

³⁵⁶ *But see* cases cited and discussed note 364 *infra* & accompanying text.

³⁵⁷ See M. FREMONT-SMITH, *supra* note 217, at 200; 4 SCOTT ON TRUSTS, *supra* note 216, at § 391. See also BOGERT ON TRUSTS, *supra* note 39, at § 411, at 324. *But see* CHARITABLE FOUNDATIONS, *supra* note 57, at § 720, at 564; Karst, *supra* note 326, at 445-49.

³⁵⁸ See Karst, *supra* note 326, at 476-83.

³⁵⁹ The history of these efforts is briefly described in *Status of State Regulation*, *supra* note 319, at 2705.

donors, and hence I consider donors and customers together under the heading of "patrons."

As suggested in section I, the elements of a nonprofit's charter, and particularly its nondistribution constraint, can be viewed as terms in a contract between the organization's managers and its patrons. Under the terms of that implicit contract, the patron contributes funds to the organization and grants the managers the right to take reasonable compensation for themselves out of those funds, while the management pledges to devote all of those funds, beyond reasonable compensation, to the organization's general purposes, or to the particular services requested by the patron. It follows that a patron has much the same interest in having the nonprofit's managers adhere to its charter as he or she has in having an ordinary profit-seeking merchant adhere to the terms of a contract of sale. To characterize a contribution to a nonprofit as a mere gift in which the donor no longer retains an interest is simply to define away these important elements of the transaction.

But whatever legal metaphor is used—whether gift or contract—it is clear that patrons will commonly feel a strong interest in seeing that the managers of nonprofits adhere to their fiduciary duties. Thus, it makes sense to deny standing to patrons only if the consequence would be large numbers of spite suits, strike suits, or suits filed through sheer idiocy—which are presumably what the courts and commentators have in mind when they raise the specter of "harassing" litigation—or of suits that, though based on a real grievance, are feebly litigated and thus do more harm than good. Yet it appears extraordinarily unlikely that suits of this nature would ever become a sufficiently significant problem to outweigh the benefits of enlisting patrons into the enforcement effort.

First, in the few jurisdictions that have taken a relatively liberal attitude toward standing, no evidence exists of a flood of problem suits. Wisconsin, for example, adopted a statute in 1945 permitting suits to enforce charitable trusts to be brought by any ten or more donors and/or members or prospective members of the class for the benefit of which the trust was established if, upon demand, the attorney general refuses to act.³⁶⁰ Yet there appear to be no reported cases between 1945 and the apparent replacement of the

³⁶⁰ WIS. STAT. ANN. § 231.34 (West 1957). Although this statute continues to appear in the West compilation as being in force, it was apparently replaced in 1969 by WIS. STAT. ANN. § 701.10(3)(a) (West Supp. 1980). See *id.* § 701.10, committee comment. But see *Estate of Sharp v. State*, 63 Wis. 2d 254, 261-62, 217 N.W.2d 258, 262 (1974) (discussing § 231.34 as if still in force without mentioning § 701.10(3)).

statute in 1969³⁶¹ in which donors or beneficiaries invoked the statute.³⁶² Similarly, by the late 1960s, the New Jersey courts had, by taking a broad view of the "special interest" exception to the prevailing doctrine,³⁶³ extended standing to bring suit to enforce a charitable trust to members of the benefited class in general.³⁶⁴ Yet, in the intervening decade, there appear to have been no reported cases in New Jersey in which private parties have brought suit against a charity or its managers. Indeed, the real problem appears to lie in creating sufficient incentives to lead individuals to bring suit rather than in creating roadblocks to hold them back.

Further, a whole armory of procedural devices is available to discourage frivolous litigation short of refusing all suits indiscriminately. Aside from simply dismissing for failure to state a claim, these include (1) requiring the plaintiff to post security for defendants' costs in cases that, after a preliminary hearing, seem tenuous, (2) requiring that any recovery in such suits go to the organization and not to the plaintiff personally, and (3) refusing to countenance a settlement in which the plaintiff receives any amount beyond actual costs in bringing the suit.³⁶⁵ Such suits by patrons are quite analogous to shareholders' derivative suits, which have long been subject to analogous constraints.³⁶⁶ As with shareholder suits, suits by patrons would presumably seek recovery for all amounts deflected from the organization's purposes, and not just for those amounts traceable to the plaintiff's own contribution. Thus, these suits would essentially be class actions, and would be subject to the usual controls on such actions, such as the requirement that the

³⁶¹ See note 360 *supra*.

The new provision restricts those who may sue to, besides the attorney general, "[a]n established charitable entity named in the governing instrument to which income or principal must or may be paid under the terms of the trust;" "[a]ny settlor or group of settlors who contributed half or more of the principal;" and "[a] cotrustee." WIS. STAT. ANN. § 701.10(3)(a) (West Supp. 1980). Given the virtual absence of "vexatious" and "harassing" litigation, it is not immediately apparent why the earlier, more permissive statute was replaced. The attorney general of Wisconsin's office, when contacted on the matter, was quite cooperative, but unable to offer a reason. Telephone Interview with George Schuahm, in Madison, Wis. (Sept. 6, 1979).

³⁶² There was, however, one attempt by the heirs of a settlor to enforce the terms of a charitable trust. See *Fairbanks v. City of Appleton*, 249 Wis. 476, 24 N.W.2d 893 (1946). The attempt failed on standing grounds.

³⁶³ See text accompanying notes 355 & 356 *supra*.

³⁶⁴ See *Township of Cinnaminson v. First Camden Nat'l Bank & Trust Co.*, 99 N.J. Super. 115, 238 A.2d 701 (Ch. Div. 1968); *Paterson v. Paterson Gen. Hosp.*, 97 N.J. Super. 514, 235 A.2d 487 (Ch. Div. 1967).

³⁶⁵ See Karst, *supra* note 326, at 447-49 (similar procedural suggestions).

³⁶⁶ See, e.g., ABA-ALI MODEL BUS. CORP. ACT § 49 (1974).

plaintiff be an adequate representative of the class, and, when appropriate, that other patrons be given notice of the suit.³⁶⁷

3. Nonpatron Beneficiaries

Standing for patrons need not be accompanied by standing for those who benefit from a nonprofit's activities but are not among its patrons, such as those who receive disaster aid from the Red Cross, or a free night's lodging from the Salvation Army. The reason for this is that the nondistribution constraint is not designed primarily for the benefit of such nonpatron beneficiaries. Rather, it is designed to protect patrons who wish to use the nonprofit as an intermediary in assisting these beneficiaries. Or, put differently, it is primarily the organization's patrons, and not its nonpatron beneficiaries, who rely on the nondistribution constraint in dealing with a nonprofit. The disaster victim who receives first aid, food, and shelter from the Red Cross does not base his or her decision to accept such assistance on the organization's nonprofit status; he or she would presumably be just as willing to accept the same free assistance from a business corporation.

Nevertheless, nonpatron beneficiaries will benefit if nonprofits adhere to their fiduciary duties, and thus have interests parallel to the organization's patrons. Moreover, such beneficiaries might often be in a better position than patrons to determine whether the nonprofit is fulfilling its obligations, and to bring suit if it is not. This is obviously true, for example, in the case of a nonprofit that provides free services financed exclusively by an endowment from a single donor who is now deceased.³⁶⁸ Consequently, there is a good case to be made that standing should exist for beneficiaries as well as patrons.³⁶⁹

³⁶⁷ See, e.g., FED. R. CIV. P. 23.

Thus, in *Stern v. Lucy Webb Hayes Nat'l Training School for Deaconesses and Missionaries*, 367 F. Supp. 536, 540 (D.D.C. 1973), see also text accompanying notes 315-18 *infra*, patients of a hospital who brought suit against the hospital's trustees for malfeasance were certified as a class under FED. R. CIV. P. 23(b)(2) for purposes of seeking injunctive relief and an award of damages to be paid into the hospital's funds, but were denied certification as a rule 23(b)(3) class for purposes of seeking monetary recovery to be paid to the hospital's patients.

³⁶⁸ Nor would granting the right to sue to the heirs of the donor be a complete solution. Not all heirs will have the donor's charitable incentive to enforce the terms of the gift, given the fact that the gift may have been carved out of their inheritance or that they may hold a reversionary interest in the gift. See generally M. FREMONT-SMITH, *supra* note 217, at 206-07.

³⁶⁹ Such a rule would be in keeping with the modern American rule that an intended third-party beneficiary of a contract may bring suit for its enforcement. See 4 A. CORBIN, CORBIN ON CONTRACTS § 810 (1957 & Supp. 1971).

To be sure, it seems less imperative to extend standing to non-patron beneficiaries than to patrons. Most nonprofits of any significance, including schools, hospitals, and public charities, have a large class of patrons that is constantly being replenished. Moreover, many of the nonprofits that do not have a large class of patrons qualify as private foundations under the Internal Revenue Code, and consequently are subject to the special restrictions and oversight that the Code imposes on such organizations.³⁷⁰ A liberal approach to standing for beneficiaries is, however, probably the better wisdom. As with patrons, there is no reason to believe that the announcement of such a rule will immediately lead to a mass of nuisance litigation, despite the constant litany from courts and commentators to this effect. And, in any case, the bother of coping with an occasional frivolous lawsuit is far preferable to leaving nonprofit organizations largely free of effective oversight.

4. The New Statutes: Standing for Members

As noted above, the nonprofit corporation statutes are generally silent on the question of standing.³⁷¹ This is not true, however, of the recent New York and California statutes. Unfortunately, both of these statutes take a narrow and misguided view of the matter.

The problem here, as elsewhere, results from uncritical imitation of the business corporation statutes. This is most obvious in the New York statute, which grants standing only to members and holders of capital certificates.³⁷² These groups were evidently chosen because they appear most analogous to shareholders in a business corporation, who have the right to bring a derivative suit.³⁷³

³⁷⁰ See text accompanying notes 340-44 *supra*.

³⁷¹ See text accompanying notes 345-47 *supra*.

³⁷² N.Y. NOT-FOR-PROFIT CORP. LAW §§ 623(a), 720(b)(3) (McKinney 1970 & Supp. 1979). Standing to sue directors and officers for misconduct is also given to holders of subvention certificates and contributors of cash or property in excess of \$1000, but only if the organization's certificate of incorporation or by-laws so provide. *Id.* § 720(b)(4) (McKinney 1970).

This grant of standing to members but not to other patrons appears especially illogical because the statute gives no definition for the term "member" and thus presumably allows each nonprofit to decide whom it will call its members, if anyone, see note 258 *supra* & accompanying text, and therefore who, if anyone, will have standing to bring suit.

³⁷³ Indeed, the legislative commentary to the statute expressly notes that the standing provisions were modeled after these sections. See N.Y. NOT-FOR-PROFIT CORP. LAW, comments to §§ 623, 720 (McKinney 1970); N.Y. BUS. CORP. LAW § 626 (McKinney 1963); N.Y. GEN. CORP. LAW §§ 60, 61 (McKinney 1943 & Supp. 1973).

Similar logic appears to have guided the California statute, which likewise explicitly grants standing only to members and creditors, regardless of whether the organization is a public benefit nonprofit or a mutual benefit nonprofit.³⁷⁴

Apart from these statutes, the standing of members to sue has been problematic. Some state courts have themselves followed the shareholder analogy and given members standing.³⁷⁵ But other courts have withheld standing from members just as from other private parties on the ground that the attorney general has exclusive authority to sue.³⁷⁶

Members are almost always patrons, and therefore the argument above for granting standing to patrons extends to members as well. But there is no reason to confine standing to those patrons who are also members, for among nonprofits in general there is no sharp demarcation between the interests of members and those of other patrons.³⁷⁷ In particular, although shareholders and customers of business corporations have little in common, members and customers of nonprofits often have analogous interests. To be sure, members of a nonprofit may sometimes be in conflict with nonmember patrons of the same nonprofit, just as different classes of shareholders in the same business corporation can be in conflict. But all patrons of a given nonprofit, just like all shareholders in a business corporation, have a similar interest in seeing that the organization, and hence they, are not defrauded by the organization's management. If anything, members are less in need of standing to sue a nonprofit's management than are nonmember patrons, because members generally have the opportunity of exercising some control over the organization's management through the exercise of voting power.

5. Some Encouraging Developments

In recent years, several jurisdictions have significantly extended the right of private parties to bring suits to rectify the errant management of nonprofit firms. The important developments to this effect in New Jersey, and the somewhat older Wisconsin statute,

³⁷⁴ CAL. CORP. CODE §§ 5420, 7420, 7710 (West Supp. 1980). Presumably, patrons are not "creditors" for purposes of these sections.

³⁷⁵ See, e.g., *Leeds v. Harrison*, 7 N.J. Super. 558, 72 A.2d 371 (Ch. Div. 1950).

³⁷⁶ See, e.g., *Dillaway v. Burton*, 256 Mass. 568, 153 N.E. 13 (1926); *Voelker v. Saint Louis Mercantile Library Ass'n*, 359 S.W.2d 689 (Mo. Sup. Ct. 1962).

³⁷⁷ See *Hansmann*, *supra* note 2, at 890-91.

have already been mentioned.³⁷⁸ Of most interest, however, are two recent cases in which consumers of a nonprofit organization's services were given standing to bring suit against the managers of the organization for misuse of funds.

In the first of these cases, decided by Judge Gesell in the District Court for the District of Columbia, a group of patients at a nonprofit hospital brought suit against the hospital's directors for financial mismanagement and self-dealing.³⁷⁹ The case has received considerable attention on account of its holding concerning the fiduciary duties of the directors of nonprofit corporations.³⁸⁰ Yet the standards of conduct to which the directors in that case were held were neither novel nor particularly strict; they are considerably less rigorous than the standards suggested above.³⁸¹ What is more remarkable—though it has been much less often remarked upon—is Judge Gesell's ruling concerning standing. For, without citing any authority, or even discussing the issue, he simply stated that "[p]laintiffs purporting to represent a class of users of the Hospital's services have a sufficient special interest to challenge the conduct of the trustees operating this charitable institution on a theory of breach of trust."³⁸² More recently still, the Supreme Court of Alabama held that the students, staff, and faculty of a private college have standing to institute a class action to force an accounting by the president and directors for breach of their duty as charitable fiduciaries in misusing federal and church funds received by the college.³⁸³

³⁷⁸ See text accompanying notes 360-64 *supra*. The California courts, too, have shown some inclination to abandon the traditional narrow view of standing. See *San Diego County Council, B.S.A. v. City of Escondido*, 14 Cal. App. 3d 189, 92 Cal. Rptr. 186 (1971).

³⁷⁹ *Stern v. Lucy Webb Hayes Nat'l Training School for Deaconesses and Missionaries*, 367 F. Supp. 536 (D.D.C. 1973). The plaintiffs were eventually victorious. See *Stern v. Lucy Webb Hayes Nat'l Training School for Deaconesses and Missionaries*, 381 F. Supp. 1003 (D.D.C. 1974), noted in 24 CATH. L. REV. 657 (1975).

³⁸⁰ See *Brown, The Not-For-Profit Corporation Director: Legal Liabilities and Protection*, 28 FED'N OF INS. COUNSEL Q. 57, 67-68 (1977); Hackler, *Hospital Trustees' Fiduciary Responsibilities: An Emerging Tripartite Distinction*, 15 WASHBURN L.J. 422 (1976); Note, *The Fiduciary Duties of Loyalty and Care Associated With the Directors and Trustees of Charitable Organizations*, 64 VA. L. REV. 449, 459-60 (1978).

³⁸¹ See text accompanying notes 209-40 *supra*. The directors were held to the normal standards of fiduciary conduct demanded of directors of proprietary firms. See *Stern v. Lucy Webb Hayes Nat'l Training School for Deaconesses and Missionaries*, 381 F. Supp. at 1013-16; notes 209 & 210 *supra* & accompanying text.

³⁸² *Stern v. Lucy Webb Hayes Nat'l Training School for Deaconesses and Missionaries*, 367 F. Supp. at 540 (quoting the court's earlier ruling following a hearing on a motion to dismiss).

³⁸³ *Jones v. Grant*, 344 So.2d 1210 (Ala. Sup. Ct. 1977).

Although all of the recent cases that have taken a liberal attitude toward standing make reference to the plaintiffs' "special interest," and thus link themselves to the established exceptions to the general rule that no private party has standing, they appear to be moving toward a wholesale abandonment of that rule. Even more explicit steps in this direction would be desirable, with the objective of extending a clear grant of standing to patrons of nonprofit organizations, and to all individuals who clearly fall within the class that the organization's patrons intended to benefit.³⁸⁴

VII. DISCLOSURE

If nonprofits are to function properly in situations marked by contract failure, information about the uses to which nonprofits put their funds should be made available to patrons. Such disclosure can help potential patrons choose the organization, whether nonprofit or for-profit, that provides services most in line with their desires. Disclosure can also help patrons ensure that their contributions to nonprofits, once made, are devoted in their entirety to the services that the organization promises to provide.

A. *Charter Purposes*

One way in which a nonprofit corporation can signal its purposes to patrons is through the purposes clause in its corporate charter. As has been suggested throughout, the charter in general, and the purposes clause in particular, can essentially be viewed as terms in the organization's agreement with its patrons concerning the uses that will be made of funds contributed by the patrons. And, in keeping with the preceding discussion of enforcement mechanisms, an attempt by a nonprofit to exceed its charter purposes should be grounds for its patrons (as well as the appropriate state authorities) to bring suit.

Nonprofit corporations, like business corporations,³⁸⁵ are naturally tempted to adopt the broadest possible statement of purposes in their charter in order to give management maximum flexibility. Currently, this temptation is readily succumbed to, since nonprofit corporation law leaves nonprofit organizations free

³⁸⁴ The New Jersey courts already appear to have moved this far with respect to beneficiaries. See *Township of Cinnaminson v. First Camden Nat'l Bank & Trust Co.*, 99 N.J. Super. 115, 238 A.2d 701 (Ch. Div. 1968).

³⁸⁵ See H. BALLANTINE, *BALLANTINE ON CORPORATIONS* § 15 (1946).

to define their charter purposes as broadly as they wish.³⁸⁶ There is something to be said, however, for forcing nonprofits to resist this temptation. The reason for this is simply that the narrower the statement of purposes, the more control the patron has over the uses made of his or her money.

Note that narrowly drawn purposes clauses are of far more importance for nonprofit corporations than for business corporations, where they have largely been abandoned in favor of boilerplate language that leaves the organization quite unconstrained.³⁸⁷ The shareholders in a business corporation, for whose protection the corporation's charter is primarily designed, typically all share a common overriding interest in money profits; at best, they have only a secondary interest in having the company remain in any particular line of business, based on their judgment that that particular line appears especially likely to be profitable.³⁸⁸ Patrons of a nonprofit, on the other hand, have a clear and direct interest in the purposes to which the organization is dedicated; someone who contributes to a cancer research institute presumably does not want to discover subsequently that the organization has turned its attention and resources (including his or her contribution) to parapsychology or the performance of pre-Columbian music on original instruments, just as someone who pays to have his or her lawn mowed will generally not be satisfied to receive a haircut instead.³⁸⁹

³⁸⁶ E.g., MODEL ACT, *supra* note 19, § 29(c). Of course, the purposes listed in the charter must fall within the general listing of permissible purposes given in the state's nonprofit corporation statute. See *generally* text accompanying notes 14-116 *supra*.

The Internal Revenue Service insists that nonprofits seeking tax exemption clearly confine their charter purposes to those that fall within the Code's listing of exempt purposes. Thus, in order to qualify for exemption, it is not sufficient that an organization simply confine its actual operation to exempt purposes; the charter must also pledge the organization to such purposes. Treas. Reg. § 1.501(c)(3)-1(b)(1)(i) (1959). Yet the tax code, as it has been interpreted and applied, exempts an enormous range of purposes. Moreover, the Service permits an organization to draft as broad a statement of purposes as it wishes so long as they are all exempt. Treas. Reg. § 1.501(c)(3)-(1)(b)(1)(ii) (1959). As a consequence, the limitations imposed on broad purposes clauses by the Service are not of much help to patrons who may be more particular about the activities that they wish to support.

³⁸⁷ See N. LATTIN, *THE LAW OF CORPORATIONS* § 63 (2d ed. 1971).

³⁸⁸ Investors in a business firm might, to be sure, have preferences for growth versus dividends depending on their tax bracket, or have preferences concerning the riskiness of the organization's activities according to their degree of risk aversion and the composition of the rest of their portfolio. But these are preferences that might well be consistent with having the company switch among any of a broad range of products or lines of business.

³⁸⁹ The currently prevailing doctrine is that a nonprofit corporation's charter, including the purposes clause, can be freely amended by vote of the organization's board of directors or, if they are entitled to vote on such an issue, its members.

Nevertheless, it would undoubtedly be wrong to attribute too much importance to this issue. Patrons generally do not read charters (though the charter statement of purposes could be among the items that a nonprofit is required to disclose and publicize) nor understand their legal significance. Further, a narrow statement of purposes carries the compensating disadvantage of inflexibility in the face of changing needs and circumstances. And finally, it would be necessary to rely on judicial or administrative discretion to determine whether a given statement of purposes is sufficiently narrow, with the consequence that the requirement might be capriciously applied or, more likely, yield constantly to the efforts by corporate counsel to undercut the requirement by drafting as general a statement as possible, thereby rendering the requirement vacuous.

B. *Public Reports*

There is much to be said for mandating that nonprofits publicize the nature and finances of their operations through (1) periodic reports available to interested members of the public,³⁹⁰ and (2) special statements targeted at individuals who are solicited to become patrons.³⁹¹ Such a flow of information can assist individuals in deciding which nonprofits to patronize in the first place, and in policing nonprofits of which they are already patrons. The motivation for disclosure in this context is therefore much the same as in the case of business corporations, where the dissemination of information to investors and potential investors has long been required by the federal securities laws.³⁹² It is important to remember, however, that where nonprofits are concerned it is not investors, but rather patrons, who need to be protected, and that the needs of patrons are not quite the same as those of investors. In particular, patrons are in special need of detail concerning both the

See, e.g., MODEL ACT, *supra* note 19, § 34. If narrowly drawn purposes clauses are to be insisted on for the sake of providing some assurance to patrons, then obviously such power to amend would need to be curtailed. One approach might be to require judicial approval for any change of purpose, *see, e.g.,* N.Y. NOT-FOR-PROFIT CORP. LAW § 404 (McKinney 1970 & Supp. 1979) (doing just this for type B and C nonprofits), and to apply to such changes a form of *cy pres* doctrine similar to that which is commonly applied to charities that seek to divert their assets to purposes not within the intention of the donor. *See* text accompanying notes 265 & 266 *supra*.

³⁹⁰ *Cf.* Securities Exchange Act of 1934 (as amended), § 13, 15 U.S.C. § 78m (1976 & Supp. III 1979) (requiring annual reporting by certain corporations).

³⁹¹ *Cf.* Securities Act of 1933 (as amended), § 5, 15 U.S.C. § 77e (1976) (requiring prospectuses to be given to public offerees of a new issue of securities).

³⁹² *See* notes 390 & 391 *supra*.

purposes for which the nonprofit uses its income and the financial arrangements concerning controlling individuals that might involve excessive compensation or self-dealing.

1. State Disclosure Requirements

Many states already impose disclosure requirements of some form on at least a subclass of nonprofits. The statutory source of such requirements is generally a charitable trust statute, a solicitation statute, or the state's nonprofit corporation act.

At present, most of the states have charitable trust statutes,³⁹³ often patterned after the Uniform Supervision of Trustees for Charitable Purposes Act.³⁹⁴ These statutes typically require that charities register with the attorney general and file periodic financial reports. Occasionally, the statutes provide that the financial reports are available for public inspection, though this right is usually placed within the discretion of the attorney general. In any case, no requirement generally exists that such reports be made available by the charity to private individuals, or even that patrons or other persons dealing with the charity be given notice of their existence. Moreover, these statutes are all confined to organizations that are "charitable" in nature, and thus do not apply to nonprofits that do not fall within that category. Also, most of the statutes exempt various broad classes of organizations from their coverage, such as religious organizations, educational organizations, hospitals, or homes for the aged. Finally, in a few cases, the statutes do not clearly apply to charities that are organized as corporations rather than as charitable trusts.

Statutes regulating charitable solicitation have also been enacted in a majority of the states.³⁹⁵ Typically, these statutes require, *inter alia*, that an organization soliciting funds for charitable purposes register with state officials and provide some form of financial report. Like the charitable trust statutes, the solicitation statutes are commonly confined to charitable organizations, and

³⁹³ An extensive survey of state charitable trust statutes is presented in *Status of State Regulation*, *supra* note 319, at 2712-52. See also CHARITABLE FOUNDATIONS, *supra* note 57, at §§ 683-688.

³⁹⁴ UNIFORM SUPERVISION OF TRUSTEES FOR CHARITABLE PURPOSES ACT, reprinted in [1954] HANDBOOK OF THE NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS 169-72, also reprinted in 9C UNIFORM L. ANN. 210-15 (1957). See also CHARITABLE FOUNDATIONS, *supra* note 45, at § 684.

³⁹⁵ A survey and discussion of charitable solicitation statutes appears in *Status of State Regulation*, *supra* note 319, at 2752-63. See also CHARITABLE FOUNDATIONS, *supra* note 45, at §§ 740-756.

also generally contain broad exemptions for religious and educational organizations, and often for other types of organizations as well. Further, although the reports that must be filed are sometimes given the status of public documents, the statutes generally provide no simple mechanism by which patrons can gain access to them. New York is among the rare exceptions; in that state, a charitable organization covered by the statute must include in its solicitation literature a statement that, on request, a person may obtain from the organization a copy of its last annual report, and the organization must respond to such requests within fifteen days.³⁹⁶

Finally, although most nonprofit corporation statutes are silent on the subject, there are a few that make some provision for disclosure. The recent New York and California statutes are in this latter category. Although these two statutes do not generally require financial disclosure from nonprofits to individuals or even to state officials, they do require that annual financial reports be made available to members of nonprofits.³⁹⁷ Here, as elsewhere, these statutes apparently take their inspiration from the business corporation statutes, and treat members as analogous to shareholders.

2. Federal Disclosure Requirements

Federal tax law imposes further disclosure requirements on nonprofits. With some exceptions, most notably for certain religious organizations, all organizations that are exempt from federal income taxation must file an annual return giving income and expenditures, a balance sheet, and identification of all officers, directors, and substantial contributors, together with any compensation or other payments received by such individuals from the organization.³⁹⁸ These annual returns are public, except for the names of contributors, and can be inspected at the offices of the IRS.³⁹⁹

In addition to the annual return, organizations classified as private foundations must file an annual financial report with the IRS.⁴⁰⁰ This report, like the annual return, is available for public

³⁹⁶ N.Y. EXEC. LAW § 174-b (McKinney Supp. 1980).

³⁹⁷ CAL. CORP. CODE §§ 6321, 8321 (West Supp. 1980); N.Y. NOT-FOR-PROFIT CORP. LAW § 519 (McKinney Supp. 1979).

³⁹⁸ I.R.C. § 6033(b); Treas. Reg. § 1.6033-2, T.D. 7551, 1978-2 C.B. 318.

³⁹⁹ I.R.C. § 6104(b); Treas. Reg. § 301.6104-2, T.D. 7350, 1975-1 C.B. 370. Applications for exemption are also made public. I.R.C. § 6104(a)(1)(A). Treas. Reg. § 301.6104-1, T.D. 7350, 1975-1 C.B. 370.

⁴⁰⁰ I.R.C. § 6056(b)(1)-(10); Treas. Reg. § 1.6056-1, T.D. 7290, 1973-2 C.B. 396.

inspection at the offices of the IRS.⁴⁰¹ The report must also be made available for public inspection at the foundation's principal office, and a notice announcing this fact must be published in a newspaper of general circulation.⁴⁰² These reports must contain detailed information concerning income and expenditures, as well as balance sheets. Disclosure concerning possible self-dealing and conflicts of interest, however, is limited to identification of the foundation's managers and substantial contributors, a listing of grants made to such persons, and a listing of any substantial investment of the foundation's assets in enterprises with which such persons are associated.⁴⁰³

3. Toward More Comprehensive Disclosure Rules

This existing patchwork of disclosure legislation suffers from several significant defects.

First, there is no reason to restrict the coverage of such legislation to "charitable" organizations. As I have argued repeatedly above, all nonprofit organizations should be held to the same rigorous fiduciary standards, regardless of the activities they undertake. Patrons of nonprofit symphony orchestras, day care centers, or political organizations should not be given a lower degree of protection via disclosure than are patrons of the Red Cross, even though the former organizations may fail to be classified as charities. Similarly, the broad exemptions commonly given to religious and other types of organizations are indefensible on any principled grounds. It might be objected that extending public disclosure even to private clubs would be an unnecessary invasion of privacy. Yet in this context, as in others, if private clubs wish to avoid the rigorous fiduciary standards appropriate for nonprofits, they should perhaps just be left the option of incorporating as cooperatives instead.⁴⁰⁴

Another difficulty is that the various reports required under the existing disclosure legislation often are not readily available to members of the public, if they are made public at all. The more comprehensive of the solicitation statutes, both existing and proposed, partially remedy this by recognizing the special need for providing information to individuals solicited for contributions. Even so, the similar needs of patrons solicited by commercial

⁴⁰¹ I.R.C. § 6104(d); Treas. Reg. § 301.6104-2, T.D. 7350, 1975-1 C.B. 370.

⁴⁰² I.R.C. § 6104(d); Treas. Reg. § 301.6104-4 (1971).

⁴⁰³ I.R.C. § 6056(b)(7), (9), (10); Treas. Reg. § 1.6056-1, T.D. 7290, 1973-2 C.B. 396.

⁴⁰⁴ See text accompanying notes 311-15 *supra*.

rather than donative nonprofits—as, for example, through advertisements directed at potential customers of nursing homes, day care centers, and health maintenance organizations—continue to be ignored. There should be provision for adequate disclosure to patrons of all types of nonprofits.

Finally, the type of information required and the format in which it must be presented vary from state to state and, within a jurisdiction, from statute to statute, and are generally not subject to uniform accounting principles.⁴⁰⁵

For all these reasons, it would be wise to supplement or replace the existing patchwork of reporting and disclosure legislation with a simple and universal requirement that all nonprofit organizations beyond a certain minimum size, whether organized as trusts or as corporations, whether charitable in their purpose or not, and without exemption for religious, educational, or any other purposes, must prepare and make public, at the very least, an annual financial statement giving a detailed account of income and expenditures, a description of the activities supported by the expenditures, and full disclosure of any transactions or investments involving the organization in which controlling persons have an interest.⁴⁰⁶ Such statements should be filed with the state attorney general and other appropriate agencies, such as the state department of health in the case of nursing homes, or the state council on the arts in the case of subsidized arts organizations. Organizations that solicit contributions or advertise their services for sale should be required to mail copies of the statements to members of the public who request them. In those situations in which it would be inexpensive to do so, such as large scale mailings soliciting contributions, and perhaps all advertisements and brochures for abuse-prone industries such as nursing and retirement homes, the nonprofit should be required to make a public declaration of the availability of such materials. For other nonprofits it may be sufficient, as under the current Internal Revenue Code provisions concerning private foundations, for such reports simply to be kept available for inspection at the organization's principal office.

Establishment of such requirements at the state rather than the federal level would have the advantage of permitting coverage of

⁴⁰⁵ See Accounting Advisory Committee, *A Study of the Inadequacies of Present Financial Reporting by Philanthropic Organizations*, in 5 COMMISSION ON PRIVATE PHILANTHROPY AND PUBLIC NEEDS, RESEARCH PAPERS 2869 (1977).

⁴⁰⁶ This is not intended to be an exhaustive list of what should be disclosed. The items given are merely the minimum necessary for adequate policing of the nondistribution constraint.

all nonprofits without difficulty; it might be awkward to establish a jurisdictional hook that would permit federal legislation to be similarly comprehensive. Nevertheless, the simplicity of securing one federal enactment rather than fifty state enactments, and the generally stronger level of expertise in federal bureaucracies, make a federal approach attractive. For example, establishing such disclosure requirements as a condition of federal tax exemption would, though leaving some (nonexempt) nonprofits unaffected, still cover most substantial nonprofits. It would also make use of an existing enforcement agency that is experienced and capable, and would involve only a modest extension of the reporting and disclosure requirements already imposed by the tax code. In any case, simultaneous federal and state efforts in the direction suggested need not conflict, particularly if efforts are made to ensure uniformity in the content and format of the disclosure statements involved, and both should be encouraged.⁴⁰⁷

VIII. TOWARD UNITARY AND RIGOROUS STANDARDS

In a misguided effort to meet the perceived needs of different types of nonprofit organizations—needs that, as it turns out, either have no legitimate basis, or could better be met through a well-designed cooperative corporation statute—nonprofit corporation law is today weak and fragmentary. In some cases, as with the Model Act, the law has tended to follow a lowest common denominator approach, applying to nearly all types of nonprofits the same minimal standards that have been thought appropriate for those organizations toward which the law should be most permissive. In other cases, as with the New York and California statutes, the law has proceeded to apply different standards to different types of nonprofits, with only slightly more satisfactory results.

⁴⁰⁷ The preceding discussion has focused primarily on the need for disclosure to help police the overall operations of nonprofit organizations. Special abuses have arisen, however, in the process of soliciting contributions itself. These problems include excessive payments to individuals or proprietary firms that manage a solicitation drive on behalf of a nonprofit and the undertaking of solicitations where it is reasonably clear in advance that a large fraction of the funds received will be necessary to pay the costs of the solicitation, with only a small portion left over to devote to the purposes described in the appeal for contributions.

Such problems have been the principal focus of much of the solicitation legislation that has been adopted at the state and local levels and proposed at the federal level. See Ginsburg, Marks & Wertheim, *Federal Oversight of Private Philanthropy*, in 5 COMMISSION ON PRIVATE PHILANTHROPY AND PUBLIC NEEDS, RESEARCH PAPERS 2575, 2644-58; *Status of State Regulation*, *supra* note 319, at 2752-73. This is an appropriate subject for concern. But it is important not to confine attention just to the solicitation process; disclosure rules should serve the broader functions discussed above as well.

I have suggested here, in contrast, that nonprofit corporation law should be both unitary and rigorous. All nonprofit corporations should be held to the same strict standards of fiduciary conduct toward their patrons. So long as nonprofit corporations are held to such standards, there should be no restrictions on the purposes that they may serve. There should be, in particular, no provision for special standards applicable to organizations that are classified as charitable, and the appeals that have been made, sometimes prominently, for a separate organizational law of charities should be rejected.⁴⁰⁸ Rather, if there is any continuing role for the concept of charity in the law of nonprofits, that role lies primarily in demarcating a class of nonprofits that provide services (including redistribution of wealth) that are perceived as public goods⁴⁰⁹ by a large segment of the public, and that are therefore deserving of public subsidies, such as that which is provided by the charitable deduction in the federal income tax.

There are, of course, a number of issues in the organizational law of nonprofits, such as the application of the securities laws and of the bankruptcy laws,⁴¹⁰ that have not been considered here, and that merit further study. Some of what has been said above may prove helpful in approaching these subjects. But there is no need to await resolution of such issues before proceeding with the simpler and more urgent task of clarifying and reforming the essential features of the corporate law.

⁴⁰⁸ See M. FREMONT-SMITH, *supra* note 217, at 42-43, 435; Karst, *supra* note 326, at 436, 476-83. I am, of course, in sympathy with the view, expressed by both Karst and Fremont-Smith, that the fiduciary standards applicable to nonprofit corporations serving charitable purposes be strengthened and brought more in line with the standards applicable to charitable trusts. I part ways with these authors, however, in their apparent feeling (more implicit than explicit, as for the most part they, like many other writers in this field, generally speak just of "charities" without relating their discussion to nonprofit entities that are not charities) that the standards applicable to charities, whether incorporated or formed as trusts, should be stricter than those applicable to other nonprofit corporations.

A role presumably remains for a separate law of charitable trusts, and in particular for the limitation of enforceable charitable trusts to purposes that are deemed charitable. The reason for this is that the charitable trust is accorded unusual privileges—most notably, the ability to serve as a vehicle by which assets may be dedicated to a particular purpose in perpetuity—that are appropriately limited to purposes that clearly serve the public interest. The rationale for confining the charitable trust form to purposes deemed charitable is therefore much the same as that for using the concept of charity to set boundaries to various explicit governmental subsidies. See text accompanying note 409 *infra*.

⁴⁰⁹ I use the term "public good" here in the economist's sense. See note 7 *supra*.

⁴¹⁰ Large though vaguely defined classes of nonprofits are exempted from federal securities regulation, 15 U.S.C. § 77c(a)(4) (1976), and from the involuntary bankruptcy provisions of the federal Bankruptcy Code, 11 U.S.C. § 303(a) (Supp. III 1979).