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Another Theory of Nonprofit Corporations

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ANOTHER THEORY OF NONPROFIT CORPORATIONS†

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There is a movement afoot to reform nonprofit corporation laws. Though long neglected by both draftsmen and legal scholars, this subject recently has attained greater prominence. California's new nonprofit code, enacted in 1979, was a major departure from prior laws.[1] An American Bar Association committee is rewriting the Association's Model Nonprofit Corporation Act.[2] At the same time, Professor Henry Hansmann has offered the first comprehensive rationale for the existence of nonprofits, a rationale intended to guide current law reform efforts.[3] His two lengthy articles dominate the field and establish the topics for discussion. Those articles build a theory that explains the existence of all nonprofit corporations by reference to the concept of "contract failure," a special circumstance that arises when consumers are "incapable of accurately evaluating the goods promised or delivered,"[4] thus rendering "ordinary contractual services inadequate to provide the purchaser of the service with sufficient assurance that the service was in fact performed as

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1. CAL. CORP. CODE §§ 5000-9927 (West 1981).

2. Michael Hone, the principal draftsman of the California law, is now the reporter to the ABA Committee. The author worked full time with Professor Hone, as co-draftsman, from the beginning of the California project through the completion of the first exposure draft, and was, therefore, a substantial contributor to the final product. Some affinity for the California approach might therefore be expected, if not excused.

3. Hansmann, *Reforming Nonprofit Corporation Law*, 129 U. PA. L. REV. 497 (1981) [hereinafter cited as *Nonprofit Corporation Law*]; Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835 (1980) [hereinafter cited as *Nonprofit Enterprise*].

4. *Nonprofit Enterprise*, *supra* note 3, at 843.

desired."[5] This difficulty typically arises from the nature of the service rather than from the nature of the consumer.[6] In developing this theory, Hansmann treats as the nonprofit's "consumers" all who transfer money to it, whether they are donors or customers. He calls this aggregated class "patrons."[7] Donors to CARE and to a university are thus "patrons," as are the students paying tuition and the dues-paying members of a nonprofit club or trade association.

Approaching the topic from an economic perspective, Hansmann sees no reason to distinguish donors and customers, for both in fact enter into an exchange: The donor expects some result from his contribution, whether it is an increase in food to the poor or opera to the cultured. From these assumptions, he develops a model for a nonprofit law structured to meet the need of patrons to overcome contract failure.

This Article argues that the distinction between donors and customers is critical, and that the contract failure model is therefore seriously flawed. It distinguishes two types of nonprofit corporations — those structured to satisfy donors' needs ("donative nonprofits") and those structured to satisfy customers' needs ("mutual benefit nonprofits"). This dichotomy suggests a very different nonprofit corporation law than the one urged by Hansmann. Once the concept of contract failure is limited to donors, it can be refined to serve as part of the rationale for donative nonprofits. Refining the concept of contract failure reveals, however, that it confuses the analysis of mutual benefit nonprofits, which actually solve a different problem for customers and thus require a different corporate structure.

The demography of nonprofit corporations might be unfamiliar to many readers. While the layman, and even the lay lawyer, often equates "nonprofit" with "charitable," only some nonprofit corporations are charitable in the usual sense of that term. Social clubs, trade organizations, and consulting companies, among others, are also formed as nonprofit corporations.[8]

The first Part of this Article places the discussion in context by outlining the purposes of a nonprofit corporation law. The second Part summarizes the Hansmann, or "contract failure," theory. The third Part develops an alternative theory and contrasts it with the

5. *Nonprofit Corporation Law*, *supra* note 3, at 504.

6. *Id.* at 505-07.

7. *Id.* at 502-03.

8. In California alone, it was estimated in 1978 that there were 62,000 nonprofit corporations. Nida, *Membership Lists: Balancing the Interests Between Use and Abuse*, 13 U.S.F. L. Rev. 797 (1979).

Hansmann thesis, considering first the donative nonprofits and then the mutual benefit nonprofits.

I. The Function of a Nonprofit Corporation Law

A nonprofit corporation code provides only a portion of the law applicable to nonprofit corporations, but that portion presents a distinct range of questions. Most of the benefits that the law typically confers on nonprofit organizations, such as income tax exemptions, eligibility for tax deductible contributions, special mail rates, and property tax exemptions, are provided by laws other than the nonprofit corporation codes. These laws usually set their own standards and do not treat incorporation as a nonprofit as determinative.[9] An organization may qualify as tax exempt without being incorporated at all, and certainly one may be incorporated as a nonprofit but fail to qualify for exemption.[10] Issues such as tax subsidization are certainly important and have received their share of attention,[11] but they are tangential to the corporation law issues and need not be addressed in developing a theory of nonprofit corporation law. The policy issues dealt with by a nonprofit corporation code can be considered in isolation from the package of benefits provided elsewhere.

A corporation code deals principally with rules of internal governance. Such rules are made necessary by incorporation: If the law is to recognize the existence of a new kind of "person," it must offer some means to distinguish between legitimate actions taken on that "person's" behalf and unauthorized assertions of authority. This is necessary both for internal purposes — *e.g.,* establishing who has authority to decide that membership fees should be increased — and for dealing with third parties — *e.g.,* establishing who has authority to commit the corporation to the purchase or sale of property. Some of the rules in the code are designed to apply only when internal corporate documents fail to resolve the dispute. (May the contested action be taken by the president alone, or did it require board approval? Was a majority vote of the board sufficient, or was a vote of the members required?) A court may fill the gaps in the documents by using either a judge-made or a statutory rule. Where there is no statute, the court may draw inferences from the articulated internal

9. Hansmann does an excellent job of surveying many of the other laws that set rules with particular application to nonprofit corporations. *Nonprofit Corporation Law*, *supra* note 3, at 519-52.

10. *See* B. Hopkins, The Law of Tax Exempt Organizations (3d ed. 1979), for a discussion of the tax code requirements.

11. *See* Bittker and Rahdert, *The Exemption of Nonprofit Organizations from Federal Income Taxation*, 85 Yale L.J. 299 (1976), and authorities cited therein.

agreement, as it appears in corporate articles, bylaws, or in other documents reflecting the understanding of the parties.[12] While an initial examination may establish that the agreement is silent on the question of whether a vote of the members is required before a particular action could be taken, parts of the agreement may indicate persuasively that such a vote was reasonably expected.[13] This kind of gap filling is no more than what courts ordinarily do; it is certainly appropriate, but it does not require an elaborate corporation law. If no more than this were needed, our corporation law could be limited to two sections: one requiring enforcement of contracts and internal agreements, and a second authorizing judicial gap filling. There are, however, four needs that statutory rules can fill that our two section law would not satisfy. These are taken up in order below.

A. *Needlepoint*

Every corporation code includes some sections that merely facilitate the paper shuffling involved in the creation, registration, and dissolution of corporations. There are rules that specify the methods by which articles are filed, fees are paid, and agents for service of process are designated. Such needlepoint rules are necessary, but they can easily be borrowed from state business corporation statutes. Since they raise no important policy issues, this Article will not deal with them.

B. *Statutory Gap Filling*

Statutory rules can, to some extent, relieve the courts of the chore of particularized gap filling. Often, a general rule sacrifices no particularized justice: The judge could not tailor the decision to the parties' probable intent because the agreement in question offers so little

12. Ellman, *Driven from the Tribunal: Judicial Resolution of Internal Church Disputes*, 69 CALIF. L. REV. 1378, 1422-28 (1981).

13. In addition to the cases cited in Ellman, *supra* note 12, see Jessie v. Boynton, 372 Mass. 293, 361 N.E.2d 1267 (1977). In *Jessie*, the court found that management's conduct of a membership meeting might have violated fiduciary duties to the membership, thereby invalidating certain amendments to the corporate bylaws adopted at that meeting. The court implied that the content of management's fiduciary duty could be found by looking to the existing governing structure adopted by the corporation and set out in its internal documents. A nonprofit corporation need not have voting members at all; it can lodge governing authority entirely within the board of directors. Thus, there can be no general rule of corporate law requiring board members to adhere to defined democratic processes in internal governance. Nonetheless, where the internal agreement does vest some governance authority in a broadly based membership operating under normal democratic principles, the courts should infer a requirement that the conduct of membership meetings must comply with certain generally accepted democratic principles. In so doing, the court is filling in the details of the parties' agreement in a manner that is consistent with the articulated portions of the agreement.

guidance that he can only rely on general principles. General statutory rules are best used to deal with situations in which there can be some consensus as to an acceptable approach. Most people expect, for example, that the majority prevails in a vote of the members, at least absent an alternative agreement; few would object to a law that so provides. Such rules reduce uncertainty. If a dispute arises, the parties or their lawyers can look to the statute for an answer. The parties might still argue over whether an agreement between them overrides the rule, but at least they will know which rule applies absent an agreement. Because nonprofit organizations are notorious for their informal organizational arrangements and incomplete recordkeeping, the existence of such statutory rules of thumb can be very helpful.

C. *Value-Based Rules*

A third function of a corporation code is to impose upon the internal operation of the corporation certain rules to which it must adhere, regardless of any internal agreements to the contrary. Such value-based rules, like the gap-filling rules, result in part from the need to formalize the entity's structure. For example, the code might require every corporation to have a board of directors with certain powers, simply to allow third parties to identify conveniently the people authorized to make certain decisions.[14] Value-based rules can also be judge-made. For example, the courts have specified procedural safeguards that must be followed before a member of a nonprofit corporation may be expelled, to ensure a minimal level of procedural fairness in the conduct of corporate affairs.[15] There are code rules with similar functions. Some codes, for example, contain rules regarding the conduct of membership meetings, board meetings, or elections.[16] Value-based rules like these are really the corporate equivalent of consumer protection legislation.

D. *Defining Rules*

Like value-based rules, defining rules are also mandatory; they

14. *E.g.*, AMERICAN BAR ASSOCIATION, MODEL NONPROFIT CORPORATION ACT § 17 (1964).

15. Such cases are almost too numerous to mention. The classic article is Chafee, *The Internal Affairs of Associations Not for Profit*, 43 HARV. L. REV. 993 (1930). A more recent and more voluminous collection of cases can be found in *Developments in the Law — Judical Control of Actions of Private Associations*, 76 HARV. L. REV. 983 (1963).

16. The new California law contains both a section setting minimum procedural standards for expulsions and one on the election of directors. CAL. CORP. CODE §§ 5341, 5520-26, 7520-26 (West 1981).

differ from value-based rules, however, in that their function is to establish the essential characteristics of the organization for which the code is drafted. They are the axioms of the statutory scheme, providing the fundamental principles that guide our choices concerning the other three kinds of rules. The shareholders of a business corporation are not given limited liability because that result is so compellingly just. The reason is rather the perceived societal need for a form or organization in which owner-investors have limited liability. The premise is that there are socially desirable activities that can be facilitated by the existence of an organizational alternative to business partnerships. A good set of defining rules establishes a distinctive form of organization that has some functional advantage in certain circumstances — a form of organization that would have "buyers."

This analysis conceives of a corporation code as a means by which to facilitate activity. Antisocial activity will be regulated by law regardless of the organizational form used to pursue it. Even though it may have a number of mandatory rules, therefore, the corporation code is not regulatory in its essential purpose. Instead, we use the code to create a legal structure that is useful as a vehicle for a particular type of legitimate activity. In a jurisdiction with well-drafted laws, organizers should have little difficulty in choosing among the organizational alternatives, and every group of individuals pursuing a lawful activity should be able to find a form of organization that meets its needs: an organization whose defining rules fit the group's *raison d'être*, whose gap-filling rules tend to meet the participants' expectations, and whose value-based rules help to protect both the participants and third parties from abuses of the organizational form.

In the next Part, I examine the Hansmann thesis, focusing on the defining rules that he advocates. These defining rules are exceptionally important because they form the basis of the entire structure of nonprofit corporation law that Hansmann would advocate. Hansmann's defining rules would subject all nonprofit corporations to a variant of the strict trust law standards in their handling of corporate property. The remainder of this Article examines the Hansmann approach and offers a functionally superior alternative.

II. The Contract Failure Theory

At one time most nonprofit laws limited the purpose for which a nonprofit corporation could be formed, and that restriction alone made nonprofit corporations distinctive. But the law has begun to move away from such restrictions, toward an approach that would permit use of the nonprofit form by any group that sees its activities as compatible with that structure.[17] Although few viewed it this way, once the purpose limits were repealed, the problem was to identify the defining rules establishing a legal structure distinctively suitable for the organizations that had traditionally gone under the label "nonprofit." Yet because the law had relied upon restrictive purpose clauses to give nonprofit corporations their distinctive identity, little thought had been given to whether the nonprofit laws did, or should, establish a distinctive internal structure for nonprofits.

Even before Hansmann's work, commentators had observed that nonprofit corporation laws typically bar the issuance of dividends to members.[18] Although this no-dividend rule had been offered, in effect, as the defining rule of nonprofit corporations, no one before Hansmann had seriously examined it. He offers an extensive theory of nonprofits, using the no-dividend rule as the defining feature.

To permit the rule to carry this burden, Hansmann expands it beyond its traditional scope. He assumes that the purpose of the dividend ban is to prevent "the distribution of net earnings to controlling individuals."[19] Yet because controlling individuals could gain access to the corporation's earnings through many methods other than the issuance of dividends, such as excess compensation, self-dealing transactions, or the distribution of assets upon dissolution, Hansmann urges that the no-dividend rule be "refined" to prohibit these and all other potential strategies of "abuse."[20] In effect, Hansmann takes many of the trust law's traditional rules, such as the absolute ban on self-dealing transactions, and argues that they should be part of a "complete" no-dividend rule. The result would be to tighten standards considerably, perhaps beyond even the level of traditional trust law, and to expand traditional rules on standing to raise claims of defalcation.[21]

While Hansmann's expanded no-dividend rule would be a major

17. For discussion of this shift in the purpose requirements imposed by nonprofit corporation laws, *see* Note, *Nonprofit Corporations — Definition*, 17 VAND. L. REV. 336 (1963) [hereinafter cited as Vanderbilt Note]; Note, *Permissible Purposes for Nonprofit Corporations*, 51 COLUM. L. REV. 889 (1951) [hereinafter cited as Columbia Note].

18. *See* Columbia Note, *supra* note 17; Vanderbilt Note, *supra* note 17.

19. *See Nonprofit Corporation Law, supra* note 3, at 553.

20. *See generally*, *id.* at 553-79.

21. A good exploration of the state of the law on charitable corporations, still largely accurate, is Karst, *The Efficiency of the Charitable Dollar: An Unfulfilled State Responsibility*, 73 HARV. L. REV. 433 (1960). *See generally* M. FREMONT-SMITH, FOUNDATIONS AND GOVERNMENT (1965); A.B.A Committee, *Duties of Trustees and Directors of Charitable Corporations*, 2 REAL PROP. PROB. & TR. J. 545 (1967).

addition to the nonprofit corporation law as such, the actual effect of the rule would vary among different nonprofits. Nonprofits that are considered charitable are usually already required to adhere to traditional trust rules, while others, like trade associations, are not.[22] This differing treatment under existing law does not arise from nonprofit corporation codes, which generally do not impose traditional trust rules. It derives instead from other sources, such as tax and charitable trust law, which impose their own requirements selectively on those nonprofits that are considered charitable.[23] Hansmann's rules do differ from traditional trust rules in some details, at least one of which is important enough to warrant extended discussion below,[24] but most charitable nonprofits are already required to comply with most of what he advocates. For the noncharitable nonprofits, however, the change would be dramatic.[25]

22. *See* People v. Larkin, 413 F. Supp. 978 (N.D. Cal. 1976); Lynch v. Spilman, 67 Cal. 2d 251, 431 P.2d 636, 62 Cal. Rptr. 12 (1967); *In re* Los Angeles County Pioneer Socy., 40 Cal. 2d 852, 257 P.2d 1 (1953); Younger v. Wisdom Socy., 121 Cal. App. 3d 683, 175 Cal. Rptr. 542 (1981); Gbur v. Cohen, 93 Cal. App. 3d 296, 155 Cal. Rptr. 507 (1979); Lynch v. John M. Redfield Found., 9 Cal. App. 3d 293, 88 Cal. Rptr. 86 (1970); Eurich v. Korean Found., Inc., 31 Ill. App. 2d 474, 176 N.E.2d 692 (1961); Louisa York Orphan Asylum v. Erwin, 281 A.2d 453 (Me. 1971). The most commonly cited case to the contrary is Stern v. Lucy Webb Hayes Natl. Training School, 381 F. Supp. 1003 (D.D.C. 1974), which was followed in Midlantic Natl. Bank v. Frank G. Thompson Found., 170 N.J. Super. 128, 405 A.2d 866 (1979). These last two cases apply the more lax corporate law rules on conflicts of interests to directors of charitable corporations.

23. The cases cited in note 22 *supra* relied on trust law. The new California nonprofit corporation law is unusual, in that it explicitly addresses this question. For public benefit corporations, a category that overlaps the traditional category of charitable corporations to a great extent, the California law adopts a standard for self-dealing transactions that is considerably stricter than the business corporation standard, although it does permit approval of transactions involving conflicts of interests where proponents of the transaction prove, for example, that the transaction is fair. CAL. CORP. CODE § 5233 (West 1981). *See* Abbott & Kornblum, *The Jurisdiction of the Attorney General Over Corporate Fiduciaries Under the New California Nonprofit Corporation Law*, 13 U.S.F. L. REV. 891, 897 (1979). Cases also arise under the tax law where the corporation has sought eligibility to receive tax deductible contributions. Such eligibility requires not only that the corporation be "charitable" but also that it be organized to serve a public rather than a private interest. Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii) (1981) and § 53.4941(d)-2(f)(2) and (4). If the nonprofit organization fails to comply, the most common result is revocation of the favorable tax status, *see, e.g.*, Unitary Mission Church v. Commr., 74 T.C. 507 (1980); Best Lock Corp. v. Commr., 31 T.C. 1217 (1959). Reliance on the tax law to enforce such fiduciary obligations is problematical. *See* Karst, *supra* note 21, at 437-43. The tax law imposes additional and considerably more stringent rules upon those charitable corporations which are considered private foundations. I.R.C § 4940-4948.

24. Hansmann departs from the existing trust law in viewing the management of nonprofit corporations as owing some special duty to all "patrons," which includes purchasers. *See* Part III, Section A(3) *infra*.

25. There are only a handful of cases on fiduciary duties in noncharitable nonprofits, but they do generally rely on business corporation law rather than trust law. *See* Avila South Condo. Assn., Inc. v. Kappa Corp., 347 So. 2d 599 (Fla. 1977); Milton Frank Allen Publications, Inc. v. Georgia Assn. of Petroleum Retailers, Inc., 224 Ga. 518, 162 S.E.2d 724 (1968), *cert. denied*, 393 U.S. 1025 (1969). The new California nonprofit corporation law adopts a special conflict of interest rule for public benefit corporations (which are analogous to charitable corporations), while adopting the business corporation rule for mutual benefit corpora-

To understand that change, one must compare traditional trust rules with business corporation rules. There are a number of differences in their treatment of self-dealing transactions — deals between the corporation and its directors. In the business corporation, unlike the trust, an otherwise offending transaction between the corporation and its directors can be sustained if it is shown to be fair to the corporation.[26] A number of cases suggest that shareholder approval of a self-dealing transaction will immunize it from attack on mere unfairness grounds, leaving it voidable only if fraud or waste[27] are shown, and some cases suggest that even fraud may be ratified.[28] In 1975, California amended its business corporation law to provide that a self-dealing transaction need be shown "just and reasonable" only when there has not been shareholder ratification.[29]

In some cases it seems quite sensible to give shareholders of business corporations the final word on disputed transactions. Certainly in a close corporation, with involved and informed shareholders, a vote by disinterested shareholders to approve a transaction between the corporation and a director should not be vulnerable to a court ruling of unfairness. We should rely on the shareholders to protect their own interests. Exceptions may be appropriate where shareholder approval is not unanimous and where the transaction is so extremely unbalanced as to amount to a gift, or to a waste of corporate assets. Such lines may, of course, be difficult to draw.

But in any event, the same issues do not arise in the context of the charitable corporation, for there are not the same *a priori* reasons to defer to shareholder decisions. The members of the charitable corporation are the analogue to the shareholders, yet often the members and directors will be the same people. Ratification by members will thus not involve any external scrutiny of the directors' decision. More important, the members have no financial interest at stake to motivate their scrutiny, nor is there the same dearth of public policy

tions. *Compare* the treatment of conflict of interest in CAL. CORP. CODE § 310 (West 1981) (business corporations) *with* that in § 5233 (public benefit nonprofits) *and* § 7233 (mutual benefit nonprofits).

26. *Compare* Fliegler v. Lawrence, 361 A.2d 218 (Del. 1976) (business corporation rule) *with* People v. Larkin, 413 F. Supp. 978 (N.D. Cal. 1976) (application of trust rule to charitable corporation).

27. *See, e.g.*, Schreiber v. Bryan, 396 A.2d 512, 518 (Del. Ch. 1978); Saxe v. Brady, 40 Del. Ch. 474, 184 A.2d 602, 610 (1962) (those attacking the transaction must show either that the shareholder ratification was obtained through misrepresentation, or that "no person of ordinary, sound business judgment would be expected to entertain the view that the consideration was . . . fair").

28. *See* Claman v. Robertson, 164 Ohio St. 61, 128 N.E.2d 429 (1955) (ratifying shareholders must be disinterested and not induced to ratify by misrepresentations).

29. *Compare* CAL. CORP. CODE § 310(a)(1) (West 1981) *with* § 310(a)(2)-(3).

reasons to oversee their decision. To the contrary, since the funds are *not* the members', their ratification is not presumptively determinative. There is good reason for courts to scrutinize the transaction, to protect the interests of both the donors and society generally.

A second difference between corporate and trust law derives from the traditional trust rule requiring charitable organizations to use their funds for their specified charitable purposes. In the context of charitable nonprofit corporations, this rule has been read to bar charitable corporations from applying existing resources to newly adopted purposes.[30] This rule ensures that the donors' contributions will not be applied to a different charitable program than that which they intended to support.[31] Business corporations, on the other hand, can normally amend their articles and change their purposes. There is no reason for the law to bar shareholders from deciding to commit their resources to some newly agreed-upon endeavor. Hansmann does not explicitly address this traditional trust rule, and it is, therefore, not certain that he would argue for its general application to all nonprofit corporations. As discussed below, however, Hansmann is otherwise consistent in arguing that there should be but one set of rules for all nonprofits, and it seems likely that he would insist that all should be governed by a single rule here as well. And the trust rule, rather than the corporate rule, seems more compatible with his theory.

Our brief description of the traditional trust rules suggests why they are sensibly applied to charities, but the traditional explanations would not extend them, as Hansmann would, to remaining nonprofits. Such an extension, therefore, requires additional explanation. Hansmann's explanation is that the rule responds to the phenomenon of "contract failure." He argues that there are certain enterprises in which consumers have special difficulty in ensuring compliance with contract terms. For example, donors to CARE have no practical method by which to determine whether the organization actually supplies food to starving Biafrans. Contract failure can also occur where services are purchased: Hansmann posits that purchasers of child care services share the CARE donors' problem because they have difficulty evaluating the service received. He calls this condition "contract failure" apparently because the inability to evaluate makes it difficult, if not impossible, to effect the donor's or purchaser's desires through ordinary contractual relationships.[32]

30. Queen of Angels Hosp. v. Younger, 66 Cal. App. 3d 359, 136 Cal. Rptr. 36 (1977).

31. Pacific Home v. County of Los Angeles, 41 Cal. 2d 844, 852, 264 P.2d 539, 543 (1953).

32. *See Nonprofit Enterprise*, *supra* note 3, at 843-54.

By using the single term "contract failure," Hansmann obscures the difference between these two examples. But because we shall see below that the difference is critical, it is important at the outset to understand it. The CARE donor's problem lies in monitoring the marginal impact of the dollar he gives. Hansmann refers generally to the donor's difficulty in seeing whether the service he paid for was delivered. Yet even if the donor knows that CARE is providing food to the needy, he will have great difficulty knowing whether it provided any more food to the needy as a result of his particular contribution. Donors can often see that the donee is carrying on the charitable program: The university holds classes and the museum displays art. But the donor cannot tell whether the classes or the art have improved or grown because of his dollar.

This problem never arises in the purchase of a private good delivered to the buyer. The marginal impact of my purchase of a carrot is clear: I now have the carrot. Even where I buy a good to be delivered to another, monitoring is not a problem where the recipient has been specified. I can see the marginal impact of the dollar I gave to the florist: My wife received a rose. But when I give money to CARE to provide food to unspecified third parties, monitoring the marginal impact becomes very difficult. Even if I know that CARE provided food to some needy people, it is virtually impossible for me ever to tell whether any food was delivered on account of *my* dollar. The same problem arises when I give an organization money to provide a "public good." Economists define "public goods" as goods that can be consumed by additional persons with no reduction in consumption by the earlier buyers. It is usually difficult to exclude consumption of public goods by those who do not pay for them. The government provides many public goods, such as national defense, since the market mechanism does not prompt others to provide them. However, some nonprofits provide public goods. Public television programming is one example discussed by Hansmann.[33] When I consume the product by turning on my television, I do not reduce anyone else's opportunity to view, and I can watch the programming without paying. The contract failure experienced by the donor to public television is precisely the same as that experienced by the donor to CARE: It is impossible to monitor the marginal impact of his dollar.

Marginal impact monitoring is not a problem to the purchaser of child care; he can see that his child has been admitted to the nursery.

33. *Id.* at 848-54.

What Hansmann posits is not a marginal impact problem, but a quality-monitoring problem. The buyer has difficulty telling whether the nursery is doing a good job. Hansmann argues that the consequence is the same since in both cases there is a monitoring problem that reduces the utility of contract as a means of ensuring delivery of the desired product. Both are, therefore, examples of "contract failure."

Nonetheless, it is important to distinguish between these two forms of contract failure. In transactions commonly described as "donations," marginal impact monitoring is generally difficult or impossible. In transactions commonly described as purchases, marginal impact monitoring is quite easy. Quality monitoring problems, on the other hand, could arise in both cases. I will have the same difficulty monitoring the quality of service provided by the free health clinic as that provided by my own doctor. With the free health clinic, however, I have the additional problem of marginal impact monitoring — of knowing whether any service at all was provided as a result of my donation, and if so, how much.

Hansmann argues that the expanded no-dividend rule overcomes the transactional obstacles created by both forms of contract failure. Because he cannot monitor compliance with the terms of an agreement, the donor or purchaser relies instead on safeguards inherent in the nonprofit form: the no-dividend rule and the strict fiduciary standards. These safeguards cannot ensure competence — indeed, the absence of a profit opportunity may reduce efficiency. But they do, according to Hansmann, at least provide assurance that the donor's or purchaser's funds will not go to the private gain of the corporation's managers. CARE will not simply pocket the money; the child care provider will not use it to pay inflated salaries or investors' returns. With these possibilities eliminated, there is a greater chance that the funds will be spent to feed the starving or to provide high quality child care.

The premise that nonprofits should be designed to overcome contract failure shapes the corporation law that Hansmann urges. Under Hansmann's theory, the obligations of a nonprofit organization's management are owed not so much to society generally as to the particular donors or purchasers who supply the nonprofit's funds. They are the ones for whose benefit nonprofits are organized; they are the ones who experience "contract failure" and who rely on the nonprofit law to deal with it. Hansmann therefore places these two ordinarily separated classes into a single group that he calls "patrons."

This definition of patron may include purchasers from as well as donors to the same nonprofit. For example, hospital patients are "patrons," so Hansmann would give them standing to raise claims of defalcation, whereas traditional law would grant standing only to the state attorney general and members of the hospital's board. Hansmann's theory suggests, moreover, that substantive claims against the nonprofit can be personal to the patrons. As we shall see below, Hansmann applies the contract failure theory to find a duty to patients which restricts the hospital's right to earn profits on services to them. Traditional charitable trust law, on the other hand, would require the hospital to adhere to the trust purpose, which might be a general one, like providing health care to a certain community. That purpose would usually be found in the hospital's articles of incorporation or in the trust instrument under which the hospital received its founding gift. Such a rule ensures compliance with the expectations of the donors. Beyond adherence to its charitable purpose, traditional trust law would be concerned only with financial irregularities, such as careless or self-interested investment policies.

The principle that duties flow to "patrons" would also affect mutual benefit nonprofits such as social clubs and trade associations. They traditionally have a membership which chooses the board, and to whom the board is responsible. For Hansmann, however, the board of a nonprofit is responsible to its "patrons" and not to its "members."[34] In part to make this point, Hansmann offers an example of a nonprofit health maintenance organization that charges nonmembers more for medical services than it charges members; such a practice would violate Hansmann's proposed fiduciary duty "to assure all of its patrons that the payments they make are being used to

34. The term "member" is used in at least two different ways in the nonprofit world. In the corporate law sense, "member" ordinarily means only those people who, under the organization's internal governing rules, have the right to vote for directors or on other internal matters. *See, e.g.*, CAL. CORP. CODE § 5056 (West 1981). When I use the term "member" in this Article, I mean it in this corporate law sense. Of course, "member" is a term also used less formally, and by for-profit as well as nonprofit organizations. For example, a proprietary athletic club will issue "memberships" that amount to no more than a contractual right to use the club's facilities. In addition, some nonprofit organizations will sell "memberships" as a fundraising device, without conferring on those "members" any internal governance rights in the organization. For example, a charitable organization such as the Cancer Society may in fact be governed entirely by a self-perpetuating board of directors, and have no members (in the corporate law sense) other than the directors themselves. Nonetheless, the public may be asked to purchase "memberships" as a donation, and as a result of such purchases the "members" might receive a pin or other token of their contribution, and may be placed on a mailing list to receive newsletters or other organizational publications. Members in this second, less formal sense have no relationship to the organization other than as contributors.

provide them exclusively with health services."[35]

In focusing so heavily on patrons' personal interests, Hansmann deemphasizes the more general obligations of nonprofit management that traditional trust law would recognize. For example, Hansmann rejects, as a defense of a pricing policy that yields profits on services to some hospital patients, the desire "to subsidize services that have more personal appeal to doctors, such as research or treatment of exotic or difficult cases."[36] Traditional trust law would routinely accept, as serving a legitimate charitable purpose, the allocation of resources to research, or the training of doctors in treatment of "difficult" cases. The hospital, of course, also has the charitable purpose of providing medical care to its patients — Hansmann's "patrons" — but traditional rules would not inquire into management's allocations among its charitable activities. Indeed, traditional trust law would rarely inquire into management's self-interested behavior unless it was *financially* self-interested; there certainly would be no basis for challenging management action on the ground that it emphasizes activities that "appeal" to the doctors.

The contract failure theory is simple and elegant, a particularly effective combination in a previously theory-less field with an incredibly diverse range of organizations. That elegance, however, is purchased by collapsing donors and buyers into the single category of patrons, donatives and mutual benefits into nonprofits, and marginal-impact and quality-monitoring problems into contract failure. This aggregation invites general statements that seem correct only because the language employed obscures important differences among the concepts. Part III reveals this difficulty by unpacking these terms. It starts by looking at donative nonprofits and then proceeds to consider mutual benefits.

35. *See Nonprofit Corporation Law, supra* note 3, at 559. Hansmann's example presumes a "membership controlled health maintenance organization" in which admission to membership requires the "acquiescence of the existing members." *Id.* Of course, the patient-members of the typical health maintenance organization are not members at all in the corporate law sense, but merely purchasers of a particular form of health insurance. Thus, they never vote on anything, not even the selection of the organization's management. The type of organization that Hansmann envisions is what I will subsequently describe as a mutual benefit nonprofit corporation, in which formal control over the organization's management is lodged in its customers. Social clubs would be a typical example. In such an organization excessive sales to nonmembers would present a problem, but it would not be Hansmann's asserted problem of violation of the nondistribution constraint or of management's fiduciary duties to its patrons. *See* text at notes 92-96 *infra*.

36. *Nonprofit Corporation Law, supra* note 3, at 561.

III. Critique of the Contract Failure Theory

A. *Donative Nonprofits*

1. *"Contract Failure" Does Not Explain the Need for Strict Standards*

Contributors to the donative nonprofits — organizations like CARE, the Salvation Army, and the American Red Cross, which receive contributions from one group of people and perform services for another group — appear, on the surface, to experience "contract failure." It is difficult and costly for them to monitor the marginal impact of their contributions. Hansmann suggests that potential donors might, therefore, prefer a nonprofit recipient committed to high fiduciary standards and bound by a rule barring the distribution of any profits to owners. Does the nonprofit structure urged by Hansmann in fact improve the donor's position in a way that could not be achieved through contract?

The strict fiduciary standards — the ban on self-dealing transactions, excess compensation, and the like — plus the no-dividend rule would bar some potential uses of the donor's dollar. While the donor remains ignorant of the marginal impact of his dollar, his ignorance is reduced since there are fewer possibilities. Indeed, if the donor is indifferent to the choice among the remaining possible uses of his dollar, then he has no problems. The special rules solve the contract failure problem if three conditions are met: (a) the donor is indifferent as among the remaining lawful uses of his dollar, (b) he would prefer the lawful uses to any of the unlawful uses, and (c) he is able to monitor, and ensure compliance with, the fiduciary rules and the dividend ban.

In many situations a donor will not be indifferent among the remaining lawful choices. A donor to a university might prefer that his gift aid undergraduate students in financial need, and not research on nonprofit corporations. Such donors may earmark their funds for the particular charitable program they favor. In some cases, it may be fairly easy for the donor to see that this program exists — there are undergraduates receiving financial aid. As we pointed out above, however, the suspicious donor is not reassured by this observation because he cannot really know whether his gift increases the level of financial aid that would have otherwise existed, or whether it freed the university administrators to reallocate other funds that would have gone to financial aid, but are now spent on research on nonprofit corporations.[37] To the extent that donors care about these possibilities, strict fiduciary rules will not fully solve their problem.

Some donors, however, might not care very much. And even for the others, strict fiduciary rules will help if condition (b) is met. That is, so long as the strict fiduciary rules eliminate the donor's least favored uses, the donor's situation is improved, even though he remains unable to monitor the precise result of his dollar. Estelle James has developed this argument more completely.[38] She points out that when marginal-impact monitoring is difficult, a business enterprise will treat receipts as fixed revenue — that is, revenue not dependent on output. The receipt of such revenue will not prompt the manager to increase output; he will merely pocket the money. If the law prohibits such pocketing, however, the manager will necessarily increase output. If the dividend ban and strict fiduciary rules eliminate the pocketing, then donors should prefer nonprofit donees to for-profit donees. Nonprofit donees may still increase the wrong output, insofar as the donor is concerned, but that is better than increasing no output at all.

James' analysis helps us to understand the role of a dividend ban and fiduciary rules that bar alternative methods of distributing gains to owners, such as excess compensation and self-dealing transactions. Nonetheless, this analysis does not clinch the case for applying trust rules to nonprofit corporations. Donors may be concerned about transactions between the nonprofit corporation and its management only if those transactions are unfair to the corporation. When the director of a nonprofit university is in the office supply business, the traditional trust rule would bar him from selling supplies to the school. Yet if the director, in an effort to help out the school, offers to sell it such supplies at his wholesale cost, it is difficult to believe that donors would object. Indeed, they might favor

37. Fundraisers understand this problem and do their best to make donors feel that they know the particular impact of their gift. It may be easier to raise funds for capital expenditures because the donor can see the result of his gift. Indeed, one sometimes sees the names of individual donors on the various pieces of a building, providing some immortality, but also giving the donor the feeling that he bought this room or that door. The donor may also reduce the problem by giving to a charity with only one very focused program, *e.g.*, research in sickle-cell anemia. Very large donors may avoid the problem: When their gift pays for an entire building, or for an entire new program, they may be fairly confident that the donee would not have otherwise undertaken the project in question. But despite those tactics of fundraisers and donors, the majority of smaller donors cannot know the marginal impact of their contributions.

38. *See* James, *Production, Consumption, and Cross-Subsidization in Nonprofit Corporations*, Working Paper #38, Program on Nonprofit Organizations, Institute for Social and Policy Studies, Yale University (1982).

such a transaction. If the trust rules were adopted, it thus seems that condition (b) might not be met since the rules might make illegal a transaction that the donor would prefer. The transaction would be permitted under the typical corporate standard because it could not be proven unfair to the corporation, as indeed it is not. It would also be permitted under the new California law, which is nonetheless stricter than the corporate rule.[39]

In sum, it seems that the no-dividend rule, combined with *some* package of rules guarding against financially self-interested behavior by nonprofit management, will help the donor cope with the problem of marginal-impact monitoring, although such rules will not solve that problem. The strict trust rules urged by Hansmann, moreover, do not follow from the analysis since they might bar a use of his money that the donor would favor.

No rules will help, however, if they cannot be enforced, as condition (c) requires. The problem of marginal-impact monitoring is not solved by adopting rules that are themselves difficult to monitor. In fact, it seems likely that the cost of monitoring and enforcing trust rules will be more than most donors would find worthwhile to pay. That is one reason to provide for enforcement of charitable trust duties by state agencies such as the attorney general, as most states do. Traditional law thus attacks the donor's problem by both stricter fiduciary rules and state enforcement. Nonetheless, state enforcement is often inadequate because the states themselves are not prepared to pay for it.[40] We could reduce state enforcement costs by adopting a flat rule barring any transactions between management and the corporation, rather than a rule requiring the state to prove that the transaction in question was unfair to the corporation. In deciding whether to impose a flat rule, one would have to balance the savings in enforcement costs against the possibility that the law will deter transactions that are actually favorable to the corporation and that donors would not oppose. The new California law compromises this conflict by avoiding a flat rule barring all transactions between the corporation and its management, but requiring instead that the party seeking to sustain the transaction prove both that it is fair and that no more advantageous arrangement could have been obtained by the corporation under the circumstances.[41]

39. *See* CAL. CORP. CODE § 5233(d)(2) (West 1981). Hansmann prefers the strict trust rule, but seems willing to accept the California standard as second best. *See Nonprofit Corporation Law*, *supra* note 3, at 569-73.

40. *See* Karst, *supra* note 21, at 452.

41. *See* CAL. CORP. CODE § 5233(d)(2) (West 1981).

Finally, we must consider whether imposing these rules by law improves the donor's position over that which could be achieved through contract. If contract alone is adequate, a new organizational form is not needed. As Hansmann himself points out,[42] the expanded no-dividend rule (simple dividend ban combined with strict fiduciary duties owed to patrons) could be imposed by contract if donors and nonprofits agreed. Professional donors, such as private foundations and government agencies in the grantmaking business, often require recipients to adhere to rules similar to those that Hansmann would impose.[43] These rules, then, would not alter the position of savvy or concerned donors. Of course, not every donor would bother to bargain for such promises, and many will contemplate gifts too small to motivate the recipient to agree to the demands, even if they were made. That is to say, in some cases the transaction costs of generating such a contract ("contracting costs") would exceed what the parties are willing to spend, while in other cases the recipient organization might be unwilling to enter into such an agreement on its merits, even apart from these contracting costs.

To the extent that one envisions the nonprofit law as a form of contract freely available to parties, it might in some cases reduce contracting costs — that is, some parties who would not have undertaken to produce their own agreement spelling out strict standards might nonetheless freely choose to operate under a nonprofit law that sets such standards for them. Hansmann suggests this possibility but does not develop it.[44] Yet this explanation does not seem to justify mandatory rules — it does not explain why we should impose these rules on parties who would not have agreed to them on their merits, apart from contracting costs. The law could offer these rules as gapfillers, allowing parties to opt out, thereby accomplishing the reduction in the contracting costs of willing parties, without impos-

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42. *See Nonprofit Enterprise, supra* note 3, at 852-53.

43. Hansmann illustrates the promises which might be required of a profit-seeking broadcasting company:

> (1) The owners could promise that no more than, for example, five percent of the income they receive from all sources will be distributed to the owners as compensation and profits.
> (2) The owners could promise that the total amounts distributed to themselves as compensation and profits will not exceed a given dollar limit.
> (3) The owners could promise that the amounts distributed to themselves will not exceed "reasonable" compensation for the services and capital they contribute to the organization.
> In each case it would need to be promised further that all amounts not distributed to the owners would be devoted to other expenses necessary for the production of broadcasts of the highest quality that those amounts permit.

Id. at 852.

44. *See id.* at 853.

ing the rules on others. Thus, even if we believe that the expanded dividend ban does solve the marginal-impact monitoring problem of some donors, we have not explained why it should be mandatory.

Again, the explanation is a reduction of the state's enforcement costs. For the many charitable organizations dependent on a large number of contributors, it might be impractical to administer a system in which the fiduciary rules governing use of the corporation's funds vary from dollar to dollar, depending on the agreement made with the contributor of that dollar. It would be far less costly for the government, when it takes on the monitoring burden, to enforce a uniform rule on all of the nonprofit corporation's funds.[45]

In sum, the strict trust standards and the no-dividend rule may offer the donor some help with the problem created by the impossibility of monitoring the marginal impact of his gift. But they will not eliminate that problem, and they will not even help if their enforcement is left to the donor because the cost of enforcement is too high. It is, therefore, necessary to have that cost subsidized by the government if we are to pursue this solution.[46] Furthermore, we have seen that the principal advantage of imposing a flat ban on self-dealing, rather than the normal business corporation rules or a rule set by contract between donor and donee, is to reduce the government's enforcement costs. Our expansion of the contract failure theory thus concludes that while the argument in favor of strict standards is not frivolous, neither is it overwhelming.[47] It helps but does not solve

45. Hansmann also makes this point. *Id.*

46. The advantage of the nonprofit form, then, is that it economizes on contracting and enforcement. Under the private contractual approach, each individual patron not only must understand and agree to a complex contract but also must police the organization's finances as a whole — or rely upon other patrons to do so. Moreover, to the extent that patrons do engage in such policing, they may be duplicating each other's actions, since the activity that constitutes breach of the contract is presumably the same for all. Consequently, considerable economies can be realized by placing all such transactions under one collective contract between the organization and its patrons: the contract determined by the state's nonprofit corporation law and policed by the state.

Id. (citations omitted).

47. Later in *Nonprofit Corporation Law*, *supra* note 3, at 568-69, Hansmann does offer some additional arguments in favor of strict standards. Their theme is that the patrons of nonprofit corporations lack rights ordinarily possessed by the shareholders of business corporations, and therefore, that stricter duties need to be imposed on the nonprofit's management to protect patron interests. The deficiencies in patron rights that Hansmann observes all flow from his definition of "patron," which includes all donors and customers. Members, including member-customers of a mutual benefit nonprofit, for example, do possess, under the law of most states, all of the rights that he identifies. As to such mutual-benefit nonprofits, then, his arguments have force only if one believes that non-member "patrons" should have a claim equal to that of the members to the allegiance of management. I do not believe this should be so. For the reasons stated in Part III (B) *infra*, I believe that it is far preferable to ensure the integrity of mutual benefit nonprofits through statutory guaranties of member democracy, combined with definitional provisions ensuring that the organizational form is in fact used by customer controlled membership organizations.

the donor's problem. The next section supplements these arguments with an additional point, not grounded in the marginal-impact monitoring problem.

2. *Strict Standards as a Solicitation Strategy*

Theft or embezzlement by a pastor, a March of Dimes organizer, or a Salvation Army Santa Claus evokes a distinctive outrage. That same feeling is not generated by the self-dealing of a business corporation director, reprehensible as we may believe it is. The difference lies in the special insult we feel when everyday evil, which we may learn to watch for, sneaks up on us disguised as virtue. Indeed, it seems likely that most people, including donors, would be suspicious of high salaries for the managers of a donative nonprofit, and they might well object to compensating management with bonuses as a reward for successful fund raising. They would almost surely object to managers, as owners, paying themselves a dividend from revenues in addition to their salary. Indeed, fundraising counsel frequently reject, as unethical, arrangements under which their pay is calculated as a proportion of the funds raised, and they may well believe that potential donors would share that objection. People are sometimes even heard to say that it is objectionable for operations like nursing homes, hospitals, or day care centers to earn profits at all. Even if the donor could see the marginal impact of his gift, he might still be concerned about such issues. He might prefer to support a donee that avoided these practices even where it offered his donation no greater marginal impact.

These observations suggest an additional explanation for strict fiduciary standards, apart from the attempt to overcome the donor's difficulty in monitoring the marginal impact of his gift. Mandatory strict fiduciary standards and the dividend ban might be explained as value-based rules vindicating a widely shared moral preference. The advantage of such an explanation is that it requires very little analytic support; the disadvantage is that it will fail to persuade those who do not share the moral preference. One strength of the contract failure theory, if its logic were to hold up, is that it explains how such mandatory rules solve a problem without relying on value choices. Even if we believe that most people share at least portions of this moral preference, it is difficult to conclude that the law should impose it on all nonprofits.

Nonetheless, the managers of a nonprofit might wish to comply with this moral preference as one tool in attracting gifts. That is, they might well take on such restrictions voluntarily. Analogous tactics for attracting business are practiced, for example, by mutual funds, which often voluntarily commit themselves to restrictions on their investment discretion. They may promise to invest only in government bonds or only in energy stocks. We have just seen, however, that individual contracts between the nonprofit and particular donors might often be impractical as a method of establishing such a commitment since enforcement is so costly. Uniform rules covering all of the nonprofit's funds work better, especially if they are enforced by the government.

In short, we see that, for reasons wholly apart from monitoring problems, a donor might prefer an organization with defining rules that bar dividends and impose strict fiduciary duties. And as indicated above, the moral preference for strict rules has distinct practical implications. The preference stems in part from the fear that self-interested acts will be disguised as charitable ones and that the "purity" of the charitable sector will thus be violated. This suggests that, in order to preserve the advantage of the strict fiduciary rules in soliciting donations, it might be necessary to make them mandatory. For the point is to establish a label — whether "nonprofit," "charitable," or "public benefit" — that serves as an easy marker whereby potential contributors can identify organizations that are bound to these standards. Accordingly, we can permit no exceptions to those standards for organizations that choose to use the label, for if exceptions are permitted, then the label's value as a marker is substantially reduced. It would be as if we permitted supermarkets to sell low quality beef with the label "prime." Such a policy would destroy the value of the label, even if we required the supermarkets to disclose their departure from the statutory "prime" standards. Under the disclosure rule buyers might protect themselves by carefully reading the package, but the label "prime" would still be rendered functionless. The purpose of the label is to enable buyers to decide how to spend their money; while we wish to offer them a range of choice that includes both prime and lesser grades of meats, we will increase the chances of optimal allocation by ensuring that the grades are clearly labeled.

The same principle applies to organizational forms. There are, or should be, organization alternatives to the nonprofit charitable form available to the organizer who wishes to create a corporation with more forgiving standards. You pay your money and you take your choice. But the choice of an organizational form requiring the strictest standards, like the choice of producing prime beef, will be preserved only if the labels are clear, so that the organization's customers can be easily reached. If we wish to have the strict-standard organization as one alternative available to organizers, we advance that goal by establishing a distinctive label that only such organizations can use. In a world without contracting or monitoring costs, we would not need such a distinct organizational form: Standards analogous to those implied by the label could simply be imposed by contract. But since donors do face such costs, as a marketing matter the nonprofit charity's solicitation strategy would work better if donor reliance on a label could obviate the need for complex, ad hoc contracts.

Considered in this light, we can see that the strict fiduciary rules must be mandatory because they are defining rules. But while they are mandatory for this label, they are not mandatory in the usual sense, for they can be avoided simply by the choice of another organizational form. They are mandatory in the sense that the standards for "prime" beef are mandatory: Sale of choice beef is perfectly legal if properly labeled. We choose to have an organizational form with such defining rules because those rules offer a functional advantage for the organization which depends upon gifts for its sustenance. Such gifts might be easier to attract for two reasons. First, donors concerned about the marginal impact of their gifts may have that concern reduced. Second, an appropriately fashioned package of rules will respond to a moral preference that many donors may have, apart from the marginal impact problem. Organizers who do not wish their managers to be bound by such requirements, whether because they do not believe that the requirements will aid in solicitation, or for any other reason, can choose a different organizational form. The labels must only be clearly enough established that donors will not be confused about the nature of the organization seeking their support.

It must be pointed out that the solicitation strategy argument, much like the marginal impact monitoring argument, does not inevitably require adoption of an absolute ban on self-dealing transactions, as opposed to a more limited ban on transactions unfair to the corporation. We are still left with the arguments on this issue suggested earlier.[48] It does suggest, however, that the donative nonprofit should have stricter standards than the business corporation since otherwise there would be no solicitation advantage. The ban on dividends is by itself an important difference. It may also be important to reduce the legal impact of the members' or directors' rati-

48. *See* text at notes 37-47 *supra*.

fication of a suspect transaction since otherwise management could unilaterally create an exception to the implicit promise that it made when it solicited funds under the donative nonprofit label. This may be especially important since the directors of donative nonprofits are typically not elected by donors, but are self-perpetuating. When we consider mutual benefit nonprofits, we will see that democratic procedures may well reduce the need for strict standards.

It is sometimes said that the managers and members of a charitable corporation do not "own" its assets, and this may be a useful conceptual device to remember in defining the difference between the charitable corporation and other corporate forms. The strict fiduciary standards flow comfortably from such a core concept; we are accustomed to imposing special rules on people handling other people's money. And in fact the people who control the charitable corporation traditionally do not possess many of the normal incidents of ownership: They do not have unrestricted discretion concerning the charitable purposes to which they can apply these assets,[49] and they certainly cannot apply them to their own benefit.[50] But the rules themselves are the defining characteristic, rather than the more amorphous concept of ownership, and the drafting of those rules should be guided by their intended function, rather than by abstract deductions from the ownership concept. Their function is to establish an organizational alternative that is especially attractive to contributors who wish to promote some cause through the nonprofit intermediary.[51]

This section has used the term "donative" nonprofits. The term is Hansmann's and it nicely describes the organizations dependent for their funds largely on gifts. Most of these organizations would traditionally be labeled "charitable," but the overlap is not perfect, and I have purposely avoided the traditional term because it connotes a host of hoary rules that would needlessly complicate our discussion.[52]

Much of the traditional law of charity will live on in the regula-

49. *See, e.g.*, cases cited in note 37 *supra* & note 57 *infra*.

50. *See* cases cited in note 22 *supra*.

51. It has also been said that the core feature of charity is that it is not "self-regarding," but "other-regarding." This concept might be more descriptive than "ownership," and could be a better shorthand phrase. It captures the special tone of the charitable corporation, and it reminds us why that organization is likely to require a very different legal structure than the business corporation.

52. For example, there are rules regarding when a purpose is charitable. *See, e.g.*, *In re* Shaw [1957] 1 W.L.R. 729; *In re* Shaw's Will Trusts, [1952] Ch. 163 (1951); State *ex rel.* Grant v. Brown, 39 Ohio St. 2d 112, 313 N.E.2d 847 (1974).

tions of the Internal Revenue Service.[53] These regulations will require their own policy rationale, independent of the conception of a corporation code advanced here. Undoubtedly, incorporated charities would choose the donative form urged here because that form would meet many of the specifications which the tax law independently requires of organizations eligible to receive tax-deductible contributions. But some donative nonprofit corporations may not meet the tax law's other requirements, such as abstention from political activities,[54] while some IRS-certified charities would not fall within our code because they did not incorporate. There is no difficulty created by this lack of congruity between the tax law and the corporate law, except the occasional confusion of the uninitiated. Indeed, confusion exists today since there are, to the layman's common surprise, many nonprofit corporations that are neither charitable nor eligible to receive tax-deductible contributions.

Nonetheless, "donative" may be a misleading label if it implies that the organization must rely on donations. The organizational form should be available to any entity that wishes the package of rules it contains. In some cases financial contributions may not support the organization, yet its organizers may think of it as charitable and may wish to adopt an organizational form which conveys that message. For example, a group of individuals may plan to sell their professional services to deserving clients at favorable rates. Their clients may even be other donative nonprofits. The organizers might wish to adopt the donative label to convey their altruistic intentions to potential customers. Both the label and the rules that it identifies are quite compatible with this purpose; these organizers in fact intend to make a partial gift of their services.

There is nothing conceptually troublesome about this result. Indeed, some largely nondonative organizations, such as hospitals,[55] are likely to choose this form to facilitate obtaining or retaining favorable tax status. Although our discussion has focused on only one function for our package of strict rules — facilitating donations — it will have others as well. Those administering property tax ex-

53. For a general discussion of the Service's enforcement of traditional charitable standards as a requirement for classification as an organization eligible to receive tax-deductible contributions, see B. HOPKINS, *supra* note 10, at 38-46.

54. The Sierra Club, for example, lost its exemption by engaging in political activity. *See* 80 HARV. L. REV. 1793 (1967). The current law is somewhat different, but still places limits on lobbying. *See* B. HOPKINS, *supra* note 10, at 177-96; Washburn, *Lobbying By Public Charities*, 4 TAX NOTES No. 44, at 3-12 (1976).

55. Some have argued that hospitals should not be nonprofit corporations. *See* Clark, *Does the Nonprofit Form Fit the Hospital Industry?*, 93 HARV. L. REV. 1416 (1980).

emptions or special mail rates may well find that the donative package of rules conveniently describes attributes that their law requires. That result only increases the usefulness of having a category of organizations that everyone understands is governed by such rules, and such usefulness is ultimately the rationale for having a separate category of organizations.

3. *The Importance of Separating Patrons into Buyers and Donors*

The above analysis of donative nonprofits supports some of the conclusions reached by Hansmann's contract failure theory: A dividend ban and heightened fiduciary obligations are key features of the donative nonprofit, allowing it to attract gifts. In reaching that conclusion, however, we have focused on the donor's problem of monitoring the impact of his gift, which is one part of the patron's contract failure problem. We have not yet considered buyers or quality-monitoring problems. The next section offers a theory of mutual benefit nonprofits that suggests that they are designed to solve the special problems confronted by some buyers. Buyers face a different problem than donors, that section argues, and require an organizational form with different defining rules. I therefore urge a nonprofit law with two categories of corporations, along the lines of the new California code. Hansmann, however, by viewing the problem in terms of patrons and contract failure, necessarily develops a unitary model — a model that contemplates one organizational form to handle the contract failure problems of all patrons.

Hansmann's model has two consequences. First, it would apply the rules appropriate to donative nonprofits to mutual benefit nonprofits as well. This difference is discussed in the next section. Second, he would impose on the nonprofits that I call "donative" the same obligations to their purchasers as to their contributors, while my model assumes that there are no special rules governing the relationship between a donative nonprofit and those who purchase from it.

It might seem odd to talk of "purchasers" in the context of donative nonprofits; surely some transactions that superficially appear to be purchases are in fact donations. When a public television station asks its viewers to "purchase" memberships, it is really asking for donations. There may be some quid pro quo, such as when the station provides its members with a monthly program guide, and to that extent the membership fee has in fact purchased a subscription. But both parties to this transaction understand that the price of the membership is well in excess of what would be charged by a commercial, profitmaking organization that simply sold a program guide; that excess is the donation. And indeed, the excess will not be the same for every member because, while the station may set a minimum price for a membership, many members will respond to pleas that they contribute more than the stated minimum. That same basic fund raising scheme has many variations: the charity ball, the $100-a-plate dinner, the benefit concert, stamps from the tuberculosis society, the newsletter to members. The actual source of the donation is not always the purchaser. In the benefit concert, for example, the performing group might be the real donors, volunteering their talents, while the ticket holders pay only the normal market price for the privilege of attending. But whenever an event is conducted by a donative nonprofit, the "profits" generated by any such fund raising scheme are donations, and they must be managed according to the strict standards that the corporation has voluntarily undertaken. Thus, these transactions are not really purchases, and they raise no new issues for donative nonprofits.

Other common transactions are purchases in substance as well as form — purchases that have no donative element. The beneficiaries of a donative nonprofit's activities sometimes purchase from it. Students pay tuition at private universities, and even scholarship students often pay reduced amounts; soup kitchens may make a token charge for a meal that is largely subsidized by donations. Health clinics may rely on contributed funds to subsidize care for the poor, but may still charge patients a lowered fee. Even though the price may be reduced by subsidies, all of these transactions are purchases in the normal sense: There is a buyer whose primary interest in the transaction is the quid pro quo. At other times donatives make unsubsidized sales. Museums, for example, commonly have museum stores that sell books, prints or other items at normal market rates; hospitals may operate parking lots that charge normal market rates. The motivations for such sales efforts vary. The museum store might be a source of profits that are channeled into general museum operations; the parking lot might be viewed as a necessary service to visitors or employees, but one that ought to pay its own way through market fees. The managers' rationales may or may not make sense, but that does not affect our analysis.[56]

The theory of donative nonprofits offered above assumes that contributors may be attracted by the nonprofit's structure, but it sug-

56. In fact, managers of nonprofits may well sell some services expressly to subsidize others. For an illuminating model of the relationship between subsidized services, profitmaking services and donations, *see* James, *supra* note 38.

gests no similar reliance by customers. The customer, unlike the donor, can see the marginal impact of his dollar. The scholarship student, the indigent buying subsidized health care, the opera patron purchasing a ticket, and the shopper at the museum store, all deal with the nonprofit provider just as they would deal with a business offering the same services. Like any customer they may be concerned about the quality of the goods or services that they are buying, but this concern is protected by the contract or tort obligation imposed by law on any seller, nonprofit or for-profit. Neither the soup kitchen patron nor the indigent medical patient chooses the nonprofit provider because of a belief that a nonprofit organization offers better meals or health care.[57] The museum shop customer might expect to find high quality products at the shop, yet he can certainly inspect the product and price before buying, and would not ordinarily rely on the museum's nonprofit status in making a purchase. Before buying a ticket, the opera enthusiast will consider a company's general reputation, its choice of opera, and the scheduled performers; he will not care whether the company is nonprofit.

Hansmann never tackles these questions, probably because they cannot be addressed without abandoning the vocabulary of "patrons" and "contract failure" to which he is committed. When Hansmann concludes that patrons should have standing to sue for violations of his mandatory fiduciary standards, he necessarily includes both donors and purchasers. Suits could, therefore, be brought not just by donors, who contributed in reliance on such standards, but also by students paying tuition, soup kitchen diners who made a token payment for their meal, and those who purchased items from the museum shop.[58] The theory extends standing to all patrons because it focuses on the patron-management relationship,

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57. Of course, both the soup kitchen and the clinic physician will operate under normal tort obligations to their customers, who effectively demand some minimal level of quality. Moreover, it may be that in soliciting donations, such organizations might make further representations concerning the quality or nature of their service, to which they will then be bound. For example, an organization that has received donations under a trust instrument requiring it to operate a museum must do so, and cannot satisfy its trust purpose by limiting its expenditures to running an art school. Commonwealth v. Barnes Foundation, 398 Pa. 458, 159 A.2d 500 (1960). As a result of its obligations to its donors, such an organization must make its collection available to public view for at least some minimal period. If the museum limits public access too severely, it will violate its duties to its contributors, but under traditional law, there would be no duties to "customers" or "patrons" that would be violated.

58. *Nonprofit Corporation Law, supra* note 3, at 606-11. Hansmann observes that customers as well as donors are included in his argument for patron standing, but he is content with the observation that "the interests of customers appear to have most in common with those of donors [rather than beneficiaries]." *Id.* at 608-09.

without distinguishing between contributor-patrons and purchaser-patrons.

Hansmann separately argues that the beneficiaries of a nonprofit's activities ought to have standing, even when they are not patrons and are therefore not part of the group to which he thinks duties are owed.[59] Proposals to allow standing to a charity's beneficiaries have been made in the past, with no particular success.[60] But whether or not one agrees with the argument, it is offered apart from the basic theory and does not purport to change the substance of the duties to be enforced. For Hansmann, that means that although the soup kitchen diner who gets his meal free will have standing to sue, duties are owed only to those diners making a token payment for their meal. The nonpatron beneficiary could thus argue that management had failed in its obligations to those who paid for their meals, but could not argue that they failed in their duty to those, like him, who received their meals free. This artificial distinction between beneficiaries results from the "patron" concept.

The aggregation of donors and buyers as "patrons" conceals logical gaps in the contract failure argument. Hansmann argues, for example, that museums are appropriately nonprofit because donors experience contract failure,[61] but never addresses whether the museum's nondonor customers are also captured by this rationale. Yet customers are patrons by definition, and Hansmann therefore proceeds to discuss the "difficulties" raised when the management uses museum shop revenues to subsidize other museum operations.[62] His discussion is based on the unexamined premise that the shop customer is also a "patron" to whom management owes special obligations, and that these obligations are violated by such "cross-subsidization." He ultimately avoids this awkward result by constructing a somewhat belabored theory of informed consent by the shop customer. The simpler explanation of why such museum practices do not ordinarily violate a nonprofit's heightened duties is that those duties do not run to the benefit of shop patrons. Patrons are ordinary customers who purchase without any reliance on the museum's nonprofit status. Either they are willing to pay the posted price for a print or a book, or they are not; if they buy the book, the marginal impact of their purchase is obvious. Hansmann's problem

59. *Id.* at 611.

60. Price, *State Arts Councils: Some Items for a New Agenda*, 27 HASTINGS L.J. 1183, 1192-94.

61. *Nonprofit Enterprise*, *supra* note 3, at 857-59.

62. *Nonprofit Corporation Law*, *supra* note 3, at 562-63.

with shop customers arises only because his focus on the "patrons" blurs the critical distinction between a donative nonprofit's relationships with its contributors and with its purchasers.[63]

Establishing a duty to the customers of a donative nonprofit would require a dramatic alteration of existing practices. Consider the "problem" of cross-subsidization in hospital care, which Hansmann explicitly addresses.[64] Because he views hospital patients as "patrons," he asks whether hospital management violates special duties owed to its patients when it subsidizes the services it provides to some patients with revenues it obtains from others. He finds that such a pricing policy violates the hospital's duties to the "overcharged" patients, unless the hospital proves that the policy is "in the overall best interests of the patrons as a class."[65]

Such a rule barring cross-subsidization, derived from the posited duty to customers, would have broad impact. Estelle James points out that cross-subsidization is an important and pervasive source of income for nonprofits.[66] James has shown that many universities regularly earn a profit on undergradute education, which they use to

63. If in fact a significant number of purchasers from, as opposed to donors to, a nonprofit also relied on the nonprofit form to overcome "contract failure," then perhaps it would make sense to fashion the rules with them in mind and not worry about the minority of cases in which these protections were not needed. In fact, however, Hansmann offers no example of a donative nonprofit for which such customer reliance commonly occurs.

64. *Nonprofit Corporation Law*, *supra* note 3, at 560-61.

65. *Id.* at 562. This assertion is also qualified by the phrase "[i]n the absence of knowledge or effective choice on the part of patrons." *Id.* Hansmann does not explore in any detail how such a legal test would work in practice — that is to say, who would have to prove what sort of facts to demonstrate exemption from the usual rule by virtue of the patron's "knowledge or effective choice." Apparently, however, he does not view this exception as being of particular comfort to hospitals, since he observes that patients do not ordinarily have effective choice and that "[w]hether the cross-subsidization currently undertaken by nonprofit hospitals can pass this test remains open to dispute." *Id.* (footnote omitted). It is also possible that Hansmann intends his rule to protect only patrons charged more than their costs, although the difficulty of allocating the many fixed costs of hospital care may make such distinctions irrelevant.

I am assuming that Hansmann's required showing — "overall best interests of the patrons as a class" — would in practice require a demonstration that all patients benefit from the subsidization policy. To require only a showing that the subsidized patients benefit would seem to rob the rule of any function. In theory it might be possible to accept a showing that total benefits to all patients have increased, even though those benefits flow entirely to the subsidized patients — *e.g.*, that we have conferred on patient class A total benefits worth X dollars, even though the increased cost imposed (by way of subsidization) on the remaining patients totals only $X/2$. But while economists can easily think in those terms, it is difficult to frame workable legal rules that would, for example, justify subsidizing Patient A's kidney dialysis only on a showing that the value of saving A's life exceeds that of the increased health Patient B would have enjoyed from additional procedures that could have been provided B had part of his payments not gone to subsidizing A.

66. Many of the examples in this paragraph are in fact borrowed from James, *supra* note 38.

subsidize research and graduate education.[67] The Metropolitan Opera uses the profit on its ballet productions to subsidize its opera. Many colleges use the profits from their football programs to subsidize other university athletic events. The University of Texas sells oil, and the New York University Law School at one time owned a successful, profitmaking noodle factory. Some donative nonprofits, including universities, own real estate that produces profits from sales or rentals. National Public Radio plans to raise money by selling recordings of its programs and transmitting business information by satellite communication. Undergraduates, ballet and football fans, oil companies, noodle eaters, and the rest are all patrons with a claim against nonprofit managers under the contract failure theory. Perhaps here, as with the museum store, it will be possible to construct some defense to these potential claims, but one must ask whether Hansmann's definition of the nonprofits' duties, on which these prima facie claims are grounded, makes sense in the first place. Is there any reason to create a special duty of nonprofits to their customers?

One reason to bar cross-subsidization, if not to have a more general rule creating special duties to customers, is the belief that cross-subsidization produces an economically inefficient result. That is, insofar as the cross-subsidization causes some goods to be overpriced and others underpriced, relative to the prices that would be set by a profit-maximizing firm in a competitive market, then there may be overproduction and overconsumption of the cheap goods, and underproduction and underconsumption of the expensive ones.[68] Yet donative nonprofits are often created to subsidize, and hence "overproduce," some goods because the market alone would fail to generate sufficient supply. Donors give to the Metropolitan Opera to increase opera production and consumption, in the belief that opera cannot otherwise "pay its own way" — that is, in the belief that a profit-making company would produce very little opera since it would have to charge an admission price that would ensure very little demand. In some cases, as Hansmann has pointed out, the market will underproduce because the goods are public goods for which market mechanisms do not work.[69] University research may be such a good, so that even if more research is produced than donors paid

67. James, *Product Mix and Cost Disaggregation: A Reinterpretation of the Economics of Higher Education*, 13 J. HUMAN RESOURCES 157 (1978).

68. W. NICHOLSON, MICROECONOMIC THEORY: BASIC PRINCIPLES AND EXTENSIONS 442-50 (1972).

69. *Nonprofit Enterprise*, *supra* note 3, at 848-51.

for, there may still be less than would be produced in a perfect world operating without market distortions. Thus, it may be difficult to know when such a good is being underpriced and overproduced — when, for example, an opera is producing too many shows, or a university is doing "too much" research. The consumers of the operas and research, of course, will never think there is too much. The donor will be concerned about underproduction of the product or service he sought to support, not about overproduction. If he has any concern, it is that his donation will be used to support production of a different product or service than the one he intended.[70] In sum, overproduction itself is not a problem, but it could become one if it were achieved with profits obtained by overpricing and underproducing another good.

It is easier to consider overcharge and underproduction a problem since in that case potential customers are not served despite their willingness to pay an economically adequate price for the product. Yet the fact that a nonprofit is earning profits on some of its customers does not necessarily mean that it is overcharging them in this economic sense, for a profit-maximizing firm in a perfectly competitive market would also earn a return on equity capital in selling the same goods to the same customers. An overcharge, and underproduction, will occur only if the nonprofit has sufficient market power to earn additional return by charging more, and producing less, than would a firm in a competitive market. Yet there seems, in general, to be no reason to assume that nonprofits, as a class, are more likely than businesses to possess such market power. We may conclude that nonprofit sellers ought to be subjected to the same antitrust rules as for-profit sellers, but we have no reason, as a matter of economic efficiency, to create special rules to eliminate cross-subsidization in nonprofits, as opposed to for-profits. That is, we have no reason, as a matter of economic policy, to impose on nonprofits any duty that we would not impose on for-profits.

Yet perhaps we have some persuasive reason, apart from economic efficiency, to impose special rules on nonprofit sellers, rules that might restrict or limit their profit making regardless of whether they earn monopoly profits. Some nonprofit institutions, for exam-

70. The donor may impose an explicit condition on the use of his gift. Such understandings are normally enforceable under charitable trust law, even though it is sometimes said that technically the restriction does not itself create a trust. The leading case in this area is St. Joseph's Hosp. v. Bennett, 281 N.Y. 115, 22 N.E.2d 305 (1939). Recent cases include: *In re* Estate of Criswell, 20 Ariz. App. 157, 510 P.2d 1062 (1973); Lefkowitz v. Cornell Univ., 35 A.D.2d 166, 316 N.Y.S.2d 717 (1970), *affd.*, 28 N.Y.2d 876, 271 N.E.2d 552, 322 N.Y.S.2d 717 (1971). *See* 4 A. SCOTT, THE LAW OF TRUSTS § 348.1 (3d ed. 1967).

ple, are given tax exemptions arguably premised on assumptions inconsistent with their profitmaking activities. Such an analysis partially explains the enactment of the Unrelated Business Income Tax.[71] But even if there are remaining problems with the income tax, or with property taxes, these problems do not imply any particular result in constructing a theory of nonprofit corporation law because these tax exemptions are not conferred by the nonprofit corporation law and are not enjoyed uniformly by all nonprofits. To the extent that the tax laws do not set the proper criteria for exemptions, they, and not the nonprofit laws, should be amended. The same argument applies to other privileges occasionally granted to some nonprofits, whether it be special mail rates or the right to conduct bingo games.

One may, however, also be concerned that the nonprofit's customers are misled by the seller's nonprofit structure into believing that it earns no profits. This reliance, one could argue, should be protected by ensuring not merely that monopoly profits are not earned, but that *no* profits are earned. But this potential concern seems factually incorrect. As argued earlier, it seems unlikely that buyers who can inspect the product and who know its price really base their purchases on beliefs about the seller's corporate structure. More fundamentally, the question is whether the law ought to encourage or discourage such reliance by the customers of donative nonprofits. We must ask whether there is some societal need for a form of organization that not only bars dividends and imposes strict fiduciary rules on management, but also requires management to forego earning any profits from sales, at least in the absence of special justifying facts. Would such a set of defining rules describe an organizational form that society needs?

Since we have never had such an organizational form, it is difficult to know for certain, but the very absence of it suggests that there is no need. Nor does the contract failure theory offer much convincing argument to the contrary, given the absence of any evidence that purchasers from donative nonprofits experience unusual monitoring or contracting costs. Indeed, the scarcity of any examples of abuse that would be cured by imposing such an additional restraint on nonprofits suggests that its benefits would be outweighed by the costs of enforcement alone, without considering the impact on revenues of

71. This provision imposes an income tax on the earnings of otherwise exempt organizations, insofar as the earnings are derived from an active business which is unrelated to the organization's exempt purpose. I.R.C. § 501(b). *See also* B. HOPKINS, *supra* note 10, at 554-601 (3d ed. 1979); Myers, *Taxing the Colleges*, 38 CORNELL L.Q. 368 (1953).

a ban on profits.[72] Any rule against cross-subsidization invites endless litigation to establish the "cost" of producing the different products that a particular nonprofit might sell; in many cases there will be joint production, rendering cost allocation essentially arbitrary.[73] At a minimum, such a rule would impose considerable recordkeeping costs on nonprofits seeking to avoid, or a least successfully defend, potential suits.

In sum, imposing on donative nonprofits a duty to their customers invites much mischief with no compensating benefit. The donative nonprofit corporation, with its no-dividend rule and heightened fiduciary obligations, is aptly designed to encourage gifts and, therefore, to pursue activities for which donative support is available. Although its defining rules are designed to appeal to donors, we have also seen a variety of reasons, extraneous to the analysis offered here, why some organizations that do not rely on gift income may nonetheless find it useful voluntarily to adopt the donative nonprofit form.[74] While we have rejected the proposition that the donative nonprofit should have defining rules structured to provide special benefits to its customers as well, there is in fact a need for a form of organization that is particularly sensitive to and controlled by its customers. The mutual benefit nonprofit is such an organization.

B. *Mutual Benefit Nonprofits*

This section develops a rationale for creating a separate category of nonprofit, the mutual benefit nonprofit corporation. That rationale is first outlined in the context of a nonprofit child care facility, and is then applied to two other typical mutual benefit nonprofits, the trade association and the social club.

72. The only example of abuse provided by Hansmann is the hospital. Hospital pricing policies have, in fact, drawn repeated attention and criticism. *See* Clark, *supra* note 55 and studies cited therein. However, hospitals may well be a special case. In the usual hospital transaction, the seller, chosen by the doctor, provides a service to the patient, which is paid for by an insurer (which may be the government). This separation of decision-maker, consumer, and payor may be unique, and clearly reduces the market's discipline of the seller's prices. The fact that Hansmann offers no other example of potentially objectionable cross-subsidization in nonprofits further suggests that the problem is peculiar to the distortions created by the market for hospital services. If that is the problem, it should be treated by a rule applying to all hospitals, whether profit or nonprofit, rather than by a rule applying to all nonprofits, whether hospital or nonhospital.

73. A. ALCHIAN & W. ALLEN, EXCHANGE AND PRODUCTION: COMPETITION, COORDINATION AND CONTROL 256 (2d ed. 1977).

74. *See* text at notes 54-55 *supra*.

1. *The Child Care Facility and Its Implications for the Law of Mutual Benefits.*

Child care facilities are provided by the government, businesses, and nonprofit organizations. Government child care programs, and some nonprofit programs, provide below-cost services to targeted groups. Since such programs cannot be supported by the fees collected from participating parents, they must rely on either private donations or government grants. As a result these child care facilities are ordinarily organized as donative nonprofits to facilitate attracting the necessary donations or grants. Such a child care facility, like a health care facility for indigents, may yet charge some fees, and both its parent-participants and donors may thus be "patrons" under the contract failure analysis. For the reasons offered in the previous section, I believe that this conception is a mistake, and that a donative child care facility has neither a greater nor a lesser obligation to its parent-purchasers than does its for-profit competitor. The same analysis would, of course, suggest that the donative child care facility has special obligations to the donors who relied on its nonprofit status.

Next, consider unsubsidized child care facilities that do not receive donations or government grants and are supported principally, if not exclusively, by the funds or efforts of the parents who use the service. Many facilities are for-profit businesses, yet some are nonprofit. The puzzle is in understanding why one would organize such a nonprofit, which foregoes investors' equity and which, by assumption, receives no gifts. The answer, developed below, is that such nonprofits exist because their customers are willing to provide their needs, whether through higher prices (as in many social or athletic clubs) or volunteer labor (as in other social clubs and some child care facilities) in return for what they see as a special product.

Before developing the argument fully, we should consider whether the contract failure theory can explain the existence of such nonprofit child care facilities. Hansmann's discussion of child care in fact focuses on the needs of parent purchasers and not those of the donors, and so it appears that he has the nondonative nonprofit in mind when he discusses nonprofit child care.[75] He explains nonprofit child care by arguing that it fills the needs of parents who experience contract failure when dealing with for-profit providers. And just as in his discussion of CARE, he argues that the nonprofit

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75. *Nonprofit Enterprise, supra* note 3, at 865; *Nonprofit Corporation Law, supra* note 3, at 506.

organization can satisfy that need only if it adheres to his expanded no-dividend rule.

According to Hansmann, contract failure arises because parents have trouble determining whether the child care facility is doing a good job. Parents, like donors to CARE, cannot adequately monitor the nonprofit's performance; and therefore they would prefer to rely on a nonprofit agency whose structural attributes reassure them that the organization is doing its job. Parent-purchasers, like CARE donors, are "patrons" battling high monitoring costs. In this case, however, the problem must be in monitoring the quality of the service provided. Clearly the parents have no difficulty in seeing the marginal impact of their purchase — their child is admitted to the nursery.

This explanation is doubly defective: There is in fact no quality-monitoring problem, and if there were, strict fiduciary standards would not solve it. Consider first whether parents find it difficult to evaluate performance. When a number of people rate the same child care program differently, their disagreement may result from different views on child care methods, not from inadequate information concerning which methods the agency in question employs. In fact, one's general impression is that, whether or not they are right, parents tend to think that they know whether their child's school or day care facility is doing a good job. Indeed, they often have strong views on the subject; almost everyone has heard parents describe the shortcomings of their child's school.

This general impression is supported by data recently collected by Jamie Newton in San Francisco, who found that a substantial majority of child care purchasers thought that it was very easy or moderately easy to judge the program's quality.[76] Moreover, Newton found that when asked to rate a variety of attributes, users placed a program's status as a nonprofit or for-profit organization as the *least* important of all the listed attributes. This result makes sense if one assumes that parents believe they can evaluate child care programs. For the buyer of child care, like the buyer of pencils, the only question is whether the seller offers a satisfactory service at a satisfactory price. Since child care purchasers believe that they know the service, and do know the price, abstract attributes like whether the organization is nonprofit are unlikely to weigh heavily,

76. The data reported here were presented by Jamie Newton at a seminar given in the Spring of 1981 at the Program on Nonprofit Institutions, Institution for Social and Policy Studies, Yale University. The data are part of a study that will ultimately be published, but until that time interested readers can obtain further information directly from Newton at San Francisco State University, Department of Psychology.

unless the potential buyer believes that price or quality will be affected by the attribute. Some respondents to Newton's questionnaire might have equated "nonprofit" with "charitable," and to the extent that he or she considered it at all, might have assumed that a nonprofit agency would charge less.

Hansmann's explanation, however, assumes that some parents will choose a nonprofit because it offers higher quality, rather than a better price; the superior quality would be due to the expanded nodividend rule. And here we get to the second defect in this contract failure explanation: Even if one agrees that parents have difficulty evaluating a child care program, high fiduciary standards will not solve their problem. For those standards deal only with financial failings by managers, which is not the parental concern assumed by the contract failure model. The model instead made the more plausible assumption that parents were concerned mainly with the quality of child care. Expanding the scope of fiduciary obligations beyond financial irregularities to include other concerns, such as whether the nursery school managers were careless in their decision to use Montessori methods, would transform and complicate traditional law quite dramatically, and Hansmann never commits himself to a proposal that sweeping. The strict fiduciary rules serve the donor concerned about marginal-impact monitoring, but not the buyer concerned about quality monitoring.

The contract failure theory does suggest one indirect connection between the standards it would impose and the quality-monitoring problem: that the owner of a for-profit facility may spend less money on care than will the management of a nonprofit. But unless the nonprofit is subsidized with gift income, this is implausible. Most of the nonprofit's expenses will be the same; labor, rent and equipment cost the nonprofit as much as the for-profit facility. If it plans to seek gifts, it should be a donative, and thus adopt the strict standards; but even if it does attract gifts and has more money to spend on care, the parents' quality-monitoring problems persist. The nonprofit might spend more per child on care, but do so in ways that the potential parent-purchaser does not believe yield better care. For example, it might buy more expensive toys, but ones that the parent thinks are undesirable; it might pay its staff more, yet choose staff with a child care philosophy that the parent opposes. In sum, the heightened fiduciary obligations called for by the contract failure model do not serve the needs of parent-purchasers.

It thus seems that by collapsing donors and purchasers into one category Hansmann has designed a theory that does not respond to the needs of purchasers. Donors may be attracted by a recipient's commitment to strict standards, for the reasons explained earlier. But a purchaser, whether of child care services or automobiles, ordinarily could not care less. If management can pay itself ten times the standard salary while offering an attractive product at an attractive price, there will be satisfied purchasers.[77] The rules appropriate for a donative nonprofit thus appear to offer very little to attract customers to a nonprofit that relies principally on sales, rather than donations.

Why then would parents organize a mutual benefit child care agency? The answer is control of the service-provider by its consumers. In the mutual benefit child care facility, for example, voting control over management would be placed in the parents themselves. The facility would be owned by the parent-customers, and they might even take turns managing the operation. Few parents would be enthusiastic about donating their time so that a for-profit proprietor could increase his earnings, but many may donate their time to a parent-run facility. When the value of their time is considered, they may in fact pay a high price for the care, but they will do so to purchase control.

Customer control might be especially important in a service like child care for three related reasons. First, the consumer is more intimately concerned with the quality of the product and will expend effort to obtain exactly what he wants. This is amplified by the fact that the purchase is a continuing one, perhaps made daily. Finally, although quality monitoring may not seem difficult, the contracting cost may be high. Those who manage the child care facility will make daily decisions that concern the purchaser and influence his view of the product's quality. Yet it would be difficult for the buyer to specify his preferences in advance, both because it would be administratively tedious to spell out such detail in a contract and because the specific issues are difficult to anticipate. What the buyer really wants are managers with good judgment and compatible values. While there may be no "contract failure" in the sense of difficulty in evaluating performance, there are severe problems with attempting to write a contract to handle the situation. But this sort

77. There are circumstances in which buyers appear to care about the size of a seller's profits, but these occur principally when the buyer has no choice of seller. If the buyer is purchasing child care from a monopolist, he may well prefer a monopolist restricted by fiduciary rules limiting his profits, just as he prefers to have utilities regulated to limit returns. Child care, however, is rarely sold by firms with monopoly power, and so long as the buyer has a choice in purchasing child care, he will focus on the product and its price rather than the seller's profits. Objections to the profits generated by competitive nurseries seem no more likely than objections to the profits generated by the sellers of pet rocks.

of problem is not special to the nonprofit world; it exists as well in commercial settings.[78] It is thus clear that such contracting problems cannot serve as the single overriding explanation for mutual benefit nonprofits. But perhaps, in combination with the other two factors, it helps explain why the mutual benefit nonprofit form has arisen.[79]

Parents' choice of the nonprofit corporation form for child care facilities would not be surprising. A mutual benefit organization will often begin as an informal association. An attorney asked to incorporate it will normally choose the nonprofit form since memberships and directorships can easily be arranged to lodge control in the participating parents. Membership in a nonprofit can cease when the child ceases attending, whereas the "members" of a business corporation are its shareholders, and withdrawal requires forfeiture of business corporation shares.[80] Memberships in a nonprofit can be made nontransferable without becoming entangled in the special provisions of a business corporation law concerning share transferability, which were drafted with a concern for financial problems not relevant here. Members can be expelled if they prove to be troublesome as participants in the group enterprise, whether because of conflicts in personality or differences in child care philosophy.[81] Finally, the no-dividend rule, while unlikely to be a major concern to the organizers, in fact seems to be quite appropriate. The only purpose of a dividend is to reward those who provide equity capital. Yet the very point of a parent-run nonprofit child care facility is that it is owned not by nonparticipants, but by the parents, and they wish to discourage ownership by nonparent investors who have only a financial interest. Easily negotiable, dividend-issuing equity shares, therefore, would be inappropriate since they would have no purpose but to facilitate ownership by the very class of persons the organization was formed to avoid.

Nor does a bar on cash dividends create any real problems for

78. *See* Goetz & Scott, *Principles of Relational Contracts*, 67 VA. L. REV. 1089 (1981), and articles cited therein.

79. The great number of for-profit child care facilities demonstrates that many parents are not motivated by these concerns to pursue the nonprofit alternative. But for our purposes all that matters is that some are so motivated, and that they find the nonprofit form a convenient organizational structure by which to achieve their goal.

80. There may also be other advantages to the nonprofit form as a result of other laws. For example, in some states any nonprofit corporation, including mutual benefit nonprofit corporations, will be charged lower filing fees than business corporations, and may be exempt from minimum corporation taxes. These are not structural attributes of the nonprofit form, however, and therefore do not concern us here.

81. There is of course a rich literature on the subject of expulsions, and there is no doubt that the law will require at least certain procedural protections for members being expelled. *See* note 15, *supra*.

the parent-owners. It simply means that any surplus must be used to improve services or to reduce fees, either of which is entirely consistent with the parents' purposes in creating or joining the nonprofit corporation. The effect of the simple no-dividend rule in this form of nonprofit is to require that any earnings be paid out to members "in kind," in the form of child care services.

But while mutual benefits share the no-dividend rule with donative nonprofits, that common feature is not nearly as central as the contract failure thesis suggests because each category requires the no-dividend rule for entirely different reasons. For the donatives it is merely one part of a larger group of rules barring financially self-interested transactions; the purpose is to attract and protect contributors. For the mutual benefits it is appropriately part of a package of rules ensuring control by the corporation's customers, which is the mutual benefits' *raison d'être*. Thus, just as strict fiduciary rules are the defining rules for donatives, rules designed to ensure customer control are the defining rules for mutual benefits. Apart from a ban on dividends, two additional groups of rules are required to ensure customer control. These rules would apply to the full range of mutual benefit nonprofits, including social clubs and trade associations.

The first rule is fairly simple: The law should require that some minimum percentage of a mutual benefit's revenue be derived from its members. This is probably the most central defining rule, for it alone ensures that the ultimate governing authority, the membership, includes at least a majority of the mutual benefit organization's customers.[82] Any mutual benefit organization might want at times

82. While nonprofit laws now do not contain such restrictions, in at least two cases courts have in fact found it necessary to create judge-made rules to deal with the problems created by a conflict between investor-members and customer-members of mutual benefit nonprofits. In Aliberti v. Green, 6 Mass. App. Ct. 41, 372 N.E.2d 534 (1978), a country club was formed by creating both a business corporation, which purchased the land, and a nonprofit, which leased the land and operated the club. Each member of the club was necessarily a member of the nonprofit corporation, and at first each member was also required to purchase a share in the sister business corporation. Over time, however, some shareholders dropped out of the club, while some persons were admitted to membership in the club without purchasing a share of the business corporation. Club members, however, still held a clear majority of the shares and therefore controlled the board of the business corporation. The minority nonmember shareholders brought an action alleging that the board had made decisions sacrificing the corporation's financial interests for the benefit of the club. While such a claim by a minority shareholder would ordinarily be actionable, the court sustained a summary judgment for the defendant board because their conduct had been approved by the shareholders. While conceding that the majority shareholders' vote was not disinterested, the court noted that in reality these two separate corporations were created "for one common purpose." 6 Mass. App. Ct. at 45, 372 N.E.2d at 538. *See also* Beaver Lake Assn. v. Beaver Lake Corp., 200 Neb. 685, 264 N.W.2d 871 (1978), a similar case involving two corporations, one a nonprofit homeowners association, the other a for-profit business corporation which acted as the developer. The court found that, although not specifically barred by any nonprofit law, the business corporation's continued domination of the Association's board (it appointed four of seven members), al-

to sell its services to some nonmembers, whether as trial members, as guests of members, or to accommodate transients. But if its customers are not predominantly its membership, it loses its character as a mutual benefit nonprofit corporation. There is, of course, nothing wrong with one group of people forming a corporation to provide a service for another, but that is not a mutual benefit corporation; it is a business corporation. The proposed rule would be inappropriate for a donative nonprofit corporation, which might not sell services at all. Nor do we wish to make the management of a donative nonprofit responsible principally to those who buy services from it. But that is precisely the purpose of a mutual benefit nonprofit.

This proposed rule would eliminate from the nonprofit world a number of existing forms of nonprofit. There are, for example, nonprofit consulting companies, controlled by key employee-members, which sell their professional time like any for-profit consulting company.[83] They often have a research aura about them, although in fact they do little or no research beyond that needed to fulfill their consulting contracts. They neither are nor attempt to be donative nonprofits. They do not rely on gifts. They do not apply for federal tax status as a charitable enterprise, and they would have no reason to choose our donative nonprofit law and thereby to subject themselves to heightened fiduciary duties and attorney general supervision. As Hansmann has pointed out, since these consulting companies often make no attempt to qualify as charities, they are not usually subject to the traditional charitable trust rules.[84] Clark has observed that hospitals might choose the nonprofit form principally to trade, misleadingly, on the label "nonprofit,"[85] and the same explanation could apply to such consulting companies.

Of course, a model law grounded on the theory advanced here would permit the organizers of such a consulting company to choose the nonprofit form if they found its rules appropriate for them. And

lowing it to advance its private financial interests at the Association's expense, was "against public policy." 200 Neb. at 690-92, 264 N.W.2d at 875.

These cases illustrate the inevitable conflicts between investors and member-customers. The same board cannot have duties to both because such duties will inevitably conflict, much as there might be a conflict between the interests of contributors to and customers of a donative nonprofit. The solution is to clarify at the outset to which group the governing board is obligated: contributors (donative nonprofit corporation), customers (mutual benefit nonprofit corporation), or investors (business corporation). The rule advanced in the text serves this purpose by ensuring that any organization that calls itself a mutual benefit nonprofit corporation is in fact controlled by its customers.

83. *See* A. NAIRN & ASSOCS., THE REIGN OF ETS 40-41, 294-370 (1980); *The Pleasures of Nonprofitability*, FORBES, Nov. 15, 1976, at 89.

84. *Nonprofit Corporation Law, supra* note 3, at 585-86.

85. Clark, *supra* note 55, at 1441-47.

some might well choose the donative nonprofit structure. For example, we noted above that a group of professionals who intended to make their services available to worthy projects at bargain rates might wish to use the nonprofit form to communicate their intentions to potential customers. The fiduciary rules associated with the donative nonprofit form would be quite consistent with this plan. All that the model advanced here would require is that, if they seek the nonprofit form, they adopt either such strict fiduciary duties or customer control. If they intend instead to engage in a joint enterprise to generate profits from the sale of their services, they should be a partnership or business corporation. Yet current law in fact allows the choice of the nonprofit form for this purpose, by virtue of its accommodating structure.

These companies are actually closely held business corporations, operating as nonprofits. As nonprofits, they cannot issue dividends, but they have no desire to do so. Like any closely held business corporation, they prefer to pay out their earnings in compensation and perquisites. In most cases the resulting harm is merely confusion: While some additional customers might be obtained through this subterfuge, it seems unlikely that many would stay if they could get a better deal from a for-profit competitor. Nonetheless, as we saw earlier, there is value in having standardized labels, so that people can easily identify the nature of the organzation with which they are dealing.[86]

There is another benefit to insisting that only true mutual benefits may use the label: clarifying the rules by which to decide internal disputes. By adopting a nonprofit form, the consulting company's organizers have placed themselves in a potentially awkward position in the event of a falling out, for their organization is in reality a business partnership. Both partnership law and business corporation law have well-developed rules by which business disputes can be adjudicated, but the nonprofit law is neither as well-developed, nor is it generated with such disputes in mind. The result is that a court asked to resolve their dispute will either use nonprofit principles drawn from social clubs, under which expulsions are generally per-

86. A recent pilot study suggests that there is considerable public confusion as to the meaning of "nonprofit." Respondents to the study had considerable difficulty distinguishing for-profit from nonprofit corporations. Only 34% of the respondents, drawn from the New Haven area, knew that the Yale-New Haven Hospital was nonprofit, and only 24% knew that Yale University itself was nonprofit. Fifty-nine percent thought Yale was a for-profit institution, while 18% did not know whether Yale was for-profit or nonprofit. There was similar confusion as to whether nonprofits offered potential customers higher quality service. Permut, *Consumer Perceptions of Nonprofit Enterprise*, 90 YALE L.J. 1623 (1981).

mitted, without compensation, so long as fair procedures are used, or it will engraft more appropriate rules, drawn from the business context, onto the nonprofit law. The former course is likely to produce an inappropriate result. The latter will confuse the law of nonprofits. This entire difficulty would be avoided by the rule advanced here, which would push business organizations into the legal forms designed for them.

These difficulties, moreover, are avoided at no costs, so long as every legitimate activity has an appropriate organizational form available to it. Under the rules advanced here, the consulting company could be formed as a partnership or a business corporation if its purpose were to make money for its organizers, as a donative nonprofit if it wanted to undertake strict fiduciary standards and Attorney General supervision, or as a mutual benefit if it planned, like the College Entrance Examination Board, to serve an identified and relatively stable set of customers who desired joint control over it.

One more step is necessary to complete our defining rules: We must ensure that the members actually control the corporation, for otherwise it will not be a true mutual benefit corporation. In general it is preferable to let the parties themselves specify the details of their arrangements, but because it is so fundamental to the character of a mutual benefit corporation, the code should guarantee some minimal level of member democracy.

Code guarantees of internal democracy are much more important to the mutual benefit corporation than to the business corporation. In the small, closely-held business corporation there is likely to be the equivalent of a partnership agreement, detailing the relationship between the parties and protecting their interests. Because financial stakes are involved, the agreement will have been drafted with some care by an attorney or by a number of attorneys representing the various parties. In such a situation, the agreement would diminish the need for statutory rules. In the large business corporation with freely tradable shares, the shareholder always has the option of selling. This option can be quite an effective vote: If many shareholders sell and prices decline, the corporation becomes an attractive takeover target, which poses a grave threat to the incumbent management. As long as the basic right to vote for the board is preserved, and can be purchased with shares, the market will discipline management in the publicly-traded business corporation.[87]

These protections are less likely to be guaranteed in a mutual

87. R. WINTER, GOVERNMENT AND THE CORPORATION (1978).

benefit nonprofit corporation. The amount of money involved often does not merit the expense of extensive legal services. Exiting will often entail financial sacrifice: The initiation fee will have gone for nothing, and the membership cannot easily be sold, if sale is even possible. Moreover, it can be even more difficult for the departing member to find an alternative provider of the service. Other mutual benefits in the same field might not be available to him, and since he originally chose a mutual benefit, any available for-profit alternatives will probably be unsatisfactory. Mutual benefits, whether social clubs or child care facilities, are not fungible; sale and substitute purchase is not as satisfactory as it is with shares of stock. By choosing a mutual benefit nonprofit provider, rather than a business enterprise, the member might have sacrificed his ability to "exit," *i.e.*, to terminate his relationship. Exit is sacrificed in exchange for the promise of "voice" — indeed, membership control is the mutual benefit's distinctive feature as an alternative organizational form.[88] The only vehicle for guaranteeing that feature is the nonprofit corporation law.[89]

This model of the mutual benefit corporation suggests no reason why its managers should be governed by specially heightened fiduciary obligations. As long as the democratic process is working, no other safeguards are needed; the rules of fiduciary responsibility found in the business corporation law would work perfectly well in a mutual benefit corporation law. Nor is there the same need for attorney general supervision and enforcement. In the case of donative nonprofits, the attorney general or other state agency acts to protect the interests of contributors, who may not be represented in the charity's governance structure.[90] If a mutual benefit is properly struc-

88. The terms "exit" and "voice" are borrowed from A. HIRSCHMAN, EXIT, VOICE AND LOYALTY (1970).

89. Courts have often sustained claims of procedural unfairness in nonprofit corporations, even though the challenged procedure violated no explicit provision in the law or in the corporate articles and bylaws. Although various explanations have been offered for such decisions, it seems likely that the unifying theme is in fact the necessity for preserving a minimal level of fairness and democracy in the governance of such organizations so that they may fulfill the function envisioned by the membership. This argument is developed in the context of churches in Ellman, *supra* note 12, at 1422-28.

90. There have at times been proposals for a more democratic structure for charitable enterprises, but these usually focus on giving the beneficiary class some representation in the governing structure. I believe that the opponents of such changes have the better of this argument because they accurately point out that it is freedom from controls by donors that enables a private charity to make controversial decisions and to play a role distinctive from government. *See* Simon, *Foundations and Public Controversy: An Affirmative View*, in THE FUTURE OF FOUNDATIONS 58 (F. Heimann ed. 1973). Empirical studies indicate that while such democratic experiments produce a noisier board, they do not necessarily improve the decisions made. Cole, *Constituent Involvement in Non-Profit Organizations*, Working Paper #18, Program on Nonprofit Organizations, Institution for Social and Policy Studies, Yale University

tured, its members will, by definition, be represented. Thus, the mutual benefit corporation's special need is in the area of democratic control: The members require a continuing voice in the policies adopted by the organization—the policies that guide day-to-day decisions. No rules of fiduciary obligations can provide them with that assurance; only the guarantee of a democratic structure can fill that need.

2. *Some Further Applications: Trade Associations and Clubs*

Corporations or individuals engaged in a common trade or business often form associations to promote their shared interests. These are certainly not donative organizations; instead, they fit comfortably into the mutual benefit category.

Trade associations are organized to serve the interests of their members. The organization is supported by the member dues — dues that purchase services in much the same way that members pay for the services of a parent-controlled child care facility. Those services usually consist of public relations and lobbying efforts to advance the membership's common interests, as well as the dissemination of information of special interest to the membership. Hansmann argues that:

> 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.[91]

Hansmann here explicitly identifies the trade association member's problems as a difficulty in assessing the marginal impact of his gift. The expanded no-dividend rule is again used to explain the suitability of the nonprofit form, and Hansmann criticizes the few cases that exclude trade associations from the nonprofit world. Such cases usually turn on the court's construction of the no-dividend rule as barring a distribution of services to the membership.[92]

These cases should be criticized because the nonprofit form is in fact appropriate to trade organizations. But those cases are gener-

(1982). A basic problem in any attempt to incorporate democratic procedures in an essentially paternalistic charitable organization is deciding on the appropriate constituency. Even where directors are politically responsible to the contributors, rather than to the beneficiaries, conflicts between the directors' political responsibility and their trust obligation become possible. *See* Defender Assn. Amendment of Articles of Incorporation, 453 Pa. 353, 307 A.2d 906 (1973).

91. *Nonprofit Corporation Law*, *supra* note 3, at 557.

92. *See id.* at 557-59.

ated by a fact that the contract failure theory denies, for they accurately perceive that the trade association is fundamentally different from the typical donative nonprofit and is not appropriately included in the same organizational category; trade associations are not donative but mutual benefit nonprofits.

It is fairly easy for a member of a trade association to see what the organization has done — whether it has provided him with information, whether it has conducted a public relations campaign, or whether it has engaged in lobbying efforts. What then prevents the member from turning to a for-profit provider of these services? There would be at least two difficulties. The first, as Hansmann also points out, is that many of the trade association's products are public goods: There is no way to provide them only to those who pay for them. A public relations campaign asserting that milk is good for you or that orange juice is not just for breakfast will benefit nonmember producers of milk and orange juice as much as member producers, and it costs as much to produce the advertisement whether one or one thousand producers agree to buy it. This difficulty, sometimes called the "free rider" problem, is certainly not solved by using the nonprofit form: All sellers, including nonprofit ones, have difficulty persuading buyers to pay for public goods, as organizers of faculty associations or membership directors of public television stations can attest. But the nonprofit trade association has one tool not normally available to a for-profit trade association: social pressure. Union organizers have used this tactic for decades, and those who solicit membership in trade associations use it as well.

Another more fundamental problem of public goods is the one identified by Hansmann and discussed above: assessing the marginal impact of the member's dues. It is particularly tempting to be a "free rider" because it is not at all clear that by joining the association and paying dues one will increase the amount of lobbying that takes place. From this fact one might conclude that trade associations share the problem of donative nonprofits and should therefore be so organized. Trade associations, however, must adopt a democratic structure for other reasons developed below. And having done so, they have generated an alternative solution to the marginal-impact monitoring problem, one that fills their needs more effectively than would the package of strict fiduciary rules.

Not all products provided by trade associations are public goods. Associations often disseminate information through association publications, subscriptions to which are obviously private goods. Others can obtain the information, but not as conveniently. Consumers

Union, the publisher of Consumers Reports, is essentially a trade association of consumers, and although it engages in some lobbying and produces other "public goods" on behalf of consumers, it sells memberships by promoting the magazine that it provides to members. The fact that it is a consumer-controlled mutual nonprofit, rather than a for-profit, may help it sell that magazine by giving its ratings more credibility. A for-profit publisher of a consumer guide might have some difficulty in persuading potential buyers that its ratings were honest, particularly if its revenue included advertising by manufacturers of rated products. That difficulty is not fatal — indeed, there are specialized for-profit magazines that evaluate products such as cars and photographic equipment. But the claim of member control, and of freedom from influence by the advertisers who patronize the for-profit magazines, apparently does aid Consumers Union in attracting member-buyers, even though the subscription cost must be raised to replace foregone advertising revenues. Not everyone prefers member-controlled rating agencies, but *some* people do, and Consumers Union can serve those people by using the nonprofit form.

The credibility problem arises in a variety of contexts. Trade associations, for example, act as intermediaries and purchase goods and services on behalf of their members. Trade associations may hire employees to lobby or prepare advertising, or they may retain Washington representatives to do their lobbying and advertising agencies to conduct their public relations campaigns. Not only must the association be trusted to select the lobbyist or advertising agency, but it must also be trusted to represent fairly and accurately the views of its members. There is no convenient mechanism by which the for-profit intermediary could persuade its potential customers that it would faithfully represent them. This is the same problem experienced by the member of the child care facility: One cannot specify all contingencies in advance, although one has no special difficulty in monitoring performance. Trade association members can see the advertisements that have been produced and the results of the lobbying efforts; they are simply unable to specify in advance exactly what advertisements or lobbying they want. As with child care, the buyer needs a seller with good judgment who shares his views.

The credibility problem can be dealt with effectively by using a membership corporation governed by democratic procedures, which selects a managing board that itself acts as the intermediary. Just as in the parent-run child care agency, the democratic structure is the key to protecting the members' interests. The simple no-dividend rule is again appropriate since the organization has no interest in attracting outside investors, who are indifferent to the membership's problems and who merely seek returns to capital. Nor is the membership interested in a cash return; they are purchasing services. And the democratic structure, necessary to solve other problems, also provides a solution to the problem of monitoring the marginal impact of one's dues on the public goods provided by the association. The opportunity to choose management oneself is at least as reassuring as the stricter fiduciary obligations, which are themselves only a partial solution. The time spent on involving oneself in the affairs of a trade association is a cost, a price of membership, but it is a cost that is necessary anyway to solve the credibility problem. That cost is not normally borne by the contributors to a donative nonprofit, who must rely on heightened fiduciary duties precisely because they have no other claim on the donative's management, which is typically self-perpetuating.

The heightened fiduciary obligations, which provide an advantage in protecting and reassuring potential contributors, are thus a useless burden to the association with a democratic structure. For example, the same arguments that support allowing shareholders to ratify suspect transactions apply to the members of the trade association; it is the members' money at stake. This contrasts with the situation in the typical donative nonprofit, where the donors are not the members, and do not have the ultimate governing authority.

Strict fiduciary rules and a democratic structure are alternative tools. For the trade association, the democratic structure is more appropriate. Indeed, some of the provisions appropriate for donative nonprofits would be extraordinarily inconvenient for the trade association. Consider, for example, the traditional trust doctrine that requires a charitable organization to use its funds for its specified charitable purpose.[93] Such a doctrine protects contributors who choose the particular charitable organization because they are interested in its goal of, for example, operating a museum of Chinese art. Those contributors, who usually have no internal governance rights in the organization, would be upset if the charity's board decided to abandon its traditional purpose, sell its collection, and use the proceeds to promote research into sickle cell anemia. Some form of the traditional trust rule, therefore, is entirely appropriate as part of a donative nonprofit corporation law.[94] But it serves no purpose in the

93. *See* cases cited in notes 37 & 57 *supra*.

94. Of course, donative nonprofit corporations should be permitted some flexibility to alter

trade organization, which ought to be able to change its purposes as easily as a business corporation on a vote of its membership. So long as the members are represented in the organization's decision-making process, there is no reason further to encumber the trade association's flexibility in the use of its funds. Consumers Union may or may not favor mandatory air bags, but no matter how the board chooses to spend its lobbying funds, some members are likely to object. They may even claim that the expenditure is a change in association policy. But these objecting members are adequately protected so long as it is reasonably possible for the membership to change the board or revise the decision. It would make no sense to apply to Consumers Union a rule allowing the attorney general, in his supervisory authority over charitable endeavors, to seek damages against the incumbent directors for their failure to conform to a trust requirement that association funds be used only to support, or oppose, mandatory highway safety devices.

Member control is similarly advantageous in the context of clubs. There are many for-profit athletic clubs while there are few for-profit trade associations, suggesting that at least some of the services provided by clubs are perfectly amenable to the entrepreneurial form. Nonetheless, in some cases member control might be desirable. For social clubs, the process of self-government itself may be the goal. The meetings, elections, and discussions provide an occasion for socializing and a sense of joint enterprise, which might be the very thing the members seek to buy.

Member control, moreover, provides a perfectly functional alternative to the market as a method of ensuring that the club will provide certain amenities. Members might be concerned that only people of a certain social class or tennis ability be admitted to ensure that the facilities never become overcrowded. In theory, it is perfectly possible for an entrepreneur with a profit motive to provide these services, and in fact it is occasionally done. But especially where members are concerned about intangible qualities, such as social class, the members might be more confident that their goal will be served in a club run by a member-chosen board than one run by outsiders seeking to maximize profits. At least they can be assured that the policy will not change when the entrepreneur sees a more advantageous profit possibility.[95]

their purposes, under a doctrine analogous to the traditional trust rule of *cy-pres*. RESTATEMENT (SECOND) OF TRUSTS § 399 (1959).

95. Of course, if that possibility is available to the entrepreneur, it would also be available to the membership, and an economist might, therefore, see no difference between the two

But while clubs comfortably fit the mutual benefit form, Hansmann concedes that they do not fit his model since there is no evidence of contract failure and no role for special fiduciary duties. The club member typically experiences neither marginal-impact monitoring difficulties, nor quality monitoring difficulties. As a result of his dues he gains admission, and he surely knows whether the facilities meet his demands. For Hansmann, the problem is to provide a home for clubs, while keeping a unitary nonprofit model. His solution is to treat clubs as cooperative corporations. This is a convenient solution since it avoids reconsidering the one-category nonprofit law. Furthermore, as Hansmann notes, the law of cooperatives is, if anything, even more primitive than nonprofit law. In the absence of any established theory of cooperatives, it is difficult to argue that a cooperative law will not work for social clubs, but Hansmann deals with the difficulty by suggesting that the cooperative law should be "reformed" to meet the needs of the clubs.[96] Whether such reforms would alter the essence of cooperative laws is impossible to say without a theory of cooperative law.

Nonetheless, some examination of the cooperative club proposal is necessary. For while Hansmann treats clubs as one minor exception to an otherwise comprehensive treatment of nonprofits, one theme of this Article is that many of the organizations that he sweeps into his net are in fact mutual benefit nonprofits. Clubs are not one minor exception to his comprehensive model, but rather an example of a major category of exceptions. If one accepts the arguments made above, then not only would some local social clubs be pushed into the cooperative laws, but so also would the Consumers Union, the American Medical Association, the American Bar Association, the National Association of Manufacturers, the American Trucking

organizations. If the members of a mutual benefit nonprofit club are willing to restrict use of their valuable facility to the limited existing membership, and forego the potential additional members who would allow a lower fee per person, then they should also be willing to pay the entrepreneur whatever fees are necessary to persuade him to restrict use. But people do not always behave as such rational economic animals. To at least some it will seem less costly to continue to use a facility already owned in a less than optimal way than to pay someone else enough to motivate them to make the same choice with their facility. That is, people may treat out-of-pocket costs differently than opportunity costs. *See* Kelman, *Production Theory, Consumption Theory, and Ideology in the Coase Theorem,* 52 S. CAL. L. REV. 669 (1979).

Hansmann has also offered an argument that the nonprofit or cooperative form may permit the members of social clubs to avoid paying an entrepreneur monopoly prices for their own status. That is, to the extent that the desirability of membership in a particular club is determined by the social status of its existing members, the price that an entrepreneur could charge members is directly proportional to their own status. The owner of an exclusive social club, therefore, may acquire the power to charge its members for their own status at a monopoly profit. *Nonprofit Enterprise, supra* note 3, at 892-93.

96. *Nonprofit Corporation Law, supra* note 3, at 595-96.

Association, the Lions, the Masons (both national organizations and local affiliates), and every Board of Realtors.

Obviously, whether these organizations are called cooperatives or mutual benefit nonprofits matters little, but even assuming that we amend the cooperative laws to fit mutual benefits, there is more than name in question. The problem is knowing what to do with the organizations that are already cooperatives: Will our reformed cooperative law fit them too? Hansmann assumes that it will, arguing that there is no important difference between a cooperative and a mutual benefit nonprofit. The assertion is hard to evaluate with so little known about cooperatives, but some points can be made.

Although some large consumer cooperatives do exist,[97] producer cooperatives dominate the field, and most cooperative laws appear to be written with them in mind.[98] Producer cooperatives are economic organizations with only economic goals, quite unlike social clubs, lobbyist groups, or Consumers Union. A producer co-op seeks a large number of members; it is organized to take advantage of the economies of scale available in the joint distribution of goods and to produce the highest possible profits.[99] A well-drafted cooperative law might require considerable attention to the members' financial interests in order to design reasonable rules governing the distribution of profits. Because of its economic purpose, a co-op does not usually place idiosyncratic restrictions, such as proper social class, upon admission to membership. And while nonprofit clubs have occasion to expel or suspend members, sometimes for subjective reasons, co-ops seldom face that question, for the cooperator has only a business relationship with the organization:[100] The co-op is an agent

97. The Consumers Cooperative of Berkeley, California, is by far the largest consumer cooperative in the nation, accounting at times in the past for as much as one half of the total sales of the national consumer cooperative wholesalers. The total assets of the Berkeley Co-op are in the neighborhood of $12 million. Ellman, *On Developing a Law for Nonprofit Corporations*, 1979 ARIZ. ST. L.J. 153, 161 n.17.

98. In many states the cooperative laws have contained purpose requirements that would appear to exclude all but agricultural and rural endeavors. Note, *Associations — Definition of Cooperative*, 17 VAND. L. REV. 646 (1964).

99. Some of the observations made here about cooperatives are also noted by Hansmann in *Nonprofit Enterprise, supra* note 3, at 889-90, 891-92.

100. When cooperatives do expel members, one would expect the reason to be a disagreement over business practices. *See, e.g., Sanchez v. Grain Growers Assn. of Cal.*, __ Cal. 3d. __, __ P.2d __, 176 Cal. Rptr. 655 (1981), in which the member was expelled because he declined to sign that year's marketing agreement, which meant that he did not agree to have the cooperative market his produce that year. 176 Cal. Rptr. at 658. In such an expulsion, the principal question is whether the member is entitled to a financial settlement from the cooperative. 176 Cal. Rptr. at 658. The dispute differs considerably from the membership expulsions normally seen in nonprofit corporations, and it is not at all clear that the same rules would be appropriate. For material on nonprofit expulsions, see note 15 *supra*.

for the sale of its goods. Clubs, on the other hand, do not ordinarily have economic goals analogous to a co-op's. A member-owned social or athletic club often provides a higher-quality alternative to the proprietary club, rather than a less expensive one. Clubs often limit the number of members for a variety of reasons that may include maintaining an aura of exclusivity and insuring that the facilities are adequate for the existing members.

Finally, there is the no-dividend rule, which we have seen fits comfortably with the needs of mutual benefit nonprofits. Co-ops, on the other hand, obviously require the ability to issue payments to members, although these payments need not necessarily be a return on equity capital. Nonetheless, they are likely to violate existing nonprofit rules barring dividends. A combined law would have to make appropriate rules for cooperative distributions without altering the essential characteristics of a mutual benefit nonprofit.

In sum, it is not clear that cooperatives and mutual benefit nonprofits share the same defining rules. The producer co-op is a joint effort by sellers; the mutual benefit nonprofit is a joint effort by buyers. Perhaps a consumer cooperative is indistinguishable from a mutual benefit nonprofit, but the producer cooperative seems more like a partnership. It is certainly clear that existing cooperative laws do not fit existing mutual benefit nonprofits, which means that some major changes in the cooperative law would be necessary before the club could fit into them. A more practical suggestion would be to repair our nonprofit laws first.

The question whether mutual benefit nonprofits are related so closely to consumer cooperatives that the two organizational forms should be combined is, in the end, a side point. The central points are that those organizations currently organized as nonprofits in fact fit comfortably into one of two alternative organizational forms, and that the nonprofit law ought to be reformed so that the needs of each group are effectively met. They are not met by current nonprofit laws, nor would they be met by a nonprofit law reformed along the lines suggested by Hansmann. Whether the next step is to fold existing consumer cooperatives into the reformed mutual benefit nonprofit law is a question that can be saved for consideration at a later day, but it seems unlikely that the cooperative form would thereby be rendered superfluous since producer cooperatives and mutual benefit nonprofits will remain very different organizational forms.

IV. Conclusion

This Article has examined the function of the nonprofit form. By asking what problems that form of organization may solve, we can find out what an ideal nonprofit corporation code would look like. We have focused on establishing the appropriate "defining" rules for nonprofit corporations — the rules that establish the form's distinctive characteristics. These rules, if well-conceived, promise an organizational structure with special advantages for some legitimate class of activity that the law seeks to encourage.

We have concluded that there are really two sets of problems and two sets of solutions. The proposed donative nonprofit law is designed to meet the needs of an organization seeking to attract contributors by including special provisions on fiduciary duties to protect their interests. These rules are particularly necessary because contributors do not ordinarily have governance rights in the organization. The donative nonprofit form may also be useful for other purposes; it might, for example, be a considerable convenience in formulating tax policy or mail rates to have the amorphous class of nonprofits clearly segregated, so that the donative nonprofits may be separately referenced.

The mutual benefit nonprofit law is designed to meet the needs of consumers who want a customer-controlled seller. While for-profit sellers usually will be adequate, we have seen three instances — child care, trade associations, and clubs — where some buyers would prefer the mutual benefit alternative. As an initial theoretical foray, this Article is necessarily general in its prescription and does not purport to answer the detailed questions that a code drafter would necessarily face. But it does offer a conceptual framework to guide a drafter's efforts. The likely outcome of laws drafted along the lines advanced here is a four category classification: donative nonprofits, to serve donors; mutual benefit nonprofits, to serve customers; cooperative corporations, to serve producers; and business corporations, to serve investors. Hansmann's work, analyzed here in detail, offers the only competing conception. This Article concludes that in attempting to explain the entire nonprofit world through the aggregated concepts of "patron" and "contract failure," Hansmann has produced a flawed model.