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Privileges and Immunities of Non-Profit Organizations

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"AND NOW ABIDETH, FAITH, HOPE AND CHARITY, these three; but the greatest of these is *charity*."[1] This unsubtle reference to the word charity describes superficially the field of non-profit or not-for-profit[2] corporation law.

The objective of this paper is not to delve into the intricacies and complexities of the non-profit area, but rather to make manifest a few of the many privileges and immunities granted to non-profit corporations.

Privilege of Tax Exemption

This subject is treated in detail elsewhere in this Symposium; and we merely touch on it here.

The fundamental test for tax-exemption to non-profit corporations is that there be *present* benefit to the general public sufficient to outweigh the loss of tax revenue.[3] One recent example is the purchase by Cleveland State University of three hundred acres of land near downtown Cleveland, which prior to its acquisition was taxable and has now become tax-exempt.[4] Although this will eliminate some of the city's tax revenue, from the community standpoint it will aid in the development of a much greater educational system and is thus *pro bono publico*.[5]

Sec. 501(c)(3) of the 1954 Internal Revenue Code enumerates the requirements to be met by any corporation seeking exemption from federal taxation. It states that any corporation or other organization, no part of whose net earnings inure to the benefit of any private share-

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[*Note*: This paper was *not* part of the Symposium. It replaces the paper on this subject which was presented at the Michigan symposium.]

[1] I Corinthians 13:13 (King James).

[2] See Generally, Laws of N. Y. 1969, c. 1066, constituting c. 35 of the Consolidated Laws of New York (McKinney's Cons. Laws of N. Y. Ann., Book 37, 1969). The words "not-for-profit" corporation law statutes have been enumerated in N. Y. State's statute: This N. Y. title seems to be a more appropriate designation than the more commonly used non-profit title, simply because a not-for-profit corporation can make a profit, although making a profit is incidental to its main function.

[3] Philada Home Fund v. Board of Tax Appeal, 5 Ohio St. 2d 135, 214 N.E. 2d 431 (1966).

[4] Blessed Are the Tax Exempt, Montage (WKYC-TV), Jan. 31, 1970.

[5] Oleck, Non-Profit Corporations, Organizations and Associations 360 (2d ed., 1965).

holder or individual, shall be exempt from taxation.[6] Once a corporation meets the requisites of § 501 (c) (3), it will qualify for an exemption under § 501 (a).[7]

Contrary to wide spread recent publicity the tax-exempt foundation as a rule is not manipulated only for the performance of improper deeds. Rather, the tax-exempt foundation represents a kind of power source that allows individuals and corporations to engage in many proper activities in which they could not otherwise financially participate.[8]

However, there have been many situations wherein a perversion of this privilege has taken place. The "feeder organization" represents a prime example. Such an organization historically carried on a trade or business for profit, and then paid this profit to a tax-exempt organization.[9] Such "feeder corporations" had a competitive advantage over private enterprises as their tax-exempt status enabled them to use their profits tax-free to expand operations, while their competitors could expand only with profits remaining after taxes. Such abuses of the tax privilege resulted in the removal of the exemption for feeder corporations and the imposition of the Federal income tax upon them.[10]

There are no general rules governing state and local taxation of non-profit corporations. Generally, non-profit organizations (or at least charitable organizations) receive total or partial tax exemptions with respect to most state and local taxes. To determine the exact nature of any exemption, however, one must look to the particular statute.[11]

One example of such a state statute is § 5739.02 (a) (12) of the Ohio Rev. Code, which states that the state tax does not apply ". . . to churches and to organizations not for profit operated, exclusively for charitable purposes, where no part of the net income inures to the benefit of any private shareholder or individual. . . ."

Real property tax exemptions are allowed in most states for certain merely "non-profit organizations," but not to all such organizations. In

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[6] Internal Revenue Code of 1954, § 501(c) (3), "Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting to influence legislation, and which does not participate in, or intervene in (Including the publishing or distributing of statements), any political campaign on behalf of any candidate for public office."

[7] I.R.C. of 1954, § 501(A); "An organization shall be exempt from taxation under this subtitle unless such exemption is denied under § 502, 503, or 504."

[8] Baum and Stiles, Power Tools: Private Foundations and Public Corporations, 13 U.C.L.A. L.R. 938, 945 (1966).

[9] Schonfield, Federal Tax Aspects of Non-Profit Organizations, 10 Vill. L.R. 487, 489 (1965).

[10] Note, Contribution of Feeder Corporations to Parent Foundation, 25 Wash. & Lee L.R. 260 (Fall, 1968).

[11] *Supra* n. 5, at 438. See also, Sierk, State and Local Tax Exemptions on Non-Profit Organizations, elsewhere in this issue.

some cases if a portion of the real property of a merely non-profit organization is devoted to a charitable use or purpose, it may be exempt; but this depends entirely upon the particular state involved and its tax exemption statutes.[12] Unfortunately, no uniform rules exist in this area.

In *Bowers v. Akron City Hospital*[13] the Ohio Supreme Court applied § 5709.12 of the Ohio Rev. Code. The defendant, Akron City Hospital, a non-profit corporation, had a parking lot adjacent to its building, which yielded a profit of $19,000 per year. The issues were whether the hospital, because it owned the parking lot, was entitled to a tax exemption as a result of its non-profit status, and whether the use of the property rather than its ownership, should be a determinative factor in the decision. The court ruled that the hospital was exempted from taxation under the statute, as property belonging to a charitable institution as long as the proceeds from the property were used solely to regulate existing conditions and provide for essential parking facilities.

The "use theory" was further propounded in a Nebraska case wherein the court stated "it is the exclusive use of property which determines whether the property is exempt from taxation." This court has long been committed to the principle that "the primary or dominant use, and not incidental use, is controlling in determining whether property is exempt from taxation." [14]

Tax immunities were originally granted to non-profit corporations because of their *pro bono publico* character. However, in many situations there has been an abuse of this privilege, for the benefit of those "in command," rather than for the public. This impropriety has led to more stringent tax restrictions on private foundations noted in ¶ 1200 of the C. C. H. handbook on the Tax Reform Act of 1969 under the heading "New Curbs on Foundation Activities," which states: "the Tax Reform Act substantially restricts the permissible activities of private foundations by imposing a variety of sanctions—in the form of a new series of excise taxes—on prohibited transactions." Several other articles in this symposium will deal more in depth with this situation.

Exemptions From Collective Bargaining With Labor Unions

In certain situations non-profit corporations have been allowed an exemption from bargaining collectively with labor unions. In *Building Service and Maintenance Union v. St. Luke's Hospital*[15] the union requested that the court issue an injunction compelling a non-profit hos-

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[12] Bennett, Real Property Tax Exemptions for Non-Profit Organizations, 16 Clev-Mar. L.R. 150, 164 (1967).

[13] 16 Ohio St. 2d 94, 243 N.E. 2d 95 (1968).

[14] Lincoln's Woman's Club v. City of Lincoln, 178 Neb. 357, 133 N.W. 2d 455, 460 (1965).

[15] 11 Ohio Misc. 218, 227 N.E. 2d 265 (Ct. of Common Pleas, 1967).

pital to bargain collectively. The Court dismissed the request for an injunction stating that the National Labor Relations Act did not affect this matter because Congress had amended the act and expressly eliminated non-profit hospitals from its scope and that no Ohio statute compels collective bargaining.[16]

A different result, however, was reached in a Utah case,[17] which represented a proceeding by the Utah Labor Relations Board against the Utah Valley Hospital to enforce the Board's order requiring the hospital to bargain collectively. The hospital refused to bargain with the Board, on grounds that the Board had no jurisdiction over the subject matter and that it was subject to control only by Congress and the N.L.R.B. The court stated that the field of labor-management relations of charitable hospitals was not occupied by Congress so as to oust states of control.[18] It was further pointed out that states may control labor-management relations in businesses which are engaged in interstate commerce unless Congress by statute limited such relations to federal jurisdiction. Thus, the State Labor Relations Board had jurisdiction to order the hospital to enter into collective bargaining with the union.

Exemptions From Contributing to Unemployment Compensation Funds

Another of the privileges granted to non-profit corporations is exemption from contribution to state unemployment compensation funds.

In a recent Ohio case[19] a "would-be" non-profit corporation which operated a home for the aged and infirm sought to be relieved from having to make such contributions, contending that it was not an "employer" because it was "organized and operated exclusively for . . . charitable purposes . . . the activities of which were confined exclusively to the rendition of services for . . . charitable purposes." [20] The residents of the home paid all or a large part of the cost of their upkeep. The only issue was whether or not the home was an employer, within the meaning of the statute. The court found that a corporation not-for-profit, which operates a home caring for the aged and infirmed is not an "employer" under § 4141.01(A), Ohio Rev. Code, required to contribute to the Unemployment Compensation Fund. Though the court stated that there may be good reasons for not exempting charitable corporations from contributing to the unemployment funds, it also concluded that statutes must be strictly construed and that "legislative intent may be inquired into only if the enactment is ambiguous upon its face." [21]

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16 *Id.*, 223, 274.

17 Utah Labor Relations Board v. Utah Valley Hospital, 120 Utah 463, 235 P. 2d 520 (1951).

18 *Id.*, 466, 523.

19 Carmelite Sisters v. Board of Review, 18 Ohio St. 2d 41, 247 N.E. 2d 477 (1969).

20 *Id.*, 43, 479.

21 *Id.*, 44, 480.

Tort Immunity

At common law an unincorporated voluntary association such as a labor union can not sue or be sued in its own name[22] since such an association had no status as a legal entity. Ordinarily, an action had to be brought against the individual members of such an association "collectively and conjointly." [23]

In Ohio, the enactment of § 1745.04 of the Rev. Code abrogated this common law rule. The statute states that "any unincorporated association may contract or sue on behalf of those who are members and, in its own behalf, be sued as an entity under the name by which it is commonly known and called." Similar statutes permitting legal action in the association's own name now are found in California,[24] Michigan,[25] Oklahoma,[26] New Jersey,[27] New York,[28] and several other states.[29] A different situation exists in Massachusetts, where an unincorporated labor union is still not a legal entity. No court judgment may be issued for it or against it, in its own name. Such a judgment, except for a mere declaratory judgment, may be entered only for or against its members.[30]

Tort immunity for non-profit corporations has been predicated upon four basic theories.[31] Cases espousing these theories are almost riotous with dissent. Reasons are more varied than results to the degree that they indicate something wrong at the beginning.[32] The basis for the various theories of tort immunity of non-profit corporations stems from the courts' concern that the important functions of these corporations not be crippled by expensive damage claims.[33]

The "trust fund" theory is premised upon the reasoning that the assets of the institution, created by the founders thereof, constitutes a trust for particular charitable purposes. Therefore, if these assets should be diverted to the payment of judgments that might be obtained in suits against the institutions the purpose of the charity as well as that of its donors would be frustrated and perhaps destroyed. In other words, the essence of this theory seems to be that the preservation of the charitable

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22 Kingsley v. Amalgamated Meat Cutters, 323 Ill. App. 353, 55 N.E. 2d 554 (1944).

23 Damm v. Elyria Lodge, 158 Ohio St. 107, 107 N.E. 2d 337 (1952); Kimball v. Lower Columbia Fire Ass'n, 67 Or. 249, 135 P. 877 (1913); Koogler et al., Trustees v. Koogler, 127 Ohio St. 57, 186 N.E. 725 (1933); State v. Freemont Lodge, 151 Ohio St. 19, 84 N.E. 2d 498 (1949).

24 Calif. Code of Civil Prac. § 388 (1960).

25 Comp. Laws Mich. § 612.12 (1948).

26 Okla. Stat. Anno. Tit. 12 § 182 (1962).

27 N.J. Stat. Anno. Tit. 2A, C-64 (1952).

28 N.Y.C.P.L.&R., § 1025.

29 Oleck, *op. cit. supra* n. 5 at 28.

30 *Ibid.*

31 *Id.*

32 President and Directors of Georgetown College v. Hughes, 130 F. 2d 810, 812 (D.C. Cir. 1942).

33 Oleck, *op. cit. supra* n. 5 at 110.

trust fund is more desirable than the right to compensation from the funds for an injury inflicted by the operations of the charity.[34] This represents the basic rule found in most states.[35]

The "waiver theory" holds that one who accepts benefits from a charitable organization waives his rights to collect damages from that organization for the torts of its agents.[36] This argument, which has been soundly repudiated in numerous decisions, is shown to be a fiction.[37]

The "exception to *respondeat superior*" theory holds that since a non-profit organization obtains no direct benefit for its purposes from its employees, it should not be liable for their torts.[38] This theory is not applicable to the commercial world where the master receives profits from his relationship with his servants.[39] This theory has been rejected by many courts which point out that the doctrine is not a question of profit, but "a consideration of the extent of the master's authority and control over his employees." [40]

Concerning the "public policy" theory, it has been stated that courts must determine between the public's interest in maintaining institutions free from liability and an injured person's right to compensation. Court relying on the public policy theory advocate that individual rights must be subordinated to the public good in order that charitable funds not be depleted and that prospective endowments will not be discouraged to the detriment of the public.[41]

Recently passed state statutes and court decisions have had a strong effect in changing tort-liability immunities of non-profit corporations.[42] The Ohio case of *Avellone v. St. John's Hospital,* not long ago, is a prime example, for it abolished the common law immunity doctrine as applied to hospitals.[43]

Liability of Directors and Officers

Fundamentally, the directors and officers of a corporation are responsible to the shareholders or members for the management of the property and business entrusted to their care.[44] But the questions re-

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[34] Foster v. Roman Catholic Diocese of Vermont, 116 Vt. 124, 70 A.2d 230 (1950).

[35] Howard v. South Baltimore General Hospital, 191 Md. 617, 62 A.2d 574 (1948).

[36] Milias v. Wheeler Hospital, 10 Calif. App. 2d 759, 241 P. 2d 684 (1952); DeGroat v. Edison Institute, 306 Mich. 339, 10 N.W. 2d 907 (1943); Holtfoth v. Roch. General Hospital, 304 N.Y. 27, 105 N.E. 2d 610 (1952).

[37] Nicholson v. Good Samaritan Hospital, 145 Fla. 360, 199 S. 344 (1940).

[38] Oleck, *op. cit. supra* n. 5 at 110.

[39] Nicholas v. Evangelical Deaconess Home, 281 Mo. 182, 219 S.W. 643 (1920).

[40] Waggoner, Decline of the Charitable Immunity Doctrine, 6 S. Tex. L.J. 207, 210 (1962).

[41] *Ibid.*

[42] Oleck, *op. cit. supra* n. 5 at 110.

[43] Avellone v. St. John's Hospital, 165 Ohio St. 467, 135 N.E. 2d 410 (1956).

[44] Pasley, Non-Profit Corporations—Accountability of Directors and Officers, 21 Bus. L. 621 (1966).

main, what standard of care must be imposed on directors and officers in the discharge of their duties, and to what extent, if any, must this standard be relaxed in the case of non-profit corporations?[45]

According to Professor Oleck, the high standard of care applied to business corporations seldom applies to non-profit corporations.[46] This observation was substantiated by *Beard v. Acherbach Memorial Hospital Association.* In its opinion this court substituted "gross or wilful negligence" for the ordinary prudent management test as a criterion for determining liability.[47] Thus, before imposing liability, the court "seems to imply a more lenient standard than that applied to directors of business corporations." [48]

For a definitive statement regarding liability of directors and officers in non-profit corporations one must consult the appropriate statute of each jurisdiction. In California and Ohio directors of non-profit corporations are generally not personally liable for debts, liabilities, or obligations of the corporation.[49]

However, very common are statutes which prohibit directors (and sometimes officers) from voting for or concurring in any unlawful distribution of assets, or the making of a loan to a director (and sometimes to an officer),[50] and impose liability on them for any losses incurred thereby to the corporation or its creditors. The extent of such liability is measured either by the amount of the illegal distribution or loan, or by the injury caused to creditors, or by both.[51]

Indemnification of Directors and Officers

Some states[52] have statutes recognizing the rights of directors and officers to be reimbursed for expenses of litigation resulting from acts performed in their official status.[53] Usually, within the limits of these statutes, the director or officer who is named as a defendant in an action for alleged breach of duty may obtain indemnification for his reasonable expenses, including attorney's fees incurred in defending the action, unless he has been found guilty of misconduct or bad baith.[54]

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45 *Ibid.*

46 Oleck, *op. cit. supra* n. 5 at 279.

47 Beard v. Acherbach Memorial Hospital Association, 170 F. 2d 859 (10th Cir. 1948).

48 Chidla, Non-Profit and Charitable Corporations in Colorado, 36 U. Colo. L. Rev. 9 (1963).

49 Calif. Code § 9504 (1962); Ohio Rev. Code § 1702.55 (1968).

50 Calif. Corp. Code Ann. §§ 823, 824 (1962), made applicable to non-profit corporations by § 9002; Ohio Rev. Code § 1702.55(B)(3) (1968).

51 Pasley, *op. cit. supra* n. 44 at 632.

52 Ohio Rev. Code § 1702.12(E)(1963); N.Y. Not-For-Profit Corp. Law, § 722-725 (1970), Calif. Corp. Code Ann. § 830 (1962), made applicable to Non-Profit Corporations by § 9002.

53 Oleck, *op. cit. supra* n. 5, at 282.

54 Pasley, *op. cit. supra* n. 44, at 635.

Contrary to the statutory requirement of most states, in a minority of jurisdictions a director is held to be entitled to indemnification for the expenses of a lawsuit only if his official acts were intended to preserve the corporation's property.[55]

Urban Renewal Corporation

The clearance of slums and other blighted areas is necessary to protect the general welfare and security of the nation and the health and living standards of its people.[56] To implement such a rehabilitation program, Congress has granted certain privileges to urban renewal corporations which are operated on a non-profit basis.

These privileges are enumerated in certain sections of the United States Code[57] which make available to the urban renewal corporations land and low-interest rate loans. All loans under these sections bear interest at such rates as the administration determines to be appropriate, but not to exceed 3% of the amount of the principle outstanding at any time, per annum.[58]

Under § 1457 of Title 42, United States Code, any real property held as part of an urban renewal project, upon the approval of the administration and subject to conditions as the administrator may determine to be in the public interest, may be made available to (1) a limited dividend corporation; (2) non-profit corporation or association; or (3) cooperative or public body or agency.[59]

The effect of these statutes can be illustrated by *Dorsey v. Stuyvesant* where a private corporation, organized under an urban development law, undertook the establishment of a city housing project and received a financial subsidy, a tax exemption, and the privilege of eminent domain.[60]

A further illustration of the privileges granted to urban renewal corporations can be cited in § 1724.10(c) of the Ohio Rev. Code which concerns land conveyed to a community development corporation by a political subdivision which is then sold by that corporation. Any excess resulting from such sale is then paid to the subdivision after deducting "the costs of such organization and sales taxes, assessments, cost of maintenance, costs of improvements to the land by the community improvement corporation, service fees, and any debt service charges of the corporation attributable to such land or interest."

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[55] Solimime v. Hollander, 129 N.J. Eq. 264, 19 A. 2d 344 (1941); Allen v. France Packing Co., 170 Pa. Super. 632, 90 A. 2d 289 (1952).

[56] 42 U.S.C.A. § 1441 (1958).

[57] *Id.*, § 1452b, 1457.

[58] *Id.*, § 1452b.

[59] *Id.*, § 1457.

[60] 299 N.Y. 512, 87 N.E. 2d 541 (1949).

Group Law Practice

Prior to 1963 a non-profit organization was unable to provide direct legal counsel to its members. However, the well known *Button*,[61] *Brotherhood of Railroad Trainmen*[62] and *United Mine Workers*[63] cases have altered this restriction.

In the *Button* case, a Virginia statute proscribed any arrangement by which prospective litigants were advised to seek assistance of particular attorneys.[64] However, the Court holding the application of the statute unconstitutional stated "that the activities of the NAACP . . . are modes of expression and association which Virginia may not prohibit, under its power to regulate the legal profession." [65]

Further meaning was added to this decision by the *Railroad Trainmen* case. This case, when before the Illinois Supreme Court, allowed the union to refer legal problems of its members to union counsel with the fee to be deducted from the recovery on a contingent basis rather than paid by the association.[66]

In the *United Mine Workers* case the court held that first and fourteenth amendment rights allow the petitioner (a union) to "hire attorneys on a salary basis to assist its members in the assertion of the legal rights." [67]

Following these three cases the group law practice privilege may now be applied to non-profit organizations. The needs of our time have shown that this area is necessary, so as to afford individuals associated with the non-profit entities "equal justice under the law."

Conclusion

The status of the non-profit area is definitely a privileged one. Such a status results from its *pro bono publico* character. However, the problem arises when the original purpose of the non-profit organization is perverted or twisted so as to benefit those involved directly rather than the public.

This type of situation must not be allowed to continue. There have to be fervent efforts made to eliminate such "horseplay" and restore to the non-profit area its *pro bono publico* character.

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61 N.A.A.C.P. v. Button, 371 U.S. 415 (1963).

62 Brotherhood of Railroad Trainmen v. Virginia Bar Assn., 377 U.S. 1 (1964).

63 United Mine Workers of America v. Illinois, 389 U.S. 216 (1967).

64 N.A.A.C.P. v. Button, *supra* n. 61 at 428.

65 *Ibid.*

66 *In re* Brotherhood of Railroad Trainmen, 13 Ill. 2d 391, 150 N. E. 2d 163, 165 (1958).

67 United Mine Workers of America v. Illinois, *supra* n. 63 at 221.