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THE DEVELOPMENT OF NONPROFIT CORPORATION LAW AND AN AGENDA FOR REFORM

by
James J. Fishman*

> Americans of all ages, all conditions, and all dispositions constantly form associations. They have not only commercial and manufacturing companies, in which all take part, but associations of a thousand other kinds, religious, moral, serious, futile, general or restricted, enormous or diminutive. The Americans make associations to give entertainments, to found seminaries, to build inns, to construct churches, to diffuse books, to send missionaries to the antipodes; in this manner they found hospitals, prisons, and schools. If it is proposed to inculcate some truth or to foster some feeling by the encouragement of a great example, they form a society. Wherever at the head of some new undertaking you see the government in France, or a man of rank in England, in the United States you will be sure to find an association.

Alexis DeTocqueville[1]

Since DeTocqueville's observation, the nonprofit[2] sector has continued in importance. Today, its size and diversity are staggering. It is difficult to accurately estimate the number of nonprofit orga-

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[1] 2 A. DeTocqueville, Democracy in America, 106 (P. Bradley ed. 1966).

[2] Charitable organizations are sometimes referred to as "not-for-profit." *See* N.Y. Not-for-Profit Corp. Law (McKinney 1970 & Supp. 1984-85). The drafters of the New York Statute used the term "not-for-profit" to indicate the true character of this type of corporation as being one organized not-for-profit but which could make a profit within the provisions of the statute. Revisers' Comment § 101, 14th Interim Report, Legis. Doc. No. 11 at 97 (1970). Explanatory memorandum, January 13, 1969 in 13th Interim Report, Legis. Doc. 83 at 48 (1969). Thus, the Not-for-Profit Corporation Law allows the creation of a legal capacity to form a not-for-profit corporation for a business, though not for a profit purpose. Note, *New York's Not-for-Profit Corporation Law*, 47 N.Y.U. L. Rev. 761, 774 (1972). We consider "not-for-profit" as interchangeable with nonprofit and use the shorter term throughout this article.

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nizations in the United States.[3] They range in size from organizations with billions of dollars of assets, such as foundations and universities, to groups with virtually no resources, such as three-person dance companies or Little Leagues.[4]

The rapid increase in the number and aggregate wealth of charitable organizations, particularly of those that take the form of nonprofit corporations, has taken the law by surprise.[5] There has been no coherent development of the law of nonprofit organizations. Courts and commentators are still developing fundamental legal principles and attempting to achieve agreement as to what nonprofit organizations are and how they should be categorized.

This article examines the development of the law of "charitable corporations" and attempts to explain why the charitable corporation rather than the charitable trust became the predominant organizational form for charitable and benevolent activities in the United States. It then discusses some of the inconsistencies of non-

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[3] Hard data is difficult to find. The Internal Revenue Service reported 851,012 active nonprofits in 1981, 1981 IRS ANN. REP. 54, Table 20, but not all nonprofits register or file with the Service as provided by law. In New York, nonprofits are not separated from business corporations on the Secretary of State's lists. Attorney General Robert Abrams reports that only 21,000 organizations register and report, as required, with the New York State Law Department. Abrams, *Regulating Charity—The State's Role*, 35 Rec. 481, 483 (1980). In California in 1978 there were an estimated 62,000 nonprofit corporations. Nida, *Membership Lists: Balancing The Interests Between Use and Abuse*, 13 U.S.F.L. REV. 797 (1979). For a state by state estimate of members of nonprofit organizations, see H. OLECK, NONPROFIT CORPORATIONS, ORGANIZATIONS, AND ASSOCIATIONS 11-14 (4th ed. 1980).

[4] No single institution is typical of the nonprofit sector. It is dominated in size by health and education activities. E. GINZBURG, D. HIESTAND & B. REUBENS, THE PLURALISTIC ECONOMY 21 (1965). In 1980 nonprofits spent $219 billion dollars, a sum greater than the combined sales of Chrysler, Ford, and General Motors that year, and employed 5.6 million people. The nonprofit sector accounts for nearly five percent of the gross national product. Rudney, *A Quantitative Profile of the Nonprofit Sector*, (Yale Program on Nonprofit Organizations, working Paper No. 40, 3, November 1981). Americans donate approximately $45 billion to charity, deducting approximately $32 billion from their taxable incomes. These deductions reduce Federal tax revenues by about $11 billion. *Protecting Charity in Tax Reform*, New York Times, Mar. 11, 1985, at A18, col. 1. There are an estimated 23,000 grant-making private foundations in the United States, representing about $41.4 billion in assets. Approximately 15% of the foundations have assets of $1 million or more. B. HOPKINS, THE LAW OF TAX-EXEMPT ORGANIZATIONS 378 (1983).

[5] Karst, *The Efficiency of the Charitable Dollar: An Unfulfilled State Responsibility*, 73 HARV. L. REV. 433, 435 (1960); W. CARY & C. BRIGHT, THE LAW AND LORE OF ENDOWMENT FUNDS 14 (Report to the Ford Foundation, 1969).

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profit corporation law and provides an agenda for future reform.

There is no uniform or standard definition for a nonprofit organization. We use the term "nonprofit" to refer to an organization that is barred from distributing profits or net earnings to individuals who exercise control over it, such as directors, officers, or members.[6] One unifying definitional principle is the prohibition against private inurement by individuals who exercise control over the organization. That is, individuals may not by reason of their position acquire any of an organization's funds except as reasonable compensation for goods and services.[7]

I. THE IMPORTANCE OF THE NONPROFIT CORPORATION IN THE UNITED STATES

The predominance of the nonprofit corporation in the United States as the organizational form for charitable activities and the lack of a coherent law of nonprofit corporations have been due to the special circumstances of the New World, the vagaries of historical scholarship, the rapid growth of the charitable sector, and increasing similarities in size, structure, and management between charitable organizations and business corporations.[8] Prior to this century the traditional common law instrument for the legal recognition of charitable activities was the charitable trust, not the charitable corporation.[9]

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[6] Hansmann, *Reforming Nonprofit Corporation Law*, 129 U. PA. L. REV. 497, 501 (1981) [hereinafter cited as Hansmann, *Reforming*]; Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835, 838 (1980) [hereinafter cited as Hansmann, *Role*].

[7] *See* I.R.C. § 501(c)(3)(1984); Treas. Reg. § 1.501(c)(3)-1(c)(2) (1976).

[8] *See generally* Note, *The Charitable Corporation*, 64 HARV. L. REV. 1168 (1951).

[9] A trust is a relationship between parties with respect to property in which one party has responsibility of management of the property as a fiduciary for the benefit of the other. RESTATEMENT (SECOND) OF TRUSTS § 2 (1959) [hereinafter cited as RESTATEMENT]; G.G. BOGERT & G.T. BOGERT, THE LAW OF TRUSTS AND TRUSTEES § 1 (rev. 2d ed. 1979); 1 A. SCOTT, THE LAW OF TRUSTS §§ 2-28 (3rd ed. 1967). A trustee is the party with the fiduciary responsibility of management who holds legal title to the property in trust. The party for whose benefit property is held is called the beneficiary or *cestui que*. The beneficiary holds equitable title to property in trust. RESTATEMENT, *supra*, at § 3; G.G. BOGERT & G.T. BOGERT, *supra*, at § 1; A. SCOTT, *supra*, at § 3.2. The trustee is answerable to the beneficiary for breach of duties imposed by law. In a private trust, beneficiaries are identifiable individuals, a characteristic essential for the trust's validity. RESTATEMENT, *supra*, at § 122; G.G. BOGERT & G.T. BOGERT, *supra*, at § 161; 2 A. SCOTT, *supra* at § 112.

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A. *Charitable Trusts as Philanthropic Vehicles*

Charitable trusts were enforced in England before the seventeenth century.[10] Since the Reformation, the trust has been the predominant form of organization for English charitable activities. It remains so today.[11]

There has been little reason for English charitable entities to use the corporate form of organization, although charitable organizations have been able to incorporate since 1597.[12] The Companies Act of 1867[13] permitted general incorporation for nonpecuniary ends, but since the Crown was the source of power to create corporations, the creation of a charitable trust was afforded greater freedom. The managers of an English charity organized in the corporate form were not relieved of supervisory responsibility by the charity commissioners or by the courts.[14] Thus, the trust form continued to be preferred.

Unlike the law of charitable trusts and nonprofit corporation law as it developed in the United States, English law as it later evolved made no distinction as to the nature of the ownership of property

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A charitable trust is one that serves several recognized charitable purposes. The beneficiaries need not be identifiable individuals. Legal title is in the trustee; equitable title lies with the public. The duty of the trustee is owed to the public rather than to a specific beneficiary. RESTATEMENT §§ 348, 364, 368-74, 379; G.G. BOGERT & G.T. BOGERT, *supra*, at § 362; 4 A. SCOTT, *supra*, at §§ 348, 364, 368-74, 379. Unlike a private trust, the charitable trust has perpetual existence. RESTATEMENT § 365; G.G. BOGERT & G.T. BOGERT, *surpa*, at § 361. Typically, the attorney general or a party who benefits specifically are the only persons with standing to enforce the trustee's responsibilities. RESTATEMENT, *supra* at § 391; G.G. BOGERT & G.T. BOGERT, *supra*, at § 411; 4 A. SCOTT, *supra*, at § 391.

[10] 4 A. SCOTT, *supra* note 9, at § 348.2; G. JONES, HISTORY OF THE LAW OF CHARITY, 1532-1827, at 3-9 (1969).

[11] M. FREMONT-SMITH, FOUNDATIONS AND GOVERNMENT 18-27 (1965). In the overdrawn words of Maitland:

> The idea of a trust is so familiar to us all that we never wonder at it. And yet surely we ought to wonder. If we were asked what was the greatest and most distinctive achievement performed by Englishmen in the field of jurisprudence I cannot think that we could have any better answer to give than this, namely, the development from century to century of the trust idea.

3 MAITLAND, COLLECTED PAPERS 271-72 (1911).

[12] 39 Eliz. 1 ch. 5 (1597).

[13] Companies Act, 1867, 30 & 31 Vict. ch. 131.

[14] M. FREMONT-SMITH, *supra* note 11, at 35.

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between a corporation and a trust.[15] For instance, contrary to American developments, the standards of care and loyalty for directors of English charitable organizations are similar whether the corporate or trust form is adopted.[16] Legal distinctions were not made between charitable trusts and charitable corporations on the basis of their forms of organization. Thus, one can speak of a unified law of charities in England in contrast to the United States.[17] The charitable trust has had a more checkered and uncertain career in this country.[18] Ironically, the growth of the nonprofit corporation in the United States was assisted by the English Statute of Charitable Uses of 1601, legislation that provided machinery for the enforcement of charitable trusts.[19]

B. *Philanthropy in the New World*

An attitude favorable to philanthropy existed from the beginning of settlement in the new world. Colonists were accustomed to the traditional support and enforcement of charities in England. Churches, which exerted a significant influence within colonial society, were favorably disposed to philanthropic endeavors.[20] De-

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[15] *Id.*; O. TUDOR, TUDOR ON CHARITIES 194 (H. Carter & F. Cranshaw, 5th ed. 1929). "Eleemosynary corporations hold their property upon charitable trusts, and are therefore subject to the jurisdiction of the court like all trustees, corporate or incorporate, lay or ecclesiastical."

[16] Charities Act, 1960, 8 & 9 Eliz. 2 ch. 58, § 46 says: " '[T]rusts', in relation to a charity, means the provisions establishing it as a charity and regulating its purposes and administration, whether those provisions take effect by way of trust or not, and in relation to other institutions, has a corresponding meaning."

[17] M. FREMONT-SMITH, *supra* note 11, at 36.

[18] L. FRIEDMAN, A HISTORY OF AMERICAN LAW 223 (1973).

[19] 43 Eliz. I, ch. 4 (1601). The statute conferred authority upon the Chancellor to appoint commissioners from time to time to inquire into any abuses of charitable bequests or donations. The commissioners could impanel juries, summon and hear witnesses, and make decrees. Persons aggrieved by commissioners' decrees could appeal to the chancellor. The statute provided for a new remedy for the enforcement of charitable trusts but did not displace the already existing remedy of an original complaint in Chancery, a fact which was to have a great impact in the United States. The new procedure was little employed after a period of time and, the importance of the law of charitable trusts lies in the preamble of the statute, which contains an enumeration of charitable purposes, 4 A. SCOTT, *supra* note 9, at §§ 348.2, 368.1.

[20] Note, *The Enforcement of Charitable Trusts in America: A History of Evolving Social Attitudes*, 54 VA. L. REV. 436, 440 (1968). Georgia was established as a charitable corpo-

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spite disagreement on other matters the various churches in the colonies "all shared the traditional Protestant emphasis upon the individual's responsibility for the spiritual material welfare of the community, and accordingly supported a variety of charitable institutions."[21] The immediate stimulus for this benevolent atmosphere was the pressing need for the establishment of public facilities such as hospitals, churches, and schools:[22]

> [The colonists] did not debate the question of public versus private responsibility . . . public and private philanthropy were so completely intertwined as to become almost indistinguishable. The law itself reflected a pragmatic approach to the solving of social problems through philanthropy. Colonial assemblies went out of their way to remove obstacles in the way of charities. The courts valuing social betterment above legal technicalities, asserted a permissive charity doctrine that supported donors' benevolent intentions, even when the formulation of their plans was clearly imperfect.[23]

Philanthropic approaches in Colonial America were not uniform.[24] From the beginning, public and private philanthropy coexisted. In Boston and other Massachusetts towns, public spending for poverty relief combined with private contributions and legacies.[25] The typical vehicle for private philanthropic efforts was the English charitable use, which enjoyed universal approval.[26]

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ration for the English poor. The grandiose scheme concocted by English philanthropists was a failure and the charter of the corporation was returned to the crown in 1752. *See* D. BOORSTEIN, THE AMERICANS: THE COLONIAL EXPERIENCE 71-95 (1958).

[21] H. MILLER, THE LEGAL FOUNDATIONS OF AMERICAN PHILANTHROPY 1776-1844, at x (1961).

[22] Note, *supra* note 20, at 440; M. FREMONT-SMITH, *supra* note 11, at 36.

[23] H. MILLER, *supra* note 21, at xi. For a discussion of Colonial statutes, see Note, *supra* note 20, at 440-41; H. MILLER, *supra* note 21, at 4-8.

[24] Wyllie, *The Search for an American Law of Charity, 1776-1844*, 46 MISS. VALLEY HIST. REV. 203, 204 (1959).

[25] *Id.* at 204-07. As early as 1658 individuals left legacies for charitable purposes, particularly for the relief of the poor. C. BRIDENBAUGH, CITIES IN THE WILDERNESS 81 (1938).

[26] Wyllie, *supra* note 24, at 204-07. In the words of Horace Binney, counsel to the estate of Stephen Girard in Vidal v. Girard's Executors, 43 U.S. (2 How.) 127, 154 (1844), "There was probably never a colony of English origin, that did not regard [charitable organizations] as both morally and legally good, and hold them to be matters of conscientious duty as well as of public policy."

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In the immediate post-Revolutionary period, the favorable attitude toward charity continued. The law relating to charities reflected the general uncertainty and transition that characterized all American law in the post-Revolutionary period.[27] Each state utilized an approach reflective of its local needs and customs. Most state constitutions were silent about philanthrophy.[28] The Massachusetts constitution of 1780, however, provided: "It shall be the duty of legislatures and magistrates, in all future periods of this Commonwealth . . . to countenance and inculcate the principles of humanity and general benevolence, public and private charity . . . and all social affections, and generous sentiments amoung the people."[29]

Pennsylvania, Vermont, and New Hampshire also gave constitutional protection to charities.[30] Other states passed statutes facilitating and reaffirming the benefits of charities to the community.[31] In part, the retention of prior statutes and practices resulted from the general continuation of English law and precedent in the first years following Independence.[32]

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[27] H. MILLER, *supra* note 21, at 15. *Cf.* W. NELSON, AMERICANIZATION OF THE COMMON LAW: THE IMPACT OF LEGAL CHANGE ON MASSACHUSETTS SOCIETY 1760-1830, at 68 (1975). In the words of Justice Samuel Chase in a circuit court opinion:

> When the American Colonies were first settled by our ancestors . . . they brought hither, as a birth-right and inheritance, so much of the common law, as was applicable to their local situation, and change of circumstances. But each colony judged for itself, what parts of the common law were applicable to its new conditions; and in various modes, by Legislative acts, by Judicial decision, or by constant usage, adopted some parts, and rejected others.

U.S. v. Worrall, 2 U.S. (2 Dall.) 384, 394 (C.C. Pa. 1798).

[28] H. MILLER, *supra* note 21, at 15.

[29] 3 F. THORPE, THE FEDERAL AND STATE CONSTITUTIONS, COLONIAL CHARTERS, AND OTHER ORGANIC LAWS OF THE STATES, TERRITORIES, AND COLONIES NOW OR HERETOFORE FORMING THE UNITED STATES OF AMERICA 1907-08 (1909).

[30] H. MILLER, *supra* note 21, at 9-10; Note, *supra* note 20, at 441; *N.H. Const.* pt. 2 (1784) *reprinted in* 4 F. THORPE, *supra* note 29, at 2467-68; *Pa. Const.* § 45 (1776) *reprinted* in 5 F. THORPE, *supra* note 29, at 3091; *Vt. Const.*, ch. 2 § 41 (1977) *reprinted in* 6 F. THORPE, *supra* note 29, at 3748.

[31] H. MILLER, *supra* note 21, at 16-18; Note, *supra* note 20, at 441-42.

[32] E. BROWN, BRITISH STATUTES IN AMERICAN LAW 1776-1836, at 24-26 (1964).

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C. *The Charitable Trust in the United States*

At the end of the eighteenth century, the rise of political and cultural nationalism and a belief that the law should be a reflection of the present rather than constricted by the dead hand of precedent joined with a broad reaction against all things British. This led to the repeal of many English statutes.[33] The state of Virginia is illustrative. Virginia retained all British statutes upon Independence, but completely repealed them in 1792.[34] This general repeal included the Statute of Charitable Uses of 1601. Emerging nationalism, combined with the specifics of Virginia colonial history and political efforts to disestablish the Anglican Church, led to a restrictive attitude toward charities.[35] The repeal of English statutes had an even greater impact on the use of the charitable trust, for lawyers argued that the repeal of the Statute of Charitable Uses meant that charitable trusts could not be sustained.[36]

Permissive charitable practices were still retained in most states, particularly in the Northeast, which had little difficulty accepting the English law of charitable trusts and upholding its validity. But seven states, including Virginia, refused to uphold the validity of charitable trusts. Courts in these jurisdictions concluded that the Statute of Charitable Uses was not in force in the state because a statute so provided, because it was inapplicable to American condition, or because it was omitted from the enumeration of English statutes which were accepted by the new state.[37]

The legal rationale behind the unenforceability of charitable trusts was the mistaken belief that the equity powers for such enforcement derived solely from the Statute of Charitable Uses and

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[33] *Id.* at 43, 104, 123; H. MILLER, *supra* note 21, at 10-15; Note, *supra* note 20, at 441.

[34] 9 HENING'S STATUTES AT LARGE 127 (W. Hening, ed., 1821). *See also* E. BROWN, *supra* note 32, at 120-28; Wyllie, *supra* note 24, at 206; C. ZOLLMAN, THE AMERICAN LAW OF CHARITY 21 (1924).

[35] H. MILLER, *supra* note 21, at 19-20; Wyllie, *supra* note 24, at 206-07; Note, *supra* note 20, at 442.

[36] Wyllie, *supra* note 24, at 206.

[37] 4 A. SCOTT, *supra* note 9, at § 348.3. *See generally* Note, *supra* note 8, at 1168 (describing special conditions present in the "New World"). The states were Maryland, Michigan, Minnesota, New York, Virginia, West Virginia, and Wisconsin.

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did not exist at common law. It was assumed that the power of enforcement was not exercised by Chancellors prior to 1601.[38] If the Statute of Charitable Uses was not carried over to American jurisdictions, there could be no common law precedent for upholding charitable trusts.

The invalidity of the charitable trust as a method of philanthropic disposition because of the lack of a common law precedent was upheld in *Trustees of Philadelphia Baptist Association v. Hart's Executors.*[39] The testator, Silas Hart, had given a charitable disposition to the Philadelphia Baptist Association, an unincorporated association, for the purpose of educating youths for the Baptist ministry. The testator's executors refused to deliver the bequest, so the Association brought suit in a Virginia Court of Chancery. The specific legal issue was whether charitable trusts should be subject to the general rule invalidating private trusts where there was no specific beneficiary.[40]

In the course of the decision the United States Supreme Court attempted to determine whether the power to enforce charitable

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[38] The jurisdiction of English courts over trusts rests upon their ordinary jurisdiction over trusts, the prerogative of the crown, and the Statute of Charitable Uses. C. ZOLLMAN, *supra* note 34, at 8. In the United States, it was mistakenly assumed that equity's jurisdiction over charitable trusts was created by the Statute of Charitable Uses. If that statute was repealed, there being no royal prerogative, there was no way to enforce attempted creations of charitable trusts. Originally charitable trusts were enforced by ecclesiastical courts, but by the beginning of the fifteenth century, complaints were heard about ecclesiastical justice and complainants turned to the Chancellor for help in enforcing charitable legacies. His jurisdiction over the enforcement of trusts came later. At this time, the bills were brought by individuals. The attorney general did not bring an information in equity on behalf of the crown until some time later. G. JONES, *supra* note 10, at 5-8.

[39] 17 U.S. (1 Wheat.) 1 (1819).

[40] *Id.* at 43. A private trust is invalid unless there is a beneficiary who is definitely ascertained at the time of the creation of the trust or definitely ascertainable within the period of the rule against perpetuities. RESTATEMENT, *supra* note 9, at § 112. In the case of a charitable trust, the persons who are to receive benefits need not be designated since the beneficial interest is not given to individual beneficiaries, but the property is devoted to the accomplishment of purposes beneficial to the community. RESTATEMENT, *supra* note 9, at § 364.

A charitable trust is enforceable at the suit of the Attorney General. RESTATEMENT, *supra* note 9, at § 391.

The justification for the private trust rule is to enable someone to have standing to enforce the trust. No one other than a beneficiary or one suing on the beneficiary's behalf can maintain a suit against the trustee to enforce the trust. 4 A. SCOTT, *supra* note 9, at § 200.

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trusts stemmed from common law. The *Calendars of the Proceedings on Chancery,* a compilation of cases from the time of Elizabeth I, had been published in England and conclusively showed that charitable trusts had been upheld prior to the Statute of Charitable Uses. However, these early Chancery reports were not yet available in the United States.[41] Because of their unavailability, the Court was unable to find evidence of the early Chancery practice, and held that the Chancellor's power was derived solely from the Statute of Charitable Uses.[42] Chief Justice Marshall concluded that the enforcement power was an extraordinary power rather than one inherent in the Chancellor's equity jurisdiction. Therefore, the power to enforce a charitable trust depended upon whether the Statute of Charitable Uses or similar law was in force in the state where a settlor created a trust.[43] Since Virginia had repealed all English statutes, the trust was not exempt from the rule requiring a definite beneficiary.

It has been suggested that the *Hart* decision was based not only upon historical ignorance but was part of the ongoing anti-charity-anti-clerical atmosphere of the period.[44] Even as wise a jurist as Justice Joseph Story supported mortmain statutes to check clerical power and believed that charities, religious or otherwise, trampled individual rights by depriving future heirs of property to which they were entitled.[45]

Chancellor Kent, among others, severely criticized the *Hart* result.[46] *Hart* was judicially undermined in a United States circuit court of appeals opinion, *Magill v. Brown,*[47] written by United

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[41] A schedule of cases from Chancery Proceedings before 1601 is listed in the argument of Horace Binney, counsel for Girard's Executors, in Vidal v. Girard's Executors, 43 U.S. (2 How.) 127, 154-61 (1844).

[42] Trustees of Philadelphia Baptist Association v. Hart's Executors, 17 U.S. (1 Wheat.) 1, 38-39 (1819).

[43] *Id.* at 47, 49.

[44] Note, *supra* note 20, at 443-44.

[45] H. MILLER, *supra* note 21, at 43-44. Story outlined this argument anonymously in the "notes" to volume four of Wheaton's Reports in which *Hart* appeared. *Id.*

[46] 4 J. KENT, COMMENTARIES ON AMERICAN LAW *286-87 (1836); Wyllie, *supra* note 24, at 211.

[47] 16 F. Cas. 408 (C.C.E.D. Pa. 1833) (No. 8954). *See also* Wyllie, *supra* note 24, at 211-20. Other decisions ignored or criticized *Hart. See* McCartee v. Orphan Asylum Society, 9

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States Supreme Court Justice Henry Baldwin. Using the *Calendars of the Proceedings in Chancery*, which were first published in the United States in 1827, Baldwin conclusively demonstrated that charitable trusts had been upheld by equity courts before 1601.

The Supreme Court corrected its historical error in *Vidal v. Girard's Executor*.[48] The financier Stephen Girard bequeathed seven million dollars to fund a school for "poor, white, male orphans" in Philadelphia. Girard's heirs sought to have the trust set aside under *Hart* on grounds that it was invalid for lack of a definite beneficiary.[49] The issue was whether courts had the inherent power to administer charitable trusts without a specialized authorizing statute. Justice Story distinguished *Hart* from *Vidal* on three grounds: 1) Virginia had expressly abolished the Statute of Charitable Uses while Pennsylvania had not; 2) the trustees in *Hart* were an unincorporated association which had no legal capacity to take and hold donations for purposes of trust; and 3) the recent historical information available proved the existence of charitable trusts at common law.[50]

Despite the *Vidal* decision, several states, principally in the South, still refused to enforce charitable trusts.[51] Other states construed their statutes permitting trusts restrictively. For instance, in 1829 the New York legislature in a statutory revision of all its laws codified the law of uses and trusts. The new statute permitted four types of trusts, but did not mention the charitable kind.[52] Throughout the nineteenth century, New York Courts interpreted the statute strictly, which meant in practice that a testator could not give his property to a charitable trust in a manner that would withstand judicial scrutiny.[53]

Cow. 437 (N.Y. 1827); Burr v. Smith, 7 Vt. 241 (1835).

[48] 43 U.S. (2 How.) 127 (1844).

[49] *Id.* at 186. Stephen Girard should be considered the patron saint of American lawyers, for his will has generated so much litigation that he possibly has helped more attorneys than orphans. *See* Tashjian, *Future of Charitable Trusts*, 99 TR. & EST. 1090 (1960) (description of the litigation involving Girard's will).

[50] *Vidal*, 43 U.S. (2 How.) at 191-93, 196.

[51] Note, *supra* note 8, at 14.

[52] Amendatory Act of 1830, ch. 320, 1830 N.Y. Laws 386-87.

[53] *See* Bascom v. Albertson, 34 N.Y. 584, 620 (1866) (overruling Williams v. Williams, 8 N.Y. 525 (1853) (enactment of the Revised Statutes did not invalidate bequests in trusts for

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For much of the nineteenth century the use of the charitable trust suffered from widespread fear of the dead hand, particularly the dead hand of the church,[54] from strict construction of trust statutes, and from judicial unwillingness to recognize the charitable trust. The primary argument brought against the charitable trust in some jurisdictions was that adequate control over the trustee was lacking because of the absence of a definite *cestui* to initiate equitable proceedings against the trustee in the event of his or her deviation from the original intent of the donor. Thus, in *Bascom v. Albertson* the New York Court of Appeals said public policy required that "funds irrevocably dedicated to purposes of charity, are to be administered through agencies and organizations sanctioned by legislative authority, and not by the intervention of private trustees."[55]

Even jurisdictions hostile to the charitable trust did not preclude donations to charities. To evade the prohibition of strict construction against charitable trusts, a donor would make the gift or bequest directly to a charitable corporation for one or more of its corporate purposes.[56] In New York, before the passage of the Tilden Act[57] in 1893, the only way a testator could ensure that a charitable gift would be upheld was to donate it to a charitable corporation of limited duration.[58]

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charitable purposes)); Owens v. Missionary Society, 14 N.Y. 380, 385 (1856); Yates v. Yates, 9 Barb. 324, 332-33 (N.Y. 1850); Scott, *Charitable Trusts in New York*, 26 N.Y.U. L. REV. 251, 254-56 (1951); Note, *supra* note 8, at 1172.

[54] L. FRIEDMAN, *supra* note 18, at 370.

[55] *Bascom*, 34 N.Y. 584, 620-21 (1866).

[56] Art Students' League v. Hinkley, 31 F. 2d 469, 476-78 (D. Md. 1929); Holmes v. Mead, 52 N.Y. 332, 339 (1873); Roy's Executors v. Rowzie, 66 Va. (25 Gratt.) 599, 608 (1874); Note, *supra* note 8, at 1169-72.

[57] 1893 N.Y. Laws 701. The Act resulted from the failure of Samuel J. Tilden's bequest of four million dollars to fund a free public library in New York City. *See* Tilden v. Green, 130 N.Y. 29, 28 N.E. 880 (1891); Scott, *supra* note 53, at 257-58; Note, *supra* note 20, at 456-57.

[58] Note, *supra* note 8, at 1172. *See also* Holmes v. Mead, 52 N.Y. 332, 339 (1873); Wetmore v. Parker, 52 N.Y. 450, 459 (1873)(A gift of property by bequest to a charitable corporation "does not create a trust in any such sense, as that term is applied to property. The corporation uses the property, in accordance with the law of its creation, for its purposes; and the dictation of the manner of its use, within the law by the donor, does not affect its ownership or make it a trustee. A person may transform himself into a trustee for another, but he cannot be a trustee for himself.").

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To sustain a charitable bequest in the nineteenth century in states such as New York, courts had to find an intent to make an absolute gift to the specific corporation for its proper purposes, rather than an attempt to create a trust for indefinite and uncertain beneficiaries.[59] To avoid a forfeiture of a testator's intent, courts engaged in the most tortuous reasoning to find that an absolute gift was intended to the corporation, even when the instrument used such precise terminology as: "I give, devise and bequeath . . . to . . . in trust . . . ."[60]

Opposition to charitable trusts weakened by the beginning of the twentieth century. By then, however, the charitable corporation had become an increasingly important form for philanthropic activities. The use of the business corporation form of organization in America and judicial uncertainty toward the charitable trust made the use of the charitable corporation for all types of charitable activities inevitably greater in America than in England.[61]

D. *The Origins of the Charitable Corporation*

The corporate form dates from the time of Edward III in the fourteenth century when chartered ecclesiastical and governmental associations came to be regarded as bodies.[62] Prior to the fifteenth

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[59] Note, *supra* note 8, at 1169.

[60] Art Students' League v. Hinkley, 31 F.2d 469, 470 (D. Md. 1929). Courts justified this result by a change in the definition of the word "trust" when it related to a charitable purpose within the functions of a charitable corporation. The word "trust" refers to proper use of the property or bequest by the corporation given the purposes in the corporate charter. *Id.* at 476-77. *See also* Domestic & Foreign Missionary Society v. Gaither, 62 F. 422 (D. Md. 1894):

> It would seem, therefore, that money given to the corporation as this legacy was is not to be held by it upon any trust, but is to be expended by it in the missionary work which it carries on within the United States. It carries on its missions and missionary works through the instrumentality of boards, committees, treasurers, bishops, clergymen, and agents; being a corporation, it can act only through its officers and agents, but the work is its own immediate and special work. This is not a case in which there is a trust or trustee or cestui que trust. It is a direct expenditure by a corporation for the very object for which it was created.

Gaither, 62 F. at 426

[61] M. FREMONT-SMITH, *supra* note 11, at 40.

[62] 3 W. HOLDSWORTH, A HISTORY OF ENGLISH LAW 476-479 (5th ed. 1942).

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century, gifts to charities were protected.[63]

Certain corporate principles such as the creation of the corporate person, the authority of the incorporators, the method of forming corporations, the powers belonging to the incorporators, and the powers, capabilities, and liabilities of corporations, were settled by the sixteenth century.[64] The earliest corporate enabling legislation was passed in 1596 to encourage charitable distributions for the establishment of hospitals, prisons, and other relief for the poor by eliminating charges for incorporation and the necessity of the sovereign's consent.[65]

E. *The Charitable Corporation in Colonial America*

As early as the seventeenth century the corporation was used in the New World as an organizational form for charitable activities. According to one commentator, "[t]he law of corporations was the law of [colonists'] being for the four original New England colonies. . . . It governed all the relations of life."[66] At the least, the practice of executive or legislative branches in the colonies from the beginning of the eighteenth century was to confer upon owners or inhabitants of political divisions or organizations with political or governmental functions the attribute of legal personality, the essence of corporateness. This line of reasoning led to the incorporation of religious societies.[67] At the beginning of the eighteenth century several colonies, borrowing from the statute of 1597 for the

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[63] 4 A. SCOTT, *supra* note 9, at § 348.2.

[64] Holdsworth, *English Corporation Law in the 16th and 17th Centuries*, 31 YALE L.J. 382, 385, 391 (1922). *See* Sutton's Hospital Case, 10 Co. Rep., 23a, 77 Eng. Rep. 960 (1613 K.B.).

[65] 39 Eliz. I, ch. 5 (1597). Under this act, corporations could be formed for the following purposes:

> to erect, found, and establish, one or more hospitals, maison de Dieu, abiding places, or houses of correction,. . . as well as for the finding, sustentation, and relief of the maimed, poor, needy or impotent people, as to set the poor to work, to have continuance forever, and from time to time place therein such head and members, and such number of poor as to him, his heirs and assigns should seem convenient.

[66] Baldwin, *History of the Law of Private Corporations in the Colonies and States*, in 3 SELECT ESSAYS ON ANGLO AMERICAN LEGAL HISTORY 236 (1909).

[67] *Id.* at 241.

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automatic incorporation of hospitals and houses of correction,[68] provided for self-incorporation of some religious, charitable or municipal institutions.[69] Almost all colonial corporations had charitable purposes. They were churches, charities, educational institutions, or municipal corporations.[70]

The early colonial corporations were of two kinds. The first was the public corporation — municipal corporations chartered by the towns or a few administrative boards charged with the oversight of public education, charity, and the like on behalf of local units of government. The second kind of private corporation included ecclesiastical, educational, charitable, and business corporations. The most numerous in this second category were corporations concerned with religious worship.[71] Next in numerical size were those formed for charitable or educational purposes, although they still might have a religious nature.[72] Business corporations were few and of little importance. Many of the colonial business corporations would be considered cooperatives or quasi-philanthropic today. They were incorporated for the purpose of erecting bridges, building or repairing roads, or promoting ends of general public utility.[73]

F. *The Charitable Corporation After Independence*

From the first years of the Republic, most states actively encouraged the incorporation of private associations that performed vital public services.[74] Upon Independence, several state legislatures passed statutes permitting incorporation of charitable organi-

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[68] 39 Eliz. 1 ch. 5 (1597).

[69] Chayes, *Introduction* to J.P. DAVIS, CORPORATIONS at vii (1961).

[70] L. FRIEDMAN, *supra* note 18, at 166. In the eighteenth century, corporate charters were issued to only 335 businesses. Only seven charters were issued to businesses during the colonial period. 2 J.S. DAVIS, ESSAYS IN THE EARLIER HISTORY OF AMERICAN CORPORATIONS 22 (1917).

[71] 1 J.S. DAVIS, *supra* note 70, at 74-75.

[72] *Id.* at 82.

[73] *Id.* at 87, 98, 103. Other early corporations would be considered mutual benefit organizations or trade associations such as the marine societies formed for the purpose of bringing together mariners of a particular port.

[74] R. SEAVOY, THE ORIGINS OF THE AMERICAN BUSINESS CORPORATION 1784-1855, at 255 (1982).

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zations such as churches, schools, and literary societies. Davis states:

> The constitution of South Carolina, adopted March 19, 1778, virtually assured freedom of incorporation for religious purposes, so far as "Christian Protestant" churches were concerned. New York passed a general incorporation act for religious purposes April 6, 1784. New Jersey followed suit March 6, 1786, and Delaware on Feb. 3, 1787. On April 6, 1791, Pennsylvania passed a similar act granting freedom of incorporation "for any literary, charitable, or for any religious purpose." In 1794 New Jersey provided similarly for "societies for the promotion of learning." In 1796 New York and in 1799 New Jersey extended the privilege to library companies. In 1788 Virginia and in 1798 Kentucky provided likewise for fire companies. There were probably a few other general incorporation acts.[75]

There were. In Maryland, general incorporation statutes were, as elsewhere, first enacted for religious corporations.[76] In the Northwest Territories a similar pattern occurred. In 1798 the legislative authority of the Northwest Territory, borrowing from the 1791 Pennsylvania statute, enacted a general corporation law for organizations with literary, charitable, or religious purposes.[77] The general act was not altered under the Indiana Territory and appears as an adoption of New York and Pennsylvania statutes in the Michigan Territorial Laws of 1821.[78]

The rationale motivating the passage of early general incorporation acts included advantage to the public if such incorporations were increased, convenience to individuals desiring to incorporate, relief of legislative workload, and promotion of freedom of

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[75] 2 J.S. DAVIS, *supra* note 70, at 16-17 (footnotes omitted). *See* 1784 N.Y. Laws 18. *See generally* Seavoy, *The Public Service Origins of the American Business Corporation*, 52 BUS. HIST. REV. 30, 38-39 (1978); J. CADMAN, THE CORPORATION IN NEW JERSEY 1791-1875, at 5-6 (1949).

[76] J. BLANDI, MARYLAND BUSINESS CORPORATIONS 1783-1852, at 11 (1934). *See* 1802 Md. Laws 111; 1798 Md. Laws 24; 1779 Md. Laws 9.

[77] G. KUEHNL, THE WISCONSIN BUSINESS CORPORATION 7-8 (1959).

[78] *Id.* at 8.

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religion.[79]

During the colonial period religious societies, if part of the established church, had been freely incorporated by royal governors and colonial assemblies. It was more difficult for other denominations.[80] Religious bodies were the first kind of organization to receive the special treatment of the general incorporation statutes, and not merely because of the number of charter applications they occasioned. The device of a general incorporation statute was seen as a means of implementing the policy of equal rights for all churches, an essential feature of the political philosophy of the new nation.[81]

By the second decade of the nineteenth century general incorporation statutes existed in New York for educational institutions, libraries, agricultural societies, medical societies, and Bible and common prayer organizations.[82] Other charitable and benevolent organizations were readily granted incorporation by special legislative charter. Whenever a class of benevolent organizations was recognized as being essentially nonpolitical and noncontroversial, a general incorporation law for that activity was readily passed.[83]

Despite the encouragement of corporateness, legislatures retained a tight control over corporate purposes and activities. The

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[79] The preamble to the Pennsylvania Statute of 1791 said in part:

> Whereas a great portion of the time of the legislature has heretofore been employed in enacting laws to incorporate private associations and it would not only be more advantageous to the public, but also convenient to individuals who are desirous of being so incorporated, that the same might lawfully be effected, without immediate application in all cases to the general assembly of the commonwealth.

Id. at 7-8.

[80] Baldwin, *supra* note 66, at 248.

[81] J. CADMAN, *supra* note 75, at 6. The preamble of the New Jersey law of 1786 providing for general incorporation of religious societies stated:

> Whereas Petitions are frequently presented to the legislature from religious Societies or Congregations of different denominations in this State, for Acts of Incorporation, for the better transacting the temporal Concerns of said Societies or Congregations, and many laws having been passed for that Purpose, and the Legislature being desirous of granting and Privileges to every Denomination of Christians, and securing to them all their civil rights.

1786 N.J. Laws 129.

[82] Seavoy, *supra* note 75, at 43-45; R. SEAVOY, *supra* note 74, at 9-32.

[83] R. SEAVOY, *supra* note 74, at 5.

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New York general incorporation statute of 1784 for the incorporation of religious societies had limitations upon the amount of an estate these bodies could accumulate and required trustees to render stated accounts to the Chancellor.[84] All of the early general incorporation statues contained limitations upon the amounts of revenue to be held by such organizations and the purposes for which such revenue was to be applied and requirements for furnishing inventories and reporting any excess property to the legislature. The legislative policy was to enforce within certain limits the accumulation of property.[85]

New York, which interpreted charitable trusts strictly, developed a broad legislative scheme for public charities through the medium of corporate bodies.[86] Beginning in 1790 the New York legislature, concurrently with the general incorporation statutes, incorporated by special charters societies for a variety of religious, literary, scientific, benevolent, and charitable purposes. The corporate body thus was kept under tight legislative control and supervision.

In 1840 the New York legislature passed an act authorizing gifts of real and personal property to any incorporated college or other charitable institution.[87] In 1848 the legislature passed a general incorporation statute for all classes of charitable organizations.[88] A similar movement toward the consolidation of charitable corporations into one general incorporation statute occurred in other

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[84] 1784 N.Y. Laws 18.

[85] Levy v. Levy, 33 N.Y. 97, 111 (1865).

[86] Other states also placed restrictions on charitable corporations. J. BLANDI, *supra* note 76, at 56-57, 61; J. CADMAN, *supra* note 75, at 15.

[87] 1840 N.Y. Laws 318.

[88] 1848 N.Y. Laws 319. The Act of 1848 provided for the general incorporation of benevolent, charitable, scientific, and missionary societies. Corporations could be formed by filing a certificate for any of the purposes listed in the title of the act. A majority of the signers had to be citizens and the certificate had to be approved in writing by a Justice of the Supreme Court. Corporations could take by purchase, devise or bequest real estate up to $50,000 in value, and personal property up to $75,000. These corporations were made subject to visitation by Justices of the Supreme Court and were required to make annually a public statement of their affairs. In 1849 the statute was amended to provide that all existing charitable corporations could reincorporate themselves under the Act of the previous year. 1849 N.Y. Laws 273. In 1862, the benefits of the Act were extended to authorize the incorporation of historical and literary societies. 1862 N.Y. Laws 273.

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states in the middle of the nineteenth century.[89]

The New York legislature enacted the Membership Corporation Law in 1895, which consolidated into one statute the laws of charitable corporations relating to medical societies, alumni corporations, veterinary societies, library corporations, and several other types of eleemosynary organizations.[90] The Membership Corporation Law applied to all corporations not organized for pecuniary profit except religious corporations and educational corporations.[91] The New York General Corporation Law applied to all corporations, whether stock, municipal, or charitable, unless there was a provision in a more specialized statute such as the Membership Corporation Law, in which case the provisions of the latter would prevail. The General Corporation Law dealt with matters of internal governance.

The Membership Corporation Law, albeit frequently amended to move directors' responsibilities toward the business corporate model,[92] remained the basic New York charitable corporation statute until the passage of the Not-For-Profit Corporation Law in 1970.[93]

Other states' charitable corporation statutes evolved similarly. In California in 1850, the first legislature enacted an "Act Concerning Corporations" which specially allowed charitable organizations to incorporate.[94] Thereafter, a variety of piecemeal legislation was passed expanding the types of organizations that could incorporate. California nonprofit legislation was generally skeletal, outlining purposes specifically permitted, elections of directors, bylaw provisions, and the requirements for the holding and mortgaging of

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[89] J. BLANDI, *supra* note 76, at 12-13; J. CADMAN, *supra* note 75, at 27.

[90] 1895 N.Y. Laws 559.

[91] N.Y. MEM. CORP. LAW § 2, 1895 N.Y. Laws 559 (repealed 1970). The Membership Corporation Law was revised in 1909 and 1940. It was succeeded by the New York Not-for-Profit Corporation Law in 1970.

[92] *See infra* text accompanying notes 156-73.

[93] *See infra* text accompanying note 171.

[94] 1850 Cal. Stat. 128 §§ 175-84. Churches, congregations, religious, moral, beneficial, literary or scientific associations and societies were entitled to incorporate. A separate statute was passed for the incorporation of educational institutions. 1850 Cal. Stat. 117 §§ 1-8.

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property.[95] In 1931, California enacted a General Nonprofit Corporation Law,[96] based largely upon an Ohio act, which in turn had been drafted on the basis of the nonprofit statutes of New York, Maryland, Illinois and Michigan.[97] The General Nonprofit Corporation Law abandoned many of the restrictions on charitable corporations, and gave nonprofit corporations greater flexibility in internal affairs. Nonprofit corporations were, however, also bound by the General Corporation Law, thereby carrying into nonprofit corporation law an undefined body of business corporate law.[98] In other areas, such as the law relating to standards of conduct of directors, trust principles governed.[99] The General Nonprofit Corporation Law was largely incorporated into the Corporation Code of 1947. In 1978, the current Nonprofit Corporation Law was enacted and for the first time treated California nonprofit corporation law as a coherent whole.[100]

Another reason the charitable corporation was favored over the charitable trust was the power of the legislature or executive of a state to dictate the terms of corporate privilege. Regulation of that privilege was thought to provide the state with greater control over charitable activities than the charitable trust, control of which would be exercised by an equity court.[101]

Incorporation enabled the trustees of a charitable organization to receive legacies and bequests, and it provided cheap legal process at the local level to ensure property was held in the corporate

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[95] 1 H.W. BALLANTINE & R. STERLING, CALIFORNIA CORPORATION LAWS § 401-.01 (R.B. Clark, 4th ed. 1984).

[96] CAL. CIV. CODE, Title 12, Art. I (1931).

[97] H.W. BALLANTINE & R. STERLING, CALIFORNIA CORPORATION LAWS 529 (1949).

[98] H. W. BALLANTINE & R. STERLING, *supra* note 95, at § 401.01[2]. Other laws applied to special types of charitable organizations such as societies for the prevention of cruelty to children, agricultural fair corporations, and institutions of higher learning.

[99] Abbott and Kornblum, *The Jurisdiction of the Attorney General Over Corporate Fiduciaries Under the New California Nonprofit Corporation Law* 13 U.S.F.L. REV. 753, 765-769 (1978-79).

[100] For a discussion of the California Statute, See *infra* text accompanying notes 239-52. The background to the enactment of the current statute can be found in 1 H. W. BALLANTINE & R. STERLING, *supra* note 95, at § 401.01[2].

[101] *Cf.* Levy v. Levy, 33 N.Y. 97, 112 (1865); Oaks, *Trust Doctrines in Church Controversies*, 1981 B.Y.U. L. REV. 805, 858-60.

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name, thus enabling title in such property to be defended at law in the name of the corporation.[102] The local public service function of early American corporations distinguished them from their English counterparts and led to their legislative encouragement.[103] This rationale for the willingness to grant corporate charters was expressed in the first American corporate law treatise: "It has been generally the policy and custom (especially in the United States) to incorporate all associations whose object tends to the public advantage in relation to municipal government, commerce, literature, and religion. The public benefit is deemed a sufficient consideration of a grant of corporate privilege."[104]

G. *The Importance of Tax Exemption*

In the twentieth century, the growth of the nonprofit corporation was spurred by the growing importance of tax exemption in an increasingly taxed society. Exemption of charitable organizations from taxation has long roots in English and American history.[105] Charitable, religious, and educational organizations were exempt from taxation in the Revenue Act of 1894.[106] This preferred status later was granted to other types of nonprofit organizations.[107] Ra-

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[102] R. SEAVOY, *supra* note 74, at 255.

[103] 2 J. S. DAVIS, *supra* note 70, at 7-8; L. FRIEDMAN, *supra* note 18, at 167.

[104] J. ANGELL & S. AMES, A TREATISE ON THE LAW OF PRIVATE CORPORATIONS, AGGREGATE 7 (1832, reprint ed. 1972).

[105] Exemption of charities from taxation goes back at least to the Statute of Charitable Uses. 43 Eliz. 1, ch. 4 (1601). From the Colonial period, tax exemption, particularly with respect to churches, was common. Religious organizations were given exemption from taxation at all levels of government. B. HOPKINS, *supra* note 4, at 5. Prior to the passage of the first federal income tax legislation in 1894, all customs and other tax legislation specified the items subject to taxation. Tax exemption existed by omission from taxation legislation. McGovern, *The Exemption Provisions of Sub-chapter F*, 29 TAX LAW. 523, 524 (1976).

[106] Revenue Act of 1894, 28 Stat. 509 c. 349 (1894); *declared unconstitutional in* Pollock v. Farmers' Loan & Trust Co., 157 U.S. 429 (1895). *See* Bittker and Rahdert, *The Exemption of Nonprofit Organizations from Federal Income Taxation*, 85 YALE L.J. 299, 302-03 (1976).

[107] Fraternal benefit organizations and certain building and loan associations were granted exempt status under the Revenue Act of 1894. Subsequent revenue acts expanded exempt status to labor, agricultural, and horticultural organizations; mutual cemetary companies, business leagues, chambers of commerce, social welfare organizations, and scientific organizations; social clubs, land banks, organizations associated with farming and title companies, public utilities and state instrumentalities; societies for the prevention of cruelty to

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tionales for tax exemption of nonprofit organizations have been based on historical, political, public policy, and moral grounds.[108]

Exempt organizations are characterized as serving public purposes rather than narrowly drawn private interests.[109] Since nonprofits are considered more responsive to community than personal goals, they are granted certain privileges.[110] To qualify for exemption from income taxation, the private inurement proscription applies to all organizations.[111]

Perhaps more important to the growth and importance of the tax exempt sector was the granting in 1917 of a deduction against individual income taxes for contributions to exempt organizations.[112] Concomitant with this privilege was the increasing regulation of exempt organizations by the federal government.[113] Perhaps

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animals and children; community chests, funds, or foundations; and organizations that foster national and international sports competitions, certain homeowner associations, and fishing associations. P. TREUSCH & N. SUGARMAN, TAX EXEMPT CHARITABLE ORGANIZATIONS 4-5 (2d ed. 1983).

[108] McGovern, *supra* note 105, at 527, cites the heritage or tradition of exemption for religious or charitable organizations: morality, in that organizations such as mutual savings banks founded and financed for the mutual benefit of members such as mutual savings banks should not be taxed; and politics as exemplified by special interest legislation. *See also* B. HOPKINS, LAW OF TAX EXEMPTION, *supra* note 4, at 3-7.

[109] *See* Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii) (1976).

[110] E. GINSBURG, D. HIESTAND, & B. REUBENS, *supra* note 4, at 22. "Evidently the exemption is made in recognition of the benefit which the public derives from corporate activities of the class named, and is intended to aid them when not conducted for private gain." Trinidad v. Sagrada Orden de Predicatores, 263 U.S. 578, 581 (1924). "The State has an affirmative policy that considers these groups [religious organizations] as beneficial and stabilizing influences in community life and finds this classification [tax exempt status] useful, desirable, and in the public interest." Walz v. Tax Commission of the City of New York, 397 U.S. 664, 673 (1970). *See* B. HOPKINS, *supra* note 4, at 5-7.

[111] P. TREUSCH & N. SUGARMAN, *supra* note 107, at 38-39.

[112] War Revenue Act, Pub. L. No. 50, 40 Stat. 300, 330 (1917). Corporate contributions became deductible in 1935 subject to a percentage of income limitation. Revenue Act of 1935, § 102(r), Pub. L. No. 407, 49 Stat. 1014, 1016 (1935). *See* P. TREUSCH & N. SUGARMAN, *supra* note 107, at 5-10.

[113] The private inurement proscription was enacted in 1909. Corporation Excise Tax Act, § 38, Pub. L. No. 51, 36 Stat. 11, 112-113 (1909). In 1934 a limitation on political activities was enacted. Revenue Act, § 101(b), Pub. L. No. 216, 48 Stat. 680, 700 (1934). In 1954, Section 501(c)(3) organizations were prohibited from campaigning on behalf of any candidate for public office. Internal Revenue Act, Pub. L. No. 591, 68A Stat. 1, 163 (1954). Lobbying by "public" charities was liberalized by the Tax Reform Act, § 1307, Pub. L. No. 94-455, 90 Stat. 1520 (1976). Corporate charitable deductions were limited in 1935 to grants

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the most significant regulatory changes occurred in 1969 when restrictions were placed upon all private foundations and a presumption was created that all § 501(c)(3) organizations were private foundations unless they could prove that they fell within one of the three enunciated public charity exceptions.[114] Private foundations were prohibited from acts of self dealing, from making certain investments, or from accumulating income. Severe penalties were imposed for violations of these strictures.[115] Federal regulation has shaped nonprofit corporation statutes and has removed the impetus for state efforts to enforce and reform state nonprofit corporation law. Often, states have merely tracked Internal Revenue Code proscriptions[116] and have yielded enforcement efforts to the Internal Revenue Service. Nonprofit corporation statutes have been an afterthought.

II. THE DEVELOPMENT OF THE LAW OF NONPROFIT CORPORATIONS

A. *English Precedents*

There has been no coherent development of the law of nonprofit organizations. In England charitable organizations ordinarily were organized as charitable trusts.[117] For the aforementioned reasons the charitable corporation became a more popular organizational form for nonprofit activities in the United States.[118] The growth in size and complexity of modern charitable organizations has resulted in an increasing abandonment of the charitable trust in

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for domestic use when made to noncorporate donees. Revenue Act, § 102(r), Pub. L. No. 407, 49 Stat. 1014, 1016 (1935). In 1938, individuals could only limit contributions to domestic grantees. Revenue Act] 23(]o), Pub. L. No. 554, 52 Stat. 447, 463 (1938). Certain prohibitions on self dealing were introduced. Revenue Act, § 331, Pub. L. No. 814, 64 Stat. 906, 957-59 (1950). In 1950, §§ 421-24 were added to I.R.C. of 1939. Revenue Act, § 301, Pub. L. No. 814, 64 Stat. 906, 948 (1950). *See generally* P. TREUSCH & N. SUGARMAN, *supra* note 107, at 5-8.

[114] Revenue Act § 101, Pub. L. No. 91-172, 83 Stat. 487, 492-498 (1969).

[115] *Id.* (adding Chapter 42 (§§ 4940-48) to the I.R.C. of 1954). *See* P. TREUSCH & N. SUGARMAN, *supra* note 107, at 5-10.

[116] *See* OR. REV. STAT. § 61.955 (1983); S.C. CODE ANN. § 33-31-310 (Law. Co-op. 1976); TENN. CODE ANN. § 48-1-604 (1984).

[117] W. JORDAN, PHILANTHROPY IN ENGLAND 1480-1600, at 119 (1950); A. SCOTT, *supra* note 9, at § 348.2; M. FREMONT-SMITH, *supra* note 11, at 18-27.

[118] *See supra* text accompanying notes 33-61.

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favor of the corporate form.[119] Unlike England, we have no law of charities or even an agreed upon definition of the word.[120]

Most English common law cases on corporations dealt with charitable corporations, particularly ecclesiastical corporations, a category of corporation disfavored in this country after the Revolution and the disestablishment of the Anglican Church.[121] Blackstone, who devoted only nineteen pages in the *Commentaries* to the law of corporations, primarily cited cases involving eleemosynary and ecclesiastical corporations, as did Stewart Kyd in *A Treatise on the Law of Corporations*.[122] Municipal corporations were also well known to English law.

Business corporations did not become important in England until the middle of the nineteenth century. As a result, English corporate law furnished only a few fundamental concepts and legal rules, and had a limited impact upon the development of American corporate law.[123] One of the first legal issues involving charitable corporations in the United States was whether they were "public" in the sense of a municipal corporation or "private" like the business corporation.

B. *The Classification of Nonprofit Corporations: The Public-Private Dichotomy*

The classification of charitable corporations as "public" or "private" corporations had an important influence upon the future of the charitable corporate form in the United States and upon the relationship of charitable corporate law to the law of business

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[119] Note, *supra* note 8.

[120] Charities Act, 1960, 8 & 9 Eliz. 2, ch. 58 §§ 45(1), 46, contains a definition of charity:

> In this Act, except in so far as the context otherwise requires, charity means any institution, corporate or not, which is established for charitable purposes and is subject to the control of the High Court in the exercise of the court's jursdiction with respect to charities.

[121] Dodd, "*American Business Association Law A Hundred Years Ago and Today*" in LAW: A CENTURY OF PROGRESS, 254, 281 (1937); *See* Oaks, *supra* note 101, at 825.

[122] W. BLACKSTONE, COMMENTARIES *467-85; S. KYD, A TREATISE ON THE LAW OF CORPORATIONS (1603, repr. ed. 1973 & 1978).

[123] E. DODD, AMERICAN BUSINESS CORPORATIONS UNTIL 1860, at 1 (1954).

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corporations.

English corporations were divided into lay and ecclesiastical categories.[124] Lay corporations existed of two sorts, civil and eleemosynary. Civil corporations received their corporate capacity from the monarch and existed for public purposes of governance. They included local government corporations and those with a public purpose such as the public trading company. Courts of law could examine the validity of the corporations and their charters.[125] Eleemosynary corporations were established to carry into effect some public charitable purpose - the distribution of free alms or a donation by the founder in such manner as directed. In this class were colleges as well as hospitals for the relief of the poor.[126]

The common law of English corporations, which applied to all corporate forms, dealt with two principal aspects: internal rules and procedures. In a crucial respect the rules of eleemosynary corporations differed from those of civil corporations. The eleemosynary corporation was founded upon private property. It was founded by private persons, based upon the founders' private property and subject to their control, rules, and visitorial powers.

In the United States, Chancellor Kent in his *Commentaries* adopted the English classification of corporations into ecclesiastical and lay.[127] This scheme was later rejected by American courts, because incorporated religious societies were not considered ecclesiastical in the sense of English law but belonged instead to a subclass of the civil corporations category.[128] This difference in classification resulted from the absence of an established church in the United States and the constitutional guarantees to all denomina-

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[124] The first division of corporations was into aggregate and sole corporations. Aggregate corporations consisted of many persons united together into one society. Sole corporations consisted of one person, typically a clergyman, who was incorporated by law in order to give him some legal capacity and advantage, particularly that of perpetuity. W. BLACKSTONE, *supra* note 122, at *469-70.

[125] Phillips v. Bury, 87 Eng. Rep. 289 (K.B. 1694); W. BLACKSTONE, *supra* note 122, at *470-72; 1 S. KYD, *supra* note 122, at 19-32.

[126] W. BLACKSTONE, *supra* note 122, at *471-72; *See* S. KYD, *supra* note 122, at 25-27.

[127] 1 J. KENT, *supra* note 46, at *274.

[128] Robertson v. Bullions, 11 N.Y. 243, 251-52 (1854).

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tions.[129] By subsuming the law of religious organizations under the law of civil corporations, courts could apply general aspects of corporate law to all charitable bodies, while avoiding decisions which broached religious doctrines or principles.

C. *Charitable Corporations as Private Corporations: The Dartmouth College Case*

Until the *Dartmouth College* case,[130] it was uncertain whether colleges and business enterprises would be placed in the same category as private corporations.[131] If charitable corporations such as universities or colleges were classified as public corporations, the state could alter the organization's charter as it saw fit. Patrons might lose incentive to donate to a charitable corporation if their munificence was susceptible to state tampering. If the charitable corporation were a private institution, as the Supreme Court concluded in the *Dartmouth College* case, the charter could not be altered because of the Contracts Clause of the United States Constitution.[132] The *Dartmouth College* decision thus established a categorical similarity between charitable corporations and business corporations. As a result, the development of business corporation law in the nineteenth century provided guidance for the internal operating rules of charitable corporations.

In an 1805 decision, *Trustees of the University v. Foy*,[133] the North Carolina Supreme Court presaged the *Dartmouth College* case by holding that a legislature could not repeal a grant of property once given to a university corporation, on the grounds that it violated the bill of rights as well as the state constitution. The court concluded: "although the Trustees are corporations established for public purposes, . . . their property is as completely beyond the control of the Legislature as the property of individuals or that of any other corporation."[134]

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[129] *Cf.* Oaks, *supra* note 101, at 836.
[130] Trustees of Dartmouth College v. Woodward, 17 U.S. (4 Wheat.) 518 (1819).
[131] E. DODD, *supra* note 123, at 17.
[132] U. S. CONST. art. I, § 10.
[133] 5 N.C. (1 Mur.) 57.
[134] *Id.* at 63. The court also stated:

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On December 13, 1769 the British crown, through the colonial governor of New Hampshire, granted a charter incorporating twelve persons under the name of "The Trustees of Dartmouth College". This charter gave the trustees and their successors the power to fill vacancies on the Board of Trustees. By acts dated June 27, 1816 and thereafter, the New Hampshire legislature amended the charter by changing the name of the college to Dartmouth University, increasing the number of trustees to twenty-one, giving the powers of appointment of additional trustees to the executive of the state, and creating a board of twenty-five overseers with power to review and disapprove of the most important acts of the trustees.[135]

The majority of the college's trustees refused to accept the amended charter and brought suit.[136] As generations of law students have learned, the United States Supreme Court, in a decision by Justice Marshall, held that the college was a private corporation; the charter was a contract within the meaning of the Contract Clause of the United States Constitution; the New Hampshire legislature's act of altering the charter without the consent of the corporation impaired the obligation of the charter and

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> Indeed, it seems difficult to conceive of a corporation established for merely private purposes. In every institution of that kind, the ground of the establishment is some public good or purpose intended to be promoted; but in many the members thereof have a private interest, coupled with the public object. In this case, the trustees have no private interest beyond the general good; yet we conceive that circumstances will not make the property of the Trustees subject to the arbitrary will of the Legislature. The property vested in the Trustees must remain for the uses intended for the University until the Judiciary of the country in the usual and common form pronounce them guilty of such acts as will, in law, amount to a forfeiture of their rights or dissolution of their body.

Id.

This analysis of the public purposes of all corporations foreshadows the majority's decision in *Dartmouth College*

[135] The charter, the subsequent amending legislation, and the facts of the litigation, are set out in elaborate detail in *Dartmouth College*, 17 U.S. at 519-551. Under the charter, the founder and President of the college, Eleazar Wheelock, could nominate his successor. Wheelock's son, John Wheelock, was President at the time of the dispute. His administration was challenged by the Trustees of the College, and Wheelock carried the dispute to the state's politicians. The politics surrounding the case are well described in M. BAXTER, DANIEL WEBSTER & THE SUPREME COURT 65-109 (1966).

[136] *Dartmouth College*, 17 U.S. at 626-27; M. BAXTER, *supra* note 135, at 70-71.

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was thus unconstitutional.[137]

The decision that a charitable corporation was a private corporation was not a foregone conclusion. English lay corporations were civil or eleemosynary, but English law made no distinction between public or private corporations. Blackstone affirmed the right of a founder of a college or other corporation to name his or her successors at common law, but the Court was not bound to follow the English rule.[138] The New Hampshire legislature did not necessarily face the same limits as the monarch under English common law nor was the New Hampshire legislature equivalent in rights to Parliament.[139] Another factor that could have caused the decision to go against Dartmouth College was whether the college actually was operated as a public institution—a forerunner of modern state action arguments. The Court, however, found that almost all corporations served public purposes and benefited the nation.[140] These public purposes, said Marshall, would be unattainable for most eleemosynary institutions without the aid of a charter of incorporation.[141]

The character of civil institutions did not derive from the incorporation itself but from the manner of formation. Although Dartmouth had public purposes, the college was a private charitable entity because private individuals founded the corporation. Whereas the civil corporation was a creature of public institutions for public advantage, the private corporation was endowed by private persons and subject to their control, laws, and visitation, and not to the general control of the government. These private powers and rights flowed from the property of the founder in the funds assigned for the support of the charity.[142]

The *Dartmouth College* case provided assurances that the grants

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[137] *Dartmouth College*, 17 U.S. at 641, 651-52. The importance of the case for corporate law purposes was limited by the suggestion in Justice Story's concurrence that a legislature could amend a charter if it reserved that right in the original grant. *Id.* at 675, 708, 712.

[138] W. BLACKSTONE, *supra* note 122, at *481-83.

[139] M. BAXTER, *supra* note 135, at 85.

[140] *Dartmouth College*, 17 U.S. at 637.

[141] *Id.*

[142] *Id.* at 660-61 (Washington, J. concurring).

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of private capital to charities would be protected from government control and appropriation. As Daniel Webster noted in his brief for the Court:

> If the franchise may be at any time taken away, or impaired, property may also be taken away, or its use perverted. Benefactors who have no certainty of effecting the object of their bounty; and learned men will be deterred from devoting themselves to the service of such institutions, from the precarious title of their offices. Colleges and halls will be deserted by all better spirits, and become a theatre for the contention of politics. Party and faction will be cherished in these places consecrated to piety and learning.[143]

Justice Marshall reflected this argument when he commented that a great inducement to charitable gifts is the conviction felt by the donor that the disposition is immutable and that the corporation constitutes the security for such gifts.[144]

D. *The Early Law of Fiduciaries - The Origins of Trustee Powers*

1. Visitorial Rights

Perhaps the most disputed area of nonprofit corporation law involves the rights and duties of directors of charitable corporations.[145] The law has moved from rigid trust principles to nearly

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[143] *Id.* at 599.

[144] *Id.* at 647.

[145] S. Weil, *Breaches of Trust: Museums, Ethics & The Law* in BEAUTY AND THE BEASTS: ON MUSEUMS, ART, THE LAW AND THE MARKET (1983); Albert, *The Legal Liabilities of Trustees, Directors and Officers of a Non-Profit Cultural Institution - Preparing for and Dealing with Financial Difficulties and Dissolution* in NON-PROFIT CULTURAL ORGANIZATIONS 103 (H. Horowitz, ed. 1979); Du Boff, *Duties and Liabilities of Trustees* in NON-PROFIT CULTURAL ORGANIZATIONS 61 (H. Horowitz ed. 1979); Eyster, *Responsibilities of Directors and Trustees of Not for Profit Organizations*, 4 ART & THE LAW 13 (1978); Gerstenblith, *The Fiduciary Duties of Museum Trustees*, 8 ART & THE LAW, 175 (1983); Hackler, *Hospital Trustees' Fiduciary Responsibilities: An Emerging Tripartite Distinction*, 15 WASHBURN L.J. 422 (1976); Hansmann, *Reforming*, *supra* note 6, at 567-74; Karst, *supra* note 5; Marsh, *Governance of Non-Profit Organizations: An Appropriate Standard of Conduct for Trustees and Directors of Museums and other Cultural Institutions*, 85 DICK. L. REV. 607 (1981); Merryman, *Are Museum Trustees and the Law out of Step*, ARTNEWS, Nov. 1975, at 24; (1975); Oleck, *Proprietary Mentality and the New Nonprofit Corporation*

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wholesale adoption of the business corporation director's standards of conduct.

At common law the founders of a charitable corporation, the individuals who originally donated funds and revenues, and their heirs, had the right to visit, inquire into, and correct all irregularities and abuses which arose in the course of the administration of the funds donated.[146] This visitorial power, which attached to all eleemosynary and ecclesiastical corporations, was an enforcement mechanism and could compel the original purpose of the charity to be "faithfully fulfilled."[147] The theory of the visitorial power was that private, charitable corporations founded and endowed by private persons were subject to the private government and rules of the founders. Therefore, they could be visited by the founders, their heirs, or such other persons as they appointed.[148] The director's power of governance of the charitable corporation developed from the visitorial power.

The founders could assign their visitation right or could nominate others—trustees—to manage or supervise the charity. In that context the visitorial power rested on the trustees in their corporate character.[149] In the United States, colleges and universities were usually established by a founder who invested in the incorporating governors or trustees the right of visitation. The management of the charitable corporation was vested in the trustees.[150] In

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Laws, 20 CLEV. ST. L. REV. 145 (1971); Report, Committee on Charitable Trusts, *Duties of Charitable Trust Trustees and Charitable Corporation Directors*, 2 REAL PROP. PROB. & TR. J. 545 (1967); Note, *Dissolution of Public Charity Corporations: Preventing Improper Distribution of Assets*, 59 TEX. L. REV. 1429 (1981); Note, *The Fiduciary Duties of Loyalty and Care Associated with the Directors and Trustees of Charitable Organizations*, 64 VA. L. REV. 449 (1978).

[146] Allen v. McKean, 1 F. Cas. 489, 497 (C.C.D. Me. 1833) (No. 229); Philips v. Bury, 87 Eng. Rep. 289 (K.B. 1694).

[147] *Dartmouth College*, 17 U.S. at 673 (Story, J., concurring). According to Chancellor Kent, the visitorial power applied only to ecclesiastical and charitable corporations. J. KENT, *supra* note 46, at *300.

[148] J. KENT, *supra* note 46, at *303.

[149] *Allen v. McKean*, 1 F. Cas. 489, 497-98.

[150] J. KENT, *supra* note 46, at *302. Variations were adopted. For instance at Harvard, a power of inspection was given to a Board of Overseers. It was not strictly speaking a visitorial power, which belongs to the fellows or members of the corporation. Some early corporations had both a board of directors and trustees. *See* Sealy, *The Director as Trustee*,

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England, when the founder had not appointed other visitors or did not exercise visitorial rights, the duties of visitation were reserved in the crown. Because of its ecclesiastical origins and the essentially aristocratic tone of its vesting in the heirs of the founder or their designates, the visitorial right in the English sense became disfavored in the United States upon Independence and is of little importance today.[151] Despite its contemporary unimportance, it illuminates the origins of the charitable corporation's board of directors and their supervisory authority.

2. Duties of Trustees

It was determined, at least in dicta, by the early nineteenth century that a court of equity obtained jurisdiction over a charitable corporation in cases of a breach of trust by its board of directors or officers.[152] The attorney general had the power to use the writ of quo warranto, the remedy for prohibiting a corporation from misusing or exceeding its franchise or for obtaining a forfeiture of the charter.[153] Private citizens could use the writ of quo warranto only as a relator.[154] Their more typical remedy was the writ of manda-

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1967 CAMBRIDGE L.J. 83, 84-85.

[151] J. KENT, *supra* note 46, at *303-304; Oaks, *supra* note 101, at 853; Nelson v. Cushing, 56 Mass. (2 Cush.) 519, 532 (1848).

[152] Attorney General v. Utica Ins. Co., 2 Johns Ch. 371, 389 (N.Y. ch. 1817); Nelson v. Cushing, 56 Mass. (2 Cush.) 519, 531-32 (1848); 1 J. STORY, COMMENTARIES ON EQUITY JURISPRUDENCE § 1584 (14th ed. 1918). Because the visitorial power ultimately lay in the crown upon an abuse or breach of trustee duty, a court of chancery did not have the initial authority to supervise the administration of a charitable corporation. However, an equity court had the power to prevent a breach of trust which might arise from a misapplication of trust funds. In the words of Chancellor Kent:

> It is now settled that the trustees or governors of a literary or charitable institution, to whom the visitorial power is deemed to vest by the incorporation, are not placed beyond the reach of the law. As managers of the revenues of the corporation they are subject to the general superintending power of the Court of Chancery, not as itself possessing a visitorial power or a right to control the charity, but as possessing a general jurisdiction in all cases of an abuse of trust, to redress grievances, and suppress fraud.

J. KENT, *supra* note 46, at *303-04.

While the visitorial power has become unimportant, it illustrates the origins of the charitable corporation's board of directors and their power to manage the corporation.

[153] E. DODD, *supra* note 123, at 57-61, 181-83; Oaks, *supra* note 101 at 853-55.

[154] E. DODD, *supra* note 123, at 58-59.

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mus to compel a corporation to live up to its charter. In the early nineteenth century, mandamus was available in some states to members and officers of nonprofit corporations who claimed that they had been wrongfully deprived of their memberships or offices.[155]

In this period, however, little progress had been made in either the business corporate or nonprofit area to define the fiduciary duties of directors.[156] Directors and officers of corporations were agents or guardians under English law and were subject to rigorous fiduciary responsibilities and duties of loyalty.[157] According to Dodd, in spite of the absence of case law in the period from 1800 to 1830, English principles of fiduciary duty were known in America.[158] Kent's *Commentaries*, first published in 1827, and Story's *Equity Jurisprudence*, initially published in 1836, dealt extensively with the fiduciary relationship.[159] In a New York decision in 1832, Chancellor Wadsworth said, in dictum, that directors of a business corporation would be liable to the corporation for losses due to their negligence or ultra vires actions.[160]

In the nineteenth century, directors were held in check through strict limitations upon corporate powers and statutory prohibitions against self-dealing.[161] For instance, New York's General Incorporation Act of 1848 limited charitable corporations' holding of real property to $50,000 and personal property to $75,000. The annual income from real and personal property could not exceed

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[155] *See, e.g.*, Fuller v. Plainfield Academic School, 6 Conn. 532 (1827); Commonwealth v. St. Patrick Benevolent Society, 2 Binn. 441 (Pa. 1810). *See Generally* E. DODD, *supra* note 123, at 62-63.

[156] Dodd, *supra* note 121, at 254, 281. In Robinson v. Smith, 3 Paige 222 (N.Y. 1832), the court held that directors could not deny to a board member the right to examine the corporation's books.

[157] *See, e.g.*, Charitable Corp. v. Sutton, 26 Eng. Rep. 642 (Ch. 1742). The plaintiff was misnamed, for it was not a charitable corporation.

[158] E. DODD, *supra* note 123, at 70.

[159] 4 J. KENT, *supra* note 46, at *341-46; 1 J. STORY, *supra* note 152, at §§ 430-50.

[160] Robinson v. Smith, 3 Paige 222, 231 (N.Y. 1832).

[161] This proscription applied to directors of business corporations as well. *See* Marsh, *Are Directors Trustees? Conflict of Interest and Corporate Morality*, 22 BUS. LAW. 35, 36-43 (1966).

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$10,000.[162] Trustees were jointly and severally liable for all debts due.[163] All charitable corporations were subject to visitations by justices of the Supreme Court. Directors were required to file annual reports with the clerk of the county in which the certificate was filed.[164] They could not engage in transactions in which they were interested unless such transactions were authorized in the bylaws and assented to by vote of all of the directors.[165] In nineteenth century corporate law, the position of director brought with it a high sense of responsibility and duty.

From the enactment of the Membership Corporation Law in 1895,[166] the standards of conduct for directors of nonprofit corporations have progressively been eroded. Under that statute, directors had to present to their members an annual report showing acquisition, disposal, and holding of property, and unlike their business corporation counterparts, still were personally liable for short term debts.[167] Restrictions on the purchase, sale, and leasing of property were mitigated, but court approval was required for leases exceeding three years.[168] The ban on interested transactions was relaxed. Such transactions could be approved if authorized by the bylaws *and* by a concurring vote of all of the directors.[169]

By 1926, directors no longer had liability for the corporation's debts, and interested transactions could be approved if authorized by the bylaws *or* by a concurring vote of two-thirds of the directors.[170] The New York Not-For-Profit Corporation Law, which was enacted in 1970 and superseded the Membership Corporation Law, utilized virtually the same requirements for standards of care and

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[162] 1848 N.Y. Laws 319 § 2.

[163] *Id.* at § 7.

[164] *Id.* at § 8.

[165] 1872 N.Y. Laws 104 § 1.

[166] 1895 N.Y. Laws 559.

[167] N.Y. MEM. CORP. LAW § 11, 1895 N.Y. Laws 559 (repealed 1970). The unlimited liability for short term debts did not apply to directors of societies for the prevention of cruelty to animals or children and of political parties!

[168] N.Y. MEM. CORP. LAW § 13, 1895 N.Y. Laws 559 (repealed 1970).

[169] *Id.* at § 12. Directors could receive a salary if authorized by the bylaws or by a two-thirds concurring vote of all of the directors.

[170] 1926 N.Y. Laws 722 §§ 46-47. No longer did charities have to obtain permission from the Supreme Court to lease property for more than three years.

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interested transactions as New York's Business Corporation Law.[171] Almost all other jurisdictions have moved from the charitable trust to the business corporate standards of conduct for directors of nonprofit corporations. California maintained the trust standards of conduct until the enactment of its Nonprofit Corporation Law in 1980.[172] That statute's approach to interested transactions is an attempt to create a more substantial approval process for public benefit charitable corporations than for business corporations.[173] California is the only state to consider the special needs of nonprofit corporations in regulating interested transactions.

E. *Nonprofit Corporation Law, the Law of Charitable Trusts, and Business Corporation Law: Similarities and Differences*

1. Similarities With Charitable Trust Law

Many of the principles and rules applicable to charitable trusts apply to the charitable corporation.[174] Both can receive tax exemptions, though the tax consequences can be quite different.[175] For both organizational forms there is a relaxation of the rule against perpetuities and limited tort liability.[176] Both are under the supervision of the attorney general, who can maintain a suit to prevent the diversion of property to purposes other than those for which it was given.[177] The doctrine of *cy pres* applies to both.[178] In matters relating to the public purposes or the objectives of the organization, courts traditionally have honored trust principles and standards for the charitable corporation. Where property is given to a charitable corporation with restrictions or specific terms, the corporation is under the same duty as the charitable trust to devote

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[171] *Compare* N.Y. NOT-FOR-PROFIT CORP. LAW §§ 715, 717 (McKinney 1970 & Supp. 1984-85) *with* N.Y. BUS. CORP. LAW §§ 713, 717 (McKinney 1963 & Supp. 1984-85).

[172] Abbott & Kornblum, *supra* note 99, at 757-64.

[173] *See* CAL. CORP. CODE § 5233 (West Supp. 1985).

[174] RESTATEMENT, *supra* note 9, at § 348 comment f.

[175] *See* P. TREUSCH & N. SUGARMAN, *supra* note 107, at 27-28; Fisch, *Choosing the Charitable Entity*, 114 TR. & EST. 874, 893-94 (1975).

[176] Note, *supra* note 8, at 1174.

[177] 4 A. SCOTT, *supra* note 9, at § 348.1.

[178] *Id.*

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the property to the specified charitable purpose.[179] Until recently, the standards of care and loyalty for directors of both organizational forms were similar.[180] However courts in no state look solely at trust principles for the solution of problems relating to charitable corporations.[181] Other legal rules differ for the two organizational forms and the dissimilarities are widening as the operating principles of the charitable corporation become more analogous to those of the business corporation.

2. Legal Distinctions Between the Charitable Corporation and the Charitable Trust

An early procedural distinction between the charitable corporation and the charitable trust was that Chancery would not assume the visitorial power and exercise supervisory power over a charitable corporation. Equity did have, however, a residual power if the directors abused their trust.[182] In the United States, courts concluded at an early date that corporate trustees were subject to the jurisdiction of equity courts.[183] This meant that corporate directors

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[179] St. Joseph's Hospital v. Bennett, 281 N.Y. 115, 22 N.E. 2d. 305 (1939).

[180] In 1969 Cary and Bright could write: "The standard by which directors of a charitable corporation are most often judged in the administration of the corporation's affairs is that which 'a man of common prudence ordinarily exercises in his own affairs.' " W. CARY & C. BRIGHT, *supra* note 5, at 40. This is no longer the standard. *See supra* text accompanying notes 170-72.

[181] W. CARY & C. BRIGHT, *supra* note 5, at 18.

[182] Attorney General v. Middleton, 28 Eng. Rep.210 (ch. 1751). *See also* J. KENT, *supra* note 46, at *305; Oaks, *supra* note 101, at 823-25. At common law, at least in the eighteenth century, a court of chancery "merely in virtue of its general jurisdiction over trusts" had a right to enforce the due performance of charitable bequests. The jurisdiction of equity courts was derived from their general authority to carry into execution the trusts of a will or other instruments according to the intention expressed in that will or instrument. 3 J. STORY, *supra* note 152, at § 1580; Oaks, *supra* note 101, at 820-21. In the nineteenth century the visitorial right declined in importance and equity courts in England assumed supervisory responsibilities over the management of charitable corporations. 1 T. LEWIN, A PRACTICAL TREATISE ON THE LAW OF TRUSTS AND TRUSTEES 429 (8th ed. 1889). According to Judge Oaks, "[A]t the time of the founding of the United States, the English court of chancery and attorney general had no general common-law supervisory or regulatory powers over charitable *corporations*, and that their jurisdiction to intervene in the application of corporate revenues was limited to correcting embezzlements." Oaks, *supra* note 101, at 825 (emphasis in original).

[183] Trustees of Dartmouth College v. Woodward, 17 U.S. 518, 676 (1819); Allen v. Mc-

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and officers had greater managerial control over the corporation's property.[184] For instance, in dictum in the *Dartmouth College* case, Justice Marshall had noted that, unlike the charitable trust, the legal and beneficial interests of the nonprofit corporation are lodged in the trustees.[185]

Because of the tangled history of the charitable trust in this country, jurisdictions differ as to whether a charitable corporation holds property conveyed to it absolutely, or whether it holds such property in trust.[186] The circumstances under which creditors can reach the organization's property differ. If a charitable corporation incurs a liability in contract or in tort, an action at law can be brought against the corporation. But it is only in equity, if at all, that a creditor can reach trust property.[187] The income from property bequeathed to a charitable corporation must be used for its charitable purposes, yet unlike the charitable trust, it is not subject to a statutory rule requiring accountings in a probate court.[188]

A charitable corporation does not hold property beneficially in the same sense that a business corporation or a non-charitable organization would hold it. In *St. Joseph's Hospital v. Bennett*, the New York Court of Appeals stated that a gift to a corporation which specified a particular purpose did not create a charitable trust, but the corporation could not receive a gift for one purpose and use it for another unless a court applied the doctrine of *cy pres*.[189]

The legal differences in the trust or corporate form are not nec-

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Kean, 1 F. Cas. 489, 497-98 (1833); Nelson v. Cushing, 56 Mass. (2 Cush.) 519, 532 (1848). J. KENT, *supra* note 46, at *304-05. According to Oaks, *supra* note 101, at 841-50, at common law the attorney general's powers to enforce charitable corporations differed from and were more tenuous than their powers over charitable trusts.

[184] *See, e.g.*, Parker v. May, 59 Mass. (5 Cush.) 336 (1850).

[185] 17 U.S. at 654.

[186] 4 A. SCOTT, *supra* note 9, at §348.1.

[187] *Id.*

[188] RESTATEMENT, *supra* note 9, at § 348.

[189] St. Joseph's Hospital v. Bennett, 281 N.Y. 115, 115, 123, 22 N.E. 305, 308 (1939). *See also* Queen of Angels Hospital v. Younger, 66 Cal. App. 3rd 359, 136 Cal. Rptr. 36 (1977). *Cf.* CAL. CORP. CODE § 9143 (West 1985) (providing cause of action for a contributor when property received by the corporation has been used in a manner contrary to the specific purpose for which it was contributed.)

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essarily consistent. In some jurisdictions, a devise of land to a charitable corporation may be prohibited or restricted, and the powers of a charitable trustee to hold property may be correspondingly broader.[190] Yet, under common law the charitable trustee could not mortage property, whereas the charitable corporation could mortage or dispose of property without seeking approval.[191]

A major distinction between the two organizational forms is that the charitable corporation is organized under legislative authority whereas the charitable trust is established by private action.[192] Because of statutory requirements on such matters as dissolution, number of directors, and corporate housekeeping requirements, the internal organization of the charitable trust may be more informal and flexible. In some circumstances, however, the trustee's requirements may be more rigid. Absent a provision in the trust instrument, a charitable trustee may need court approval to resign. Some of the common law requirements of non-profit corporations can be altered through creative drafting.

3. Business Corporations and Charitable Corporation Law

At the beginning of the nineteenth century, the essential nature of the business corporation changed from unique, ad hoc creations, vesting exclusive control over a public asset or natural resource in one group of favorites, to the typical mode for organizing a business.[193]

The development of the business corporation in the United

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[190] In Wyoming a charitable corporation can only acquire property "such as may be necessary or proper for the purposes of such corporation." WYO. STAT. §17-7-103 (1977). Other states restrict the amount of property that can be owned. *See* ARK. STAT. ANN. § 50-201 (1947); OHIO REV. CODE ANN. § 1715.39 (Page 1978); OKLA. STAT. ANN. tit. 18, § 563 (West 1951). Nevada limits a charitable corporation's ownership of real estate to one block in any town or city and ten acres in the country. NEV. REV. STAT. § 86.160 (1979).

[191] Fisch, *supra* note 175, at 893.

[192] A charitable trust is created either by a testamentary or inter vivos transfer of property by the owner to a trustee for charitable purposes. It comes into existence when the settlor who indicated an intention to create a trust delivers a trust for charitable purposes for the benefit of indefinite beneficiaries. Fisch, *supra* note 175, at 875.

[193] L. FRIEDMAN, *supra* note 68, at 168-69.

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States has been viewed as the transfer of the public service functions from traditional charitable organizations (churches and schools), to internal improvement corporations (railroads, coach, bridges, water supply companies), to wholly private business corporations that exploited an anonymous market.[194] The business corporation provided the engine of organization for a market economy.

In the first half of the nineteenth century, the essential public service nature of the business corporation changed and diverged from the traditional charitable corporation. Because of easier access of entry through general incorporation statutes, unlimited duration, and a relaxation of restrictions on purposes, capital requirements, and management, the business corporation became the general form in which to cast the organization of one's business.[195]

Even during the early 1800's, it was realized that different kinds of public service organizations required varying degrees of state regulation. Yet, charitable corporations received little further attention once general incorporation statues were passed.[196] At the turn of the nineteenth century, the case law on corporations was thin.[197] As the business corporation became more common, so did case law involving it. The prior law which might apply equally to the charitable or private corporation was no longer germane.[198]

Business corporations, whose function was to carry on business for profit, inevitably bred more litigation than incorporated churches, colleges, or orphanages. Commencing in the early nineteenth century, with the growing number of business corporations there was a corresponding increase in litigation which raised important issues of corporate law.[199] The rules of nonprofit corporations were ill-suited to business corporations and rules relating to non-stock entities were of little assistance in dealing with such nineteenth century corporate issues as the liability of shareholders

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[194] R. SEAVOY, *supra* note 74, at 5-7; W. NELSON, *supra* note 27, at 133.
[195] L. FRIEDMAN, *supra* note 18, at 168-69.
[196] R. SEAVOY, *supra* note 74, at 255.
[197] L. FRIEDMAN, *supra* note 18, at 175.
[198] W. NELSON, *supra* note 27, at 133-34.
[199] E. DODD, *supra* note 123, at 12.

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to pay assessments, methods of transferring shares, or the rights of shareholders in earnings and assets of the corporation.[200] Thus, the law of business corporations as it developed in the nineteenth century diverged from that of the charitable corporation.

In some areas, however, nonprofit law was greatly influenced by business corporate developments. Business corporate principles were applied to the internal governance of nonprofit corporations, but trust law governed the fiduciary responsibilities of directors and officers of nonprofit corporations. Nonprofit corporation law converged with business corporation law in the twentieth century. In some jurisdictions, nonprofit corporation statutes literally tracked their business corporate counterparts.[201] Nowhere did nonprofit corporation law develop according to its specific needs.

Increasingly, nonprofit corporation law reflected business corporate rather than trust principles in solving charitable corporate problems. Courts and statutes long have applied corporate standards to matters dealing with internal administrative management or housekeeping functions of charitable corporations.[202] Unlike the charitable trust, but similar to the business corporation, litigation is conducted in the name of the corporation rather than the name of the individual directors.[203] Contracts are executed in the name of the corporation rather than the directors, and the corporation can borrow money in its name. The rules governing charitable corporation bylaws, internal procedures, and qualification and renewal of board members are based upon business corporate rather than trust principles.[204]

Procedures and practices relating to financial investments and

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[200] *Id.* at 195-96.

[201] *Compare* N.Y. NOT-FOR-PROFIT CORP. LAW (McKinney 1970 and 1984-85 Supp.) *with* N.Y. BUS. CORP. LAW (McKinney 1963 and 1984-85 Supp.).

[202] "Corporate principles are applied to the solution of such [administrative] problems with remarkable uniformity by the courts of all states, regardless of whether they adhere to the trust theory or the theory of absolute ownership for other purposes." W. CARY & C. BRIGHT, *supra* note 5, at 19.

[203] Note, *supra* note 8, at 1173.

[204] Grace v. Grace Inst., 19 N.Y.2d 307, 313, 279 N.Y.S. 721, 724, 226 N.E.2d 531, 533 (1967); Leeds v. Harrison, 9 N.J. 202, 87 A.2d 713 (1952); W. CARY & C. BRIGHT, *supra* note 5, at 24.

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management of charitable estates have become more flexible in recent years.[205] Even before the adoption by some states of the Uniform Management of Institutional Funds Act, corporate principles were applied to financial investment policies and formal administration of charitable corporations.[206] The board of directors of the charitable corporation has had broader powers of delegation than trustees of the charitable trust. For instance, charitable corporations could delegate supervisory powers of investment to external sources.[207] Nor did the directors of a charitable corporation have to limit investments to a legal list like that governing investment decisions by trustees.[208]

4. The Need for Nonprofit Corporation Law to Reflect the Charitable Sector's Diversity and Requirements

The law of charitable corporations has developed so that it is a hybrid of trust and corporate principles. Courts and statutes have favored charities and their property. The words of Cary and Bright written fifteen years ago ring true today: "An examination of the cases makes it clear that the choice of principles depends upon the factual situation presented and upon the result which the courts deem it socially desirable to attain."[209]

In matters of internal administration and financial management, the movement to corporate principles is salutory. The growth in size and complexity of the modern charitable organization has led to an increasing adandonment of the use of the charitable trust, particularly as the nonprofit corporation increasingly resembles its corporate counterpart.

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[205] *See* Cary & Bright, *The "Income" of Endowment Funds*, 69 COLUM. L. REV. 396 (1969); Cary & Bright, *The Delegation of Investment Responsibility for Endowment Funds* 74 COLUM. L. REV. 207 (1974); UNIF. MANAGEMENT OF INSTITUTIONAL FUNDS ACT, 7A U.L.A. 411 (1972).

[206] W. CARY & C. BRIGHT, *supra* note 5, at 26-27.

[207] Attorney Gen. v. Olson, 346 Mass. 190, 191 N.E.2d 132 (1963). *See* Stern v. Lucy Webb Hayes Nat'l Training School, 381 F.Supp. 1003 (D.D.C. 1974)(limiting the powers of delegation); RESTATEMENT, *supra* note 9, at § 379 comment b.

[208] RESTATEMENT, *supra* note 9, at § 389 comment b.

[209] W. CARY & C. BRIGHT, *supra* note 5, at 18.

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Yet, the "trust-corporate standard" dichotomy has often centered on the label to be applied, rather than upon an analysis of the corporate problem involved. Too often, the selection of the label has determined the result. At other times, the label has been used as a convenient rationalization of a socially desirable result without analysis of the principles involved.[210]

This approach takes into account neither the differences or special needs of nonprofit corporations, nor the dissimilarities within the nonprofit sector. The new California Nonprofit Law[211] and proposed revision of the ABA's Model Nonprofit Corporation Act are welcome developments. Still, most nonprofit corporate statutes reflect the colorful words of Henn and Boyd: "Nonprofit organizations have been the neglected stepchildren of modern organization law. The law historically has given nonprofit organizations, like Cinderellas, the hand-me-downs of their half-siblings, the business organizations."[212] The remainder of this article shall examine some areas where nonprofit corporate law should be reformed to reflect the diversity and needs of nonprofit corporations.

III. AN AGENDA FOR THE REFORM OF NONPROFIT CORPORATION LAW

A. *The Classification of Nonprofit Corporations - The Need for a Close Corporation Analogue*

1. Classification by Relationship to Patrons

There is no uniform classification scheme or generally accepted typology of nonprofit organizations. Only recently have there been attempts to develop a theoretical rationale for the nonprofit sector.[213] In a seminal article on nonprofit corporations, Professor Howard Hansmann used an economic perspective to divide all cor-

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[210] *Id.* at 15.

[211] *See* CAL. CORP. CODE §§ 5000-10831 (West. Supp. 1980).

[212] *See* Henn & Boyd, *Statutory Trends in the Law of Nonprofit Organizations: California, Here We Come!*, 66 CORNELL L. REV. 1103, 1104 (1981).

[213] *See* Hansmann, *Reforming*, *supra* note 6; Hansmann, *Role*, *supra* note 6; Ellman, *Another Theory of Nonprofit Corporations*, 80 MICH. L. REV. 999 (1982); Ben-Ner, *A Theory of Nonprofit Organizations* (Yale Program on Nonprofit Organizations, Working Paper No. 51, April 1982).

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porations into three categories: business corporations, cooperative corporations, and nonprofit corporations, each of which was defined by a different relationship between the organization and its patrons (donors).[214] Hansmann developed four ideal typologies of non-profits: 1) donative — those organizations such as CARE or the American Red Cross, who receive the bulk of their income from relatively unrestrictive donations; 2) commercial — those organizations, such as nonprofit day care centers, nursing homes and hospitals, as well as consumers' unions, who obtain most of their money from prices charged for goods or services they produce; 3) mutual — organizations such as social clubs or Common Cause, controlled by their patrons; and 4) entrepreneurial organizations such as hospitals or those organized for relief of the poor, which are not controlled by their patrons.[215] Hansmann's approach may be a misstep in the right direction. Though one may differ with his perception of the nonprofit corporation, he offers perhaps the first coherent theory of the charitable sector.

2. Classification Under the Internal Revenue Code

The size and attractiveness of the nonprofit form of organization today rests upon its exemption, complete or partial, from income taxation under the Internal Revenue Code.[216] Under subchapter F of the Internal Revenue Code, full or partial exemption from income taxation is granted to several types of organizations under separate subsections.[217] The various categories of tax exempt organizations in subchapter F are not the result of any planned legisla-

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[214] Hansmann, *Reforming*, *supra* note 6, at 597.

[215] *Id.* at 502-04. Hansmann's model is criticized in Ellman, *supra* note 213. Professor Oleck divides nonprofit corporations into six categories: charitable organizations; social organizations; political organizations; trade associations; mixed business-nonprofit organizations; and governmental organizations. H. OLECK, *supra* note 3, at 51-52.

[216] The Internal Revenue Code exempts a wider range of groups than solely those traditional charities which serve a public benefit. Other exempt organization which are operated primarily for the benefit of their members—mutual benefit organizations—are granted tax exemption as well. Bittker and Rahdert, *supra* note 106, at 301-02.

[217] P. TREUSCH & N. SUGARMAN, *supra* note 107, at 16; Bittker and Rahdert, *supra* note 106, at 302. One cannot overestimate the importance of tax exemption and of the Internal Revenue Code for nonprofits. One typically refers to the kind of organization by the applicable section of the Code.

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tive scheme but were enacted through the years "by a variety of legislators for a variety of reasons."[218] Within the category of exempt organizations, the Code provides for differing tax treatment.[219] In this article, we have focused upon "public" charities classified under Section 501 (c)(3).[220]

3. State Statutory Approaches

Most nonprofit organizations are incorporated. States have used diverse schemes for categorizing nonprofit corporations. Some have followed the approach of the Model Nonprofit Corporation Act,[221] which parallels the provisions of the Model Business Corporation Act.[222] The Model Act offers a series of permissible purposes,[223] or,

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[218] McGovern, *supra* note 105, at 524.

[219] A few are exempt regardless of the nature of their income. Others may lose exempt status on receiving income from proscribed sources; some may lose their exemption if they engage in specific political activity. Most are taxed on unrelated business income. There are other distinctions among the many kinds of exempt organizations listed under Section 501(c) and other such sections. Bittker and Rahdert, *supra* note 106, at 302.

[220] The most desirable categories of exemption are "public" charities organized and operated exclusively for religious, charitable, scientific testing, public safety, literary, or educational purposes. I.R.C. § 501(c)(3) (West Supp. 1985). "Public" charities are those with broad public support as defined in I.R.C. § 509(a)(2) (West Supp. 1985). Section 501(c)(3) organizations which fail to qualify as "public" charities and are classified as private foundations are subject to additional restrictions and requirements. *See* I.R.C. §§ 507-09, 4940-48 (West Supp. 1985). In addition to exemption from the payment of federal income tax, organizations organized as exempt under § 501(c)(3) may also enjoy tax exemption under state and local income, property, sales, use or other kinds of taxation. Contributions to § 501(c)(3) organizations are deductible on the individual or corporate donor's tax returns. I.R.C. § 170(c) (1978 & West Supp. 1985). Services performed for a § 501(c)(3) organization may be exempt from social security and unemployment contributions, I.R.C. § 3121(b)(8)(B) (1978 & West Supp. 1985), and receive preferred postal rates, 39 C.F.R. § 3626.134.5 (1974).

[221] MODEL NONPROFIT CORP. ACT (1964) [hereinafter cited as "MODEL ACT"].

[222] *Id.* at vii. *See* Hansmann, *Reforming*, *supra* note 6, at 528-30. The Model Act is being revised and will probably result in a statute similar to that in California. Professor Michael Hone, the principal draftsperson of the California statute, is the chief reporter of the Model Act revision group.

[223] The MODEL ACT states:

Section 4. Purposes

Corporations may be organized under this Act for any lawful purpose or purposes,including, without being limited to, any one or more of the following purposes: charitable; benevolent; eleemosynary; educational; civic; patriotic; political; scientific; agricultural; horticultural; animal husbandry; and professional, commercial, industrial or trade association; but labor unions, cooperative organizations,

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in the alternative, permits incorporation "for any lawful purpose or purposes."[224] In some states, the nonprofit form is delineated by a series of permissible purposes and is limited by a non-distribution constraint.[225] In other jurisdictions, a chapter of the general corporation statute applies to all nonprofit corporations. It is followed by chapters for specific types of nonprofits — agricultural corporations, educational corporations, cemetery associations, etc.[226] One jurisdiction, Delaware, has no separate statute for charitable corporations, but several sections of its unified corporation law apply to charities, and the general corporation statute governs.[227] Still other statutory forms defy classification.[228]

New York applies a functional and economic approach to classify charitable corporations. Nonprofit corporations may be formed for business purposes, but the purpose must not be for pecuniary profit or financial benefit. No part of the assets or income can inure to the benefit of the corporation's members, directors, or officers.[229] The New York statute creates four categories of nonprofit corporations based upon the purpose of the organization and provides for differing degrees of regulation.[230]

> and organizations subject to any of the provisions of the insurance laws of this State may not be organized under this Act.

MODEL ACT §4.

[224] Alternate Section 4 states:

> "Corporations may be organized under this Act for any lawful purpose or purposes except . . . [list if any]"

MODEL ACT at 68.

[225] *See generally* Hansmann, *Reforming*, *supra* note 6, at 553-67.

[226] H. OLEUK, *supra* note 3, at 44-45. OHIO REV. CODE ANN. §§ 1702.01-.03 (Page 1985). Illinois follows the MODEL ACT for its general nonprofit act and then has provisions for specific types of nonprofits. ILL. ANN. STAT. ch. 32, § 163a (general not for profit corporations); § 164-188.3 (religious corporations); § 201 (education and charitable corporations); § 661-652f (hospital service corporations); (Smith-Hurd 1970).

[227] *See* DEL. CODE ANN. tit. 8, §§ 125, 127, 313 (1983).

[228] Henn and Boyd, *supra* note 212, at 1107.

[229] N.Y. NOT-FOR-PROFIT CORP. LAW § 102(a)(5), 204 (McKinney 1970 & Supp. 1984-85). However, directors and officers are entitled to reasonable compensation. *Id.* at § 202(a)(12). A corporation may pay interest on its debt, *id.* at § 202(c)(a), on subvention, *id.* at § 504(d), and bonds, *id.* at § 506(b). It may earn incidental profits but they may not be distributed in the form of dividends *Id.* at § 515(a).

[230] *Id.* at § 201. Purposes.

> (a) A corporation, as defined in subparagraph (5), paragraph (a) of § 102 (Definitions), may be formed under this chapter as provided in paragraph (b) unless it

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Type "A" corporations, the least regulated, are typically civic, patriotic, political, social, fraternal, athletic, agricultural, horticultural, professional, or trade associations. This type of organization has members, who are the primary beneficiaries of the organization. Members have the potential power to control the organization and to ensure that its nonprofit purposes are achieved.[231] Members in type "A" corporations are most analogous to shareholders of business corporations. Type "B" corporations are the most closely regulated and are somewhat, although not completely, similar to organizations classified under Section 501(c)(3) of the Internal Revenue Code.[232] Type "B" corporations are traditional charitable organizations - colleges, hospitals, or symphonies.

Type "C" corporations reflect an attempt to close a gap under

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may be formed under any other corporate law of this state in which event it may not be formed under this chapter unless such other corporate law expressly so provides.

(b) A corporation, of a type and for a purpose or purposes as follows, may be formed under this chapter, provided consents required under any other statute of this state have been obtained:

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

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

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

Type D — A not-for-profit corporation of this type may be formed under this chapter when such formation is authorized by any other corporate law of this state for any business or non-business, or pecuniary or non-pecuniary, purpose or purposes specified by such other law whether such purpose or purposes are also within types A, B, C, above or otherwise.

For an analysis of § 201, see 6 F. WHITE, WHITE ON NEW YORK CORPORATIONS, NOT-FOR-PROFIT CORPORATION LAW § 201 (B. Prunty 13th ed. 1982); Note, *supra* note 2, at 775-79. For a criticism of New York's classification scheme, see Hansmann, *Reforming*, *supra* note 6, at 530-35.

[231] N.Y. NOT-FOR-PROFIT CORP. LAW § 201(b) (McKinney 1970 and Supp. 1984-85); Note, *supra* note 2, at 776; Reviser's Comment § 201, 14th Interim Report, *supra* note 2, at 101.

[232] In Bodell v. Ghezzi, 50 A.D.2d 674, 375 N.Y.S.2d 426 (1975), the court held that exemption under § 501(c)(3) did not necessarily qualify it as a type "B" nonprofit.

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New York's previous statute, the Membership Corporation Law.[233] A type "C" corporation is a nonprofit corporation formed for a business purpose to achieve a lawful public or quasi-public objective.[234] An example of a type "C" corporation might be a food cooperative in a low income community.

Type "D" corporations are adapters or connectors which enable the Not-for-Profit Corporation Law to function as the foundation statute if the corporation's power of formation is covered by another statute.[235] For example, the New York Private Housing Finance Law encourages private and public participation in the construction, renewal, and financing of low income housing.[236] The

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[233] The Membership Corporations Law contained no definition of "nonprofit corporation." A membership corporation was defined as "a corporation not organized for pecuniary profit." N.Y. MEM. CORP. LAW § 2, 1895 N.Y. Laws 559 (repealed 1970). Section 10 of the Membership Corporations Law permitted incorporation for "any lawful purpose . . . except a purpose for which a corporation may be created under any general [statute other than the membership law]." *See* 6 F. WHITE, *supra* note 230, at § 201.01. Therefore, the Membership Corporations Law prevented the formation of a for profit or nonprofit corporation for a business purpose. The Stock Corporation Law § 5, permitted incorporation only for a business purpose. A business purpose meant a profit purpose. As a result, a nonprofit could not be formed under the stock corporation statute even if its purposes were exclusively "business" purposes. Note, *supra* note 2, at 765. Thus, under prior New York corporate statutes:

> [A] not for profit corporation could not be formed under the Stock Corporation Law. A not for profit corporation could be formed under the Membership Corporations Law unless it was to be formed for a business purpose. If to be formed for a business purpose, it could not be formed under that statute because it would be for a purpose for which a corporation could be formed under any other general law which phrase included the Stock Corporation Law. The rather strange result of this cross-breeding of the concepts of "for profit" and "not for pecuniary profit" and "for a business purpose" and "not for a business purpose" was that one could form under the Stock Corporation Law a "for profit corporation" for a "business purpose" and under the Membership Corporations Law a "not for pecuniary profit corporation" for a non-business purpose but one could not form a "not for pecuniary profit corporation" (non-profit corporation) for a "business purpose" under either law. This condition began to cause problems when non-profit corporations in the business area became common.

Lesher, *The Non-Profit Corporation — A Neglected Stepchild Comes of Age*, 22 BUS. LAW. 951, 953-54 (1967).

[234] N.Y. NOT-FOR-PROFIT CORP. LAW § 201(b) (McKinney 1970 & Supp. 1984-85).

[235] 6 F. WHITE, *supra* note 230, § 201.05. The incorporation and organization of a housing development fund company to develop a housing project for persons of low income would be an example of a type "D" corporation. *See* N.Y. PRIV. HOUS. FIN. LAW § 573 (McKinney 1976).

[236] N.Y. PRIV. HOUS. FIN. LAW §§ 11, 11-a (McKinney 1976 & Supp. 1984-85).

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statute permits the organization and incorporation of housing development fund companies to develop housing projects for persons with low incomes.[237] These corporations are eligible to receive financing from municipal and state sources, but they are bound by the nondistribution constraint[238] and are organized for the benefit of the families who are to reside in the housing they create. The formation and some powers - to receive state funds - of a housing development funding company are governed by the Private Housing Finance Law, but the resulting corporation is bound by the Non Profit Corporation Law as a type "D" corporation.

California's nonprofit corporation law, adopted in 1978 and effective in 1980, divides nonprofit organizations into three categories: nonprofit public benefit corporations, nonprofit religious corporations and nonprofit mutual benefit corporations.[239] California's classification system reflects the vast diversity in purposes, nature, and governance of organizations that comprise the nonprofit sector. Nonprofits within each category are separately regulated by the statute and differently supervised by the attorney general.

Public benefit corporations, a category most analogous to 501(c)(3) organizations, type "B" corporations under the New York statute, and more traditional charities, are those that are formed for public or charitable purpose, not for the private gain of any individual, and have a distribution constraint while operating and upon dissolution.[240] The California statute, which is primarily concerned with internal governance, places the definitional burden as to what is a "public" or "charitable" purpose upon those who form public benefit corporations.

The assumption of the drafters of the California statute was that there was no need to define public benefit corporations, since, com-

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[237] *Id.* at § 573.

[238] *Id.* at § 573(3)(b).

[239] *See generally* Ellman, *On Developing a Law of Nonprofit Corporations*, 1979 ARIZ. ST. L.J. 153 (one of the drafters of the Cal. Nonprofit Corporation Law traces the issues and purposes behind the law); Hone, *California's New Nonprofit Corporation Law — An Introduction and Conceptual Background*, 13 U.S.F.L. REV. 733, 738-41 (1979) (defining each category); *Symposium: California Nonprofit Corporation Law*, 13 U.S.F.L. REV. 729 (1979).

[240] CAL. CORP. CODE §§ 5049, 5111, 5130, 5410 (West Supp. 1985).

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pared to religious corporations and mutual benefit corporations, the attorney general has greater jurisdictional authority over public benefit corporations,[241] stricter conflict of interest rules apply,[242] members have no proprietary interest in the organization,[243] no tax benefits are conferred in the non-profit statute itself,[244] and their purposes, powers and activities may be subject to other statutes. The assumption was thus that people would not choose the public benefit category if a more desirable alternative were available.[245] This rationalization is somewhat precious, for the primary reason that people select the public benefit form is for the tax exemption advantages it brings.

Religious corporations are those organized primarily or exclusively for religious purposes and not for private inurement.[246] Religious corporations are substantially less regulated than public benefit corporations.[247] There are two justifications for less stringent supervision: 1) fear of First Amendment entanglements; and 2) self-regulation may be more appropriate given the religious corporation's unique functions and moral posture.[248]

Mutual benefit corporations are a residual category under the California Code including all corporations which are not public benefit corporations or religious corporations.[249] They include

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[241] *See* Abbott and Kornblum, *supra* note 99, at 770-85.

[242] CAL. CORP. CODE § 5233 (West Supp. 1985).

[243] CAL. CORP. CODE §§ 5049, 5410 (West Supp. 1985).

[244] With the exception of religious corporations, corporations exempt from state taxation must be organized as public benefit corporations. CAL. CORP. CODE § 9912(a) (West Supp. 1985).

[245] Report of the Assembly Select Committee on Revision of the Nonprofit Corporation Code (Aug. 27, 1979) at 6, *quoted in* Hone, *supra* note 239, at 735.

[246] CAL. CORP. CODE §§ 5061, 9111, 9130 (West Supp. 1985). Note that the definition of religious corporation is broader than that contained in the Internal Revenue Code which limits religious corporations to "churches, their integrated auxiliaries, and conventions or associations of churches." I.R.C. § 6033(a)(2)(A)(i)(1984). This point is discussed in Hone, *supra* note 239, at 739-40. The courts will be burdened with defining what is a religion.

[247] *Compare* CAL. CORP. CODE §§ 9240-51 (religious corporations) *with* CAL CORP. CODE §§ 5230-41 (public benefit corporations).

[248] *See* Abbott and Kornblum, *supra* note 99, at 790. There is another reason: there was no consensus among the drafting committee and representatives of religious bodies as to how much regulation of secular affairs should be imposed on religious corporations. *Id.*

[249] CAL. CORP. CODE §§ 5059, 9912(a)(5) (West Supp. 1985).

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trade associations, fraternal organizations, and activities which provide some benefit to their members. They cannot make distributions to members except upon dissolution.[250] With the one exception of charitable trusts, mutual benefit corporations are less regulated by the attorney general and have more liberal provisions relating to self-dealing by directors.[251] The theory behind less regulation is that mutual benefit corporations resemble business corporations in terms of internal monitoring and control. Their members, similar in many ways to shareholders, will ensure that directors carry out their fiduciary duties and that the organization properly pursues its purposes.

The California approach is salutory, although there are some definitional ambiguities as to the particular categories in which nonprofits will fit.[252] The revised Model Non Profit Corporation Law will reflect the California approach. However, all of the statutory classification schemata focus upon a functional analysis of the purposes and activities of the organization and ignore structural differences in methods of actual operation and rationales for existence.

Many nonprofit organizations incorporate and seek tax exempt status solely to be eligible for foundation grants. Such incorporators have little knowledge of or interest in corporate practices. The advantage of limited liability is less important than in the business corporate sector. State and federal filing requirements for exempt organizations have taken into account differences in economic size, but there has been no attempt to accommodate standard corporate procedures and governance rules to the informalities that permeate smaller nonprofit corporations.

Beyond the debate as to the most appropriate classification scheme for nonprofits, an unaddressed issue is whether all nonprofit corporations should have similar requirements for corporate governance. Many nonprofit corporations, particularly smaller or-

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[250] *Id.* at § 7411.

[251] *Compare* CAL. CORP. CODE §§ 7230-38 (mutual benefit) *with* CAL. CORP. CODE §§ 5230-38 (public benefit). See Basile, *Directors' Liability Under the New California Nonprofit Corporation Law*, 13 U.S.F.L. REV. 891, 906-09 (1979).

[252] *See* Hansmann, *Reforming*, *supra* note 6, at 535-37.

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ganizations, ignore directors' statutory responsibilities and corporate formalities. Does it make sense to have the same corporate requirements for all sizes of nonprofit corporations? Should differing corporations, united only by the proscription against private inurement and their desire to obtain an exemption from income tax, be treated by state corporation statutes in the same way?

In the business corporate setting, the law has recognized that smaller corporations, ones with fewer shareholders, have special needs and methods of operating. These organizations, called close corporations, resemble partnerships in the way business is conducted. They tend to have an integration of ownership and management and few shareholders.[253] Close corporations are characterized by an informality of management and often by a failure to follow normal corporate procedures.[254]

4. The Close Nonprofit Corporation

There is a need for a nonprofit equivalent to the close corporation.[255] While incorporation is not a requirement to gain tax exemption,[256] most nonprofits incorporate prior to seeking section 501(c)(3) status. Nonprofit organizations often have little concept of the norms of corporate behavior or principles of corporate governance. Many organizations have only the statutory minimum

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[253] There is no single generally accepted definition of the close corporation. The term is used to emphasize an integration of ownership and management in which the shareholders occupy management positions. There is no established market for the corporation's stock. The close corporation is more functionally related to the partnership than the corporation. *See* W. CARY & M. EISENBERG, CORPORATIONS 377 (5th ed. 1980); 1 F. O'NEAL, CLOSE CORPORATIONS §§ 1.02, 1.07 (1971).

[254] *See* Donahue v. Rodd Electrotype Co., 367 Mass. 578, 328 N.E.2d 505 (1975).

[255] For a case applying close corporation principles to a charitable corporation, see American Center for Educ., Inc. v. Cavner, 80 Cal. App. 3d 476, 145 Cal. Rptr. 736 (1978).

[256] An unincorporated association is recognized as eligible for tax exempt status under § 501(c)(3). An unincorporated nonprofit association that has a constitution, bylaws, and elected officers is treated as a corporation under the statute. Blake v. Comm'r, 29 T.C.M. 513 (1970); Morey v. Riddel, 205 F. Supp. 918 (S.D. Cal. 1962); John T. Blake, T.C. Memo 1970-117, 29 T.C. M. 513 (1970). *Cf.* I.R.C. § 7701(a)(3) (1984) (defining "Corporation" for Code purposes). An unincorporated association that has neither an organizing instrument, governing rules, nor a defined method of operation will not qualify as an exempt organization under I.R.C. § 501(c)(3). Trippe v. Comm'r, 9 T.C.M. 622 (1950).

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number of directors, all of whom are employees with a strong desire for employee-director control. These inside directors adopt the corporate form of organization only for its tax exempt status and for revenue purposes. In their relationships to each other, the participants are more analogous to partners. The formalities of corporate governance are ignored. The corporate form is but a vehicle to solicit charitable contributions. The finances of such organizations are particularly parlous. Self-dealing and private inurement are common, yet the costs and difficulties of enforcing fiduciary standards are enormous, and, for all practical purposes, are impossible. Small close corporations necessarily are unregulated. Creating a category of nonprofit close corporations would reflect the realities of much of the charitable sector.

The close nonprofit corporation would have the definitional characteristics of an integration of directors and employees and an upper level of permitted assets. A certain percentage of budget allocations for salaries of staff and directors might be another indicator of close corporation status.[257] Most importantly, the close nonprofit corporation would be eligible for classification under section 501(c)(3) and section 170(c) of the Internal Revenue Code. This would enable these organizations to receive funds from patrons and the government and would give the organization the cherished "determination letter".[258]

The private inurement proscription and restrictions on the distribution of assets upon dissolution would remain.[259] For tax and

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[257] State and federal filing requirements for nonprofits also vary depending upon the receipts of the organization. For example, I.R.C. § 6033 requires an annual return on Form 990, Return of Organization Exempt From Income Tax, for organizations exempt from tax under I.R.C. § 501(a) except for religious organizations and organizations that have annual gross receipts of not more than $25,000. An asset limitation may be somewhat analogous to close corporation legislation which defines a close corporation according to a maximum number of shareholders. *See, e.g.*, DEL. CODE. ANN. tit. 8, § 342(a)(1) (1974) (30 shareholders).

[258] The determination letter is a ruling issued by the National Office of the Internal Revenue Service for recognition of exemption. *See* Rev. Proc. 80-25, 1980-1 C.B. 667. Prospective patrons of a nonprofit organization, particularly if the patron is a private foundation, will request as a part of the application process a copy of the determination letter. It is the most important indicator of nonprofit status.

[259] Treas. Reg. § 1.501(c)(3)-1(b)(4),-1(c)(2) (1976).

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corporate law purposes, the close nonprofit corporation would be treated as an incorporated partnership. The receipt of funds from patrons or governmental donors would be treated as partnership income, yet such income would not be taxed so long as the income and monies dispersed for salaries and expenses were reasonable. Enforcement would rest upon state and federal tax authorities.

This approach would remove from the nonprofit sector and from attorney general supervision thousands of small nonprofit corporations that ignore corporate formalities and may be too insignificant to monitor, given scarce resources. The close nonprofit corporation would recognize that in many small nonprofit organizations self-dealing that is inappropriate in the context of large, for-profit business corporations is crucial for the small, closely held organization's survival.[260]

The close nonprofit corporation would reflect the informality that exists in so much of the nonprofit world. Liability for the misuse of public monies and the advantages of tax exempt status would shift directly to the individuals in the organization and away from an artifically separated board of directors.[261]

B. *Improving State Regulation of Charitable Organizations*

1. Supervision of Charitable Corporations—Standing Limitations

All commentators on the subject agree that there is inadequate supervision of nonprofit corporations.[262] In the United States, su-

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[260] "Conflicts of interest," in the sense of transactions between directors or officers and their nonprofit corporation, abound in the nonprofit sector. Patterns of interested transactions parallel business corporate practices. In many situations interested transactions are a healthy necessity. They may provide access to resources unavailable from the commercial marketplace. The financial status of the nonprofit corporation may be so poor that market sources of credit or supplies are unattainable. The loan of money, of goods, or of services, may be available only from an interested director who is concerned with the organization's welfare. In other situations, the interested transaction is unethical or illegal and in violation of the director's duty of loyalty to the corporation and to the public.

[261] *See, e.g.*, DEL. CODE ANN. tit. 8, § 350 (1974); MD. CORPS. AND ASS'NS CODE ANN. § 4-303 (1975); N.Y. BUS. CORP. LAW § 620(f) (McKinney 1963 & Supp. 1984-85)(all relieving directors of liability when close corporation status is elected and imposing upon the shareholders the liability for managerial acts or omission normally imposed on directors).

[262] Abrams, *supra* note 3, at 484; M. FREMONT-SMITH, *supra* note 11, at 226-28;

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pervision of charities has long been exercised by the state attorney general or, in a few jurisdictions, by a district attorney.[263] Usually suit is brought by the attorney general on his own initiative, but in a few states suit may be brought by the attorney general on the relation of, or the information of, a third person.[264] That person is called a "relator."[265]

Attorneys general have a multiplicity of responsibilities and extremely limited resources. In 1977, only eight states assigned attorneys full time to the enforcement of charitable trusts and regulation of charitable corporations. Eleven states had no attorneys assigned, while most had one or two attorneys assigned part-time.[266] Given the thousands of nonprofit corporations, the lack of resources devoted to monitoring means charitable organizations are for all practical purposes self-regulated. While directors of charitable corporations generally have standing to sue, they rarely bring derivative suits. Members of charitable corporations may have standing to sue.[267] However, many nonprofit corporations are

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Hansmann, *Reforming*, *supra* note 6, at 600-06; Karst, *supra* note 5, at 434, 449-53, 476. Even before the Statute of Charitable Uses, the attorney general had the responsibility to enforce the purposes of charitable organizations. 4 A. SCOTT, *supra* note 9, at § 391. According to Blackstone, the source of the attorney general's power was the monarch as *parens patriae* who had general superintendence of all charities. This oversight was exercised through the throne's chief aide, the Chancellor. Whenever it was necessary to enforce a charity, the attorney general "at the relation of some informant (who was usually called the relator), filed ex officio an information in the Court of Chancery to have the charity properly established." 3 W. BLACKSTONE, *supra* note 122, at *427.

[263] G.G. BOGERT & G.T. BOGERT, *supra* note 9, at § 411.

[264] *Id. See* Brown v. Memorial Nat'l Home Found., 162 Cal. App. 2d 513, 329 P.2d 118 (Cal. Ct. App. 1958); Sarkeys v. Independent School. Dist., 592 P.2d 534 (Okla. 1979).

[265] The relator did not exist at common law but was a creature of the Statute of Anne, 9 Anne, ch. 20 (1710). That act provided that it should be lawful "for the proper officer, by leave of the court, to exhibit an information in the nature of a quo warranto at the relation of any person desiring to prosecute the same." The statute was adopted in toto by some states. Newman v. United States, 238 U.S. 537, 544 (1914). Jurisdictions differ on the procedures to be followed to institute an action on behalf of a relator and regarding whether the Attorney General can control an action once brought.

[266] NATIONAL ASSOCIATION OF ATTORNEYS GENERAL, STATE REGULATION OF CHARITABLE TRUSTS AND SOLICITATIONS 8 (1977).

[267] *See* CAL. CORP. CODE §§ 5420, 7420, 7710 (West Supp. 1980); N.Y. NOT-FOR-PROFIT CORP. LAW §§ 623(a), 720(b)(3) (McKinney 1970 & Supp. 1984-85); Hansmann, *Reforming*, *supra* note 6, at 606 (while most statutes are silent on standing questions, they generally adopt charitable trust rules). Some state courts have given standing to members; others

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non-membership corporations with self-perpetuating boards. For this latter sort of organization only the attorney general or a director has standing to sue.[268]

Under trust and corporate principles, the public has no standing to sue absent a specific statutory grant. The rationale is that property is devoted to the accomplishment of purposes which are beneficial to the community at large, rather than to a specific person.[269] Even a specific beneficiary of a charity is but an intermediary through whom the public advantage is achieved. Therefore, enforcement of charitable purposes is undertaken by the attorney general on behalf of the public.[270] A more practical reason for denying the public standing is that the persons benefited by charities are usually members of a large and shifting class of the public. If any member of that class had standing, the charity would be subjected to much unnecessary litigation.[271]

Traditional standing limitations occasionally have been relaxed in matters of public importance that relate to charities.[272] The gen-

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have not. *Compare* Leeds v. Hanson, 7 N.J. Super. 558, 72 A.2d 371 (1950) *with* Voeller v. St. Louis Merchantile Library Ass'n, 359 S.W.2d 689 (Mo. 1962).

[268] *See* N.Y. NOT-FOR-PROFIT CORP. LAW §§ 720(c), 112 (McKinney 1970 & Supp. 1984-85).

[269] 4 A. SCOTT, *supra* note 9, at § 364; Tushnet, *The New Law of Standing*, 62 CORNELL L. REV. 663, 675 (1977).

[270] G.G. BOGERT & G.T. BOGERT, *supra* note 9, at § 54 (quoting *In re* Pruner's Estate, 390 Pa. 529, 136 A.2d 107 (1957)).

[271] *Id.* at § 411.

[272] *See* Fitzgerald v. Baxter State Park, 385 A.2d 189 (Me. 1978) (Land was conveyed to the state as a trust for a state park. The park authority and attorney general as members of former trustees were to carry out the purposes of the trust. Plaintiffs as Maine citizens and users of park were given standing to sue); Gordon v. City of Baltimore, 258 Md. 682, 267 A.2d 98 (1970) (taxpayer had standing to sue to prevent transfer by charitable corporation of its library to another corporation so that city of Baltimore would support library); Jones v. Grant, 344 So. 2d 1210 (Ala. 1977) (faculty, staff, and students had standing to bring class action against president and board of directors for misuse of funds); Parson v. Walker, 28 Ill. App. 3d 517, 328 N.E.2d 920 (1975) (citizens have standing to oppose deviation of gift of land made to state university for park); Patterson v. Patterson General Hospital, 99 N.J. Super. 514, 235 A.2d 487 (1967) (residents of city and taxpayers had standing to sue to prevent relocation of hospital). *But see* Simon v. Eastern Ky. Welfare Rights Org., 426 U.S. 26 (1976) (indigents had no standing to maintain an action against the Secretary of the Treasury and Internal Revenue Service in order to set aside a ruling that a nonprofit hospital was exempt from taxation even though it did not provide free or below-cost services to the poor); Stern v. Lucy Webb Hayes Nat'l Training School for Deaconesses and Mission-

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eral rule, however, remains that, absent a statutory right, there is no private enforcement of a charitable trust, a nonprofit trust, or a nonprofit corporation. Nor should any member of the public have standing to sue. The effects of a suit on a charitable organization are often even more severe than those typically resulting for a business corporation or an individual. Publicity generated by the mere filing of the suit may dry up sources of funds. The reputation of the organization may never recover. Nevertheless, the enforcement problem remains, and abuses do occur.

Twenty-five years ago, Professor Kenneth Karst suggested that a state board of private charities be established on the English model.[273] Today, we live in an age of deregulation. There are few who believe that another agency with additional resources is a sufficient cure for any social ill. The effectiveness of regulatory efforts will have to come from other sources.

2. Increasing the Use of Relators

Expanding the use of relators could complement attorney general enforcement yet avoid the dangers of broadened standing by members of the public. The resources needed for the effective regulation of nonprofits are great. The use of relators offers a structure of costs and benefits preferable to expanded government regulation.

A relator is a party who may or may not have a direct interest in a transaction, but is permitted to institute a proceeding in the name of the people when that right to sue resides solely in the attorney general.[274] This use of relators is derived from the quo

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aries, 367 F. Supp. 536, 540 (D.D.C. 1973) (patients of hospital certified as a class under Fed. R. Civ. P. 23(b)(2) for purposes of seeking injunctive relief in advance of damages to be paid into hospital funds. Certification denied under Fed. R. Civ. P. 23(b)(3), which might entitle patients to receive monetary recovery); Christiansen v. National Savings and Trust Co., 683 F.2d 520 (D.C. Cir. 1982) (subscribers of health plan did not have standing to enforce director's fiduciary duties).

[273] Karst, *supra* note 5, at 476-83.

[274] Brown v. Memorial Nat'l Home Found., 162 Cal. App. 2d 513, 329 P.2d 118, *cert. denied*, 358 U.S. 943 (1958).

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warranto proceeding.[275] Usually a relator must have a direct interest in the matter of the proceeding. Jurisdictions differ regarding whether a relator must seek permission of a court in order to bring suit and the formal status the relator occupies as a party to the litigation.[276] State statutory approaches differ greatly. Some jurisdictions have incorporated the quo warranto action under other labels while enforcing statutory requirements relating to corporations. Typically, these actions are brought by the attorney general for involuntary dissolution of a corporation or failure to adhere to the terms of corporate franchise.[277]

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[275] Quo warranto is an extraordinary civil proceeding whereby the state demands that an individual or corporation show by what right some franchise or privilege has been granted by the state. Quo warranto can be resorted to only when the act or wrong complained of does injury to the public. *See generally* 5 W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS §§ 2324-29 (rev. per. ed. 1976). In most American jurisdictions, there are constitutional or statutory provisions for the exercise of this remedy. Quo warranto can be an appropriate proceeding to challenge the validity and legality of a corporation's existence, to remedy usurpation, misuse, abuse, or nonuse of franchises or privileges, to reach criminal or illegal acts, to oust corporate officers, or to try title to a corporate office. *Id.* at § 2330. The theory of this use of quo warranto is that corporations have been granted a franchise from the legislature and that the usurpation of the corporate office or improper activities by the officers or directors is a violation of the privilege granted by the state. Quo warranto has been used against charitable corporations. *See* cases cited *id.* at § 2332 nn.17-20.

[276] There are three variations: 1) the relator may appear as an ordinary party plaintiff and bring suit in his own name; 2) the state may be the nominal party plaintiff with the relator suing in the name of the state, formally appearing in the title as relator; and 3) the public attorney may appear as relator. In the latter situation, the role of the private party may be as active as a nominal party plaintiff would be or as passive as the complaining witness in a criminal matter. Annot., 51 A.L.R. 2d 1306, 1309 (1957).

[277] Several jurisdictions have enacted legislation, derived from quo warranto procedures, that affects nonprofit corporations. Typically these are actions for involuntary dissolution of the corporation, brought by the attorney general or other state official as a result of violation of the nonprofit corporation statute. *See* ARK. STAT. ANN. § 64-1917 (1980) (procuring incorporation through fraud); GA. CODE ANN. §14-3-217 (Michie 1982) (failure to file an annual report); IDAHO CODE § 30-1-94 (1980) (procuring incorporation through fraud); ILL. ANN. STAT. ch. 32, § 163a 49, 50 (Smith-Hurd 1973 & Supp. 1984-85) (answering interrogatories falsely and fraudulent solicitation of money); IND. CODE ANN. § 23-7-1.1-66 (Burns 1981) (deadlock); IOWA CODE ANN. § 504A.53 (West Supp. 1981) (exceeding or abusing authority); 1981 Ky. Rev. Stat. & R. Serv. § 273.320 (Baldwin) (acts detrimental to the interests and welfare of people); ME. REV. STAT. ANN. tit. 13B, § 1105 (1969) (assets misapplied or wasted); MD. CORPS. & ASS'NS CODE ANN. § 1-405 (1975) (illegal conduct connected with organized crime); MASS. GEN. LAWS ANN. ch. 180, § 11B (West Supp. 1981) (inactive and in public interest); MICH. COMP. LAWS ANN. § 450.1821 (West 1973) (conducting business in an unlawful manner).

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Some jurisdictions complement the state regulation of charities by allowing relators to file with the attorney general informations alleging abuses by charitable organizations. In this situation, the suit may be brought by the attorney general or on relation of a third person, who need not have a direct interest in the matter. The attorney general, rather than the relator, has control over the conduct of the lawsuit, but the relator is liable for costs, which otherwise would have to be paid by the state.[278] Relator status has been granted in the nonprofit context to bar associations,[279] taxpayers,[280] cemetery plot holders,[281] directors of other state departments,[282] and members of a social club.[283]

One jurisdiction where an expanded use of relator status has complemented the attorney general's regulation of charities is California.[284] According to regulations promulgated by the California attorney general, the relator submits to the attorney general an application for leave to sue, a verified complaint, and a statement of facts as to why the proposed proceeding should be brought in the name of the state and under the state's jurisdiction.[285] If the attorney general grants the application, the relator must post a five hundred dollar bond and agree to pay for any costs and expenses recovered against the plaintiff.[286] Importantly, the attorney general controls the action at all times, and can at any stage of the proceeding withdraw, discontinue, or dismiss the action or assume the proceeding's management.[287]

An expanded use of relator status based on the California ap-

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[278] Sarkeys v. Independent School Dist. No. 40, 592 P.2d 529, 534 (Okla. 1979); G.G. BOGERT & G.T. BOGERT, *supra* note 9, at § 411.

[279] People *ex rel.* L.A. Bar Assoc. v. California Protective Corp., 76 Cal. App. 2d 354, 244 P. 1089 (1926).

[280] People v. Thompson, 101 Ill. App. 2d 104, 242 N.E.2d 49 (1968).

[281] State of Kansas *ex. rel.* Londerholm v. Anderson, 195 Kan. 649, 408 P.2d 864 (1965).

[282] People *ex rel.* Brown v. Illinois State Trooper Lodge No. 41, 7 Ill. App. 3d 98, 286 N.E.2d 524 (1972).

[283] State of Florida *ex rel.* Van Aartsen v. Barton, 93 So. 2d 388 (Fla. 1957).

[284] The statutory authority is CAL. CIV. PROC. CODE § 803 (West 1980).

[285] CAL. ADMIN. CODE tit. 11 §§ 1-2 (1984).

[286] *Id.* at § 6.

[287] *Id.* at § 8.

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proach would expand and strengthen the attorney general's enforcement efforts, yet it would protect the charitable organization from frivolous suits brought by a member of the public. Who would seek to be relators? Public spirited citizens or public interest law firms, one would hope. One hindrance to significant expansion of enforcement through this approach is the question of attorney's fees for the successful relator. The defendant charitable organization or its directors are an obvious source, but they may not have the financial resources. However, the financial situation of many nonprofits would make this kind of litigation unattractive to the aggressive, fee-seeking plaintiff's bar so active in the private sector.[288] A fund for the compensation of attorneys similar to those that exist in the criminal area might be created. The fund would be under the supervision of the attorney general. An expanded use of relators to enforce the responsibilities of charitable organizations to the public would provide an appropriate balance between more effective regulation of charitable activities and the protection of nonprofits from nuisance litigation.

C. *Restructuring the Nonprofit Board*

1. The Need for an Effective Board of Directors

Directors who do not direct are not unique to the nonprofit world.[289] Where there is an absence of even potential shareholder monitoring and an inadequacy of governmental oversight this problem assumes a special urgency, however. The figurehead director assumes an inactive role on the board, rarely attends meetings, and does not become involved in oversight responsibilities. Board members of nonprofits are sought for many reasons, including deep pockets, prestige within the community, contacts with prominant individuals or sources of funding, and general interest in the organization.[290] Some nonprofit boards can be composed solely of token

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[288] *See* Coffee, *Rescuing the Private Attorney General: Why the Model of the Lawyer as Bounty Hunter Is Not Working*, 42 MD. L. REV. 215 (1983).

[289] *See* M. EISENBERG, THE STRUCTURE OF THE CORPORATION 139, 139-44 (1976); M. MACE, DIRECTORS: MYTH AND REALITY (1971); Douglas, *Directors Who Do Not Direct*, 47 HARV. L. REV. 1305 (1934).

[290] *Cf.* Glueck, *Power and Esthetics: The Trustee*, ART IN AMERICA, July-Aug., 1971, at

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members controlled by in-house director employees. In contrast to directors of business corporations, nonprofit board members may have few other institutional, board, corporate, or legal experiences.[291] Often they have little sense of what is expected from them as a director. Nonprofit practices have been traditionally much looser than those of the business corporation. In the business corporation, there may be a greater sense of shared directorial expectations. Information may be demanded from inside director-managers. Independent or outside directors may have a greater shared sense of what is proper behavior. Particularly in the public corporation, there may be reporting requirements which inculcate standard operating and reporting procedures.

Other checks and balances ensure that business corporate boards fulfill their responsibilities. Shareholders have theoretical powers through election of directors,[292] calling of special meetings, and removal of directors with or without cause.[293] The threat of derivative suits combined with an active plaintiff's bar encourages directorial responsibility. In the public corporation, the scrutiny of the financial press and the securities industry serves as a check. The filing requirements and the Securities and Exchange Commission's oversight responsibilities also insure oversight of the board.[294]

78, *reprinted in* 2 J. MERRYMAN & A. ELSEN, LAW, ETHICS AND THE VISUAL ARTS 7-60 to 7-63 (1979).

[291] That business corporate directors and senior management share common business and professional backgrounds and live in the same social and economic milieu has been well documented. *See* Brudney, *The Independent Director - Heavenly City or Potemkin Village*, 95 HARV. L. REV. 597, 612-13, especially sources & nn.43-45 (1982); McAlmon, *The Corporate Boardroom: A Closed Circle*, BUS. & SOC'Y. REV., Winter 1974-1975, at 64; Solomon, *Restructuring the Corporate Board of Directors; Fond Hope—Faint Promise?* 76 MICH. L. REV. 581, 584-86 (1978).

[292] "Virtually all statutes provide that the directors of a business corporation shall be elected at annual or other periodic intervals by the shareholders." W. CARY & M. EISENBERG, *supra* note 253, at 141.

[293] *See* N.Y. BUS. CORP. LAW §§ 602-03, 706 (McKinney 1963 & Supp. 1984-85); DEL. CODE ANN. tit. 8, §§ 141(k), 211(c) (1983). Even potential shareholder power has been criticized. *See* Manning, Book Review, 67 YALE L.J. 1478 (1958) (reviewing J. A. LIVINGSTONE, THE AMERICAN STOCKHOLDER); Chayes, *The Modern Corporation and the Rule of Law* in THE CORPORATION IN MODERN SOCIETY 25 (E. Mason ed. 1959).

[294] Corporations that are registered with the Securities and Exchange Commission pursuant to § 12 of the Securities Exchange Act of 1934, 15 U.S.C. § 78 L (g)(1) (1983), must file monthly, quarterly, and annual reports, all of which are public documents. Stock ex-

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2. The Need for Higher Standards of Conduct

The conflicting origins of nonprofit corporation law have affected the way nonprofit organizations are administered and the standards and fiduciary duties imposed upon those in charge.[295] The trust and corporate law origins of nonprofit law come into conflict in defining the legal responsibilities of the boards of directors of nonprofit corporations.[296] In recent years, nonprofit standards and patterns of governance have moved toward business corporate standards.[297] Certainly, in matters of internal governance or corporate housekeeping the move toward corporate rules is salutory. However, to apply a business corporate standard to all board members' actions and responsibilities in all kinds of nonprofits may be too lenient.[298] This approach ignores the special public purposes and public trust of the nonprofit corporation, the nature of the nonprofit board, and the inadequacy of internal control and enforcement.

There are few cases dealing with a director's standards of proper

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changes have disclosure requirements. The Proxy Solicitation and other reporting requirements of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78m, 78n (West 1983), ensure a flow of available information.

[295] *See infra* notes 319-21 and accompanying text.

[296] Thus, the choice of organizational form — trust or nonprofit corporation — may determine which body of law will apply to the particular charity and the standards of conduct of the director. Note, *The Fiduciary Duties of Loyalty and Care Associated with Directors and Trustees of Charitable organizations*, 64 VA. L. REV. 449, 450 (1978). In the words of Professor Kenneth Karst:

> A distinction which gives such great weight to organizational form rather than operational need carries a substantial burden of justification, and as yet that burden has not been met . . . There is no good reason for making different rules for the managers of two large foundations simply because one is a corporation and the other a trust. The law should recognize that the charitable trust and the charitable corporation have more in common with each other than each has with its private counterpart.

Karst, *supra* note 5, at 436.

[297] Stern v. Lucy Webb Hayes Nat'l Training School for Deaconesses and Missionaries, 381 F. Supp. 1003, 1013 (D.D.C. 1974) ("the modern trend is to apply corporate rather than trust principles in determining the liability of the directors of charitable corporations"); Hansmann, *Reforming*, *supra* note 6, at 567-74.

[298] *Compare* N.Y. NOT-FOR-PROFIT CORP. LAW § 715 (McKinney 1970 & Supp. 1984-85) *and* N.Y. BUS. CORP. LAW § 717 (McKinney 1963 & Supp. 1984-85) *with* CAL. CORP. CODE §§ 309, 5231, 7231 (West 1977 & Supp. 1985).

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conduct that apply to charitable corporations. One could suggest that the issue of which standard to apply—corporate or trust—is a theoretical question with but little practical import. Yet, higher, well-articulated standards of behavior will inform board members and will better produce expected and appropriate standards of behavior. The basic problem in the nonprofit area is educational. Development of appropriate standards of conduct must strike a fair balance between society's interest in the effectiveness with which charities accomplish their purposes and the need to avoid undue restrictions or burdensome procedures that make it difficult to recruit directors.

The primary need for effective boards of directors results from the fact is that charities are largely self-regulated.[299] The nature of the nonprofit form, particularly in non-membership corporations, leads to self-perpetuating boards with only theoretical accountability to the public through the attorney general.[300] Some nonprofit corporations with members, such as mutual benefit corporations,[301] resemble stock corporations. Their members, like shareholders, have standing to monitor and enforce the board's fiduciary responsibilities. Religious corporations create special problems. Because of First Amendment requirements, attorneys general in most states are loath to monitor them closely.[302]

Unlike business corporations, there is relatively little dispute regarding the identity of those for whom nonprofit officers and directors are trustees.[303] Society has an interest in the proper administration of charities, and this interest is the same regardless of organizational form. Tax exemption provides charitable organiza-

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[299] Abrams, *supra* note 3, at 485.

[300] *See supra* note 267. Under the New York statute members have standing to sue. N.Y. NOT-FOR-PROFIT CORP. LAW § 720 (McKinney 1970 & Supp. 1984-85). However, in nonmembership corporations only directors and the attorney general have standing to sue.

[301] *See supra* text accompanying notes 249-51; CAL. CORP. CODE §§ 7310-54 (West Supp. 1985).

[302] *See supra* notes 247-48. The rationalization that religious organization should be self-regulated lies not only with the restrictions placed on public oversight by the constitutional guarantees of freedom of religion, but also with the higher ethical norms expected from such organizations.

[303] *Cf.* Hansmann, *Reforming*, *supra* note 6, at 508-09; Elman, *supra* note 213, at 1010-12.

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tions with specific benefits and substantial advantages.[304] The public has a justified expectation that nonprofits will be run efficiently and that they will fulfill the public purposes for which funds have been contributed or for which the government has granted them tax exemptions. The charitable sector's exemption from taxation is an expense borne by all taxpayers.[305] Nonprofits may be exempt from taxation, but they should not be exempt from the responsibilities that go with such benefits.

A widespread perception of abuse by charities will affect the charitable sector generally and may lead to such congressional action as that which occurred in the legislative reform of private foundations in 1969.[306] High standards will serve as a model of directorial behavior. Most directors want to do what is appropriate. The problem is that appropriate board behavior is an uncertain concept. Higher standards of conduct will create a unity of interest among the public, the organization, and the board, and will ensure that tax exempt monies will be expended for public purposes in

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[304] *See supra* note 220.

[305] *See* A. FELD, M. O'HARE, & J. SCHUSTER, PATRONS DESPITE THEMSELVES: TAXPAYERS AND ARTS POLICY (1983); Simon, *Charity and Dynasty Under the Federal Tax System*, Yale Program on Nonprofit Organizations, Working Paper No. 5, at 1 (1978).

[306] In 1969, as a result of perceived improper activities by private foundations, Congress enacted substantial sanctions on private foundations. Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487 (1970) (codified as amended in scattered sections of 26 U.S.C. (1982)). For the first time, "private foundation" was defined in I.R.C. § 509(a) to mean every domestic or foreign charitable organization described in I.R.C. § 501(c)(3), save for four categories referred to in I.R.C. §§ 509(a)(1),(2), (3), and (4). Charitable organizations in I.R.C. § 509(a) are divided into two classes - private foundations or public charities which obtain support from a broad segment of the public. The Tax Reform Act of 1969 also introduced into the Internal Revenue Code other sections affecting private foundations, including I.R.C. §§ 4940 (an excise tax based on investment income), 4941 (taxes on self-dealing transactions between a "disqualified person" and 501(c)(3) organizations that are private foundations), 4942 (taxes for failure to distribute income) 4943 (taxes on excess business holdings), 4944 (taxes on investments which jeopardize charitable purposes), and 4945 (taxes on taxable expenditures). The Tax Reform Act of 1969 introduced several provisions strengthening disclosure requirements. *See* I.R.C. §§ 6065 (verification of returns), 6104 (publicity of information requirement), 6652 (penalties for failure to file certain information), 6684 (certain assessable penalties equal to tax liability), and 6685 (assessable penalties relating to private foundation annual returns). The rationale behind Congress's actions can be found in STAFF OF JOINT COMMITTEE ON INTERNAL REVENUE TAXATION,GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1969, 91st Cong., 2d Sess., 3-4, 29-31, 40-41, 46-48 (Comm. Print 1970). *See* P. TREUSCH & N. SUGARMAN, *supra* note 107, at 269-87.

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the most efficient way. High standards of conduct and increasing education of board members is one approach.[307] The restructuring of the nonprofit board is another.

3. Bifurcating the Nonprofit Board — The Board of Advisors and the Board of Director-Managers

One way to improve oversight of nonprofit organizations and to encourage directorial responsibility would be to restructure the nonprofit board by bifurcating it into a board of director-managers who would be responsible for day-to-day management of the organization and a supervisory board of advisors charged with oversight of the management board.

A bifurcated board might recognize the disparate functions, experience, and participation of nonprofit board members and provide greater oversight. The Board of Advisors would owe primary fiduciary responsibilities to the public, to beneficiaries, and to patrons, but, unlike present directors, would not be directly concerned with managing the nonprofit corporation. Advisors would not be employees or senior management of the nonprofit.

Patrons and beneficiaries are often named to nonprofit boards. Under this bifurcated board proposal, these types of directors would serve on the Advisory Board. This approach would reflect these directors' lesser level of participation. Members of the Board of Advisors would be subject to a lesser standard of conduct than present directors. In compensation, the Board of Director-Managers would be subject to higher standards.

Under this proposal, the Board of Advisors could select and remove the Board of Director-Managers, set their salaries, bring suit on behalf of the nonprofit corporation, and report annually to funding sources and beneficiaries on the financial situation of the

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[307] This has been attempted by the Association of American Museums, which has sponsored publications such as COMMITTEE ON ETHICS, MUSEUM ETHICS: A REPORT TO THE AMERICAN ASSOCIATION OF MUSEUMS (1978), and A. ULLBERG & P. ULLBERG, MUSEUM TRUSTEESHIP (1981). The Metropolitan Museum of Art has published INFORMATION FOR TRUSTEES (1978). However, smaller museums may not be members of the American Association of Museums and probably would not have the resources to publish guides for directors.

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nonprofit. Its only participation in management responsibilities would arise if the Director-Managers desired to change the nonprofit purposes of the organization. The Board of Advisors also might identify extraordinary problems faced by the organization, could call members' meetings and could authorize dissolution.

This separation into a managing board and an advisory board is not without analogue in civil law systems or in the common law.[308] In a broad sense, the responsibilities of the Board of Advisors resemble those of the indenture trustee, who protects a large number of widely dispersed bondholders and ensures that the debtors fulfill their responsibilities.[309]

A more applicable example in American law is the unaffiliated director under Section 10(a) and 15(c) of the Investment Company Act of 1940.[310] Section 10(a) requires that every investment company have a board of directors of whom at least forty percent are "disinterested." A "disinterested" individual is one who does not serve or have other interests in the management of the company.[311] Under Section 15(c) of the 1970 amendments to the act, the primary responsibility of "the unaffiliated director" is to request and evaluate such information as may reasonably be necessary to evaluate managerial contacts with outside investment advisors.[312] Unaffiliated directors approve the distribution contract's valuation of non-listed securities and have the final responsibility for the expenditure of fund assets.[313] They look to the full time directors and officers for information and serve as watchdogs over shareholders'

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[308] An American business corporate law example is the disinterested director's requirement of Sections 10(a) and 15(c) of the Investment Company Act of 1940, Pub. L. No. 76-686, 54 Stat. 789, 806, 813 (Codified as amended at 15 U.S.C. §§ 80a-10(a), 80 a 15(c)(1982)). Bifurcated boards are found in civil law systems such as France, Germany, Italy, The Netherlands, Sweden, and in Latin American countries. *See* Vagts, *Reforming The Modern Corporation; Perspectives from the German*, 80 HARV. L. REV. 23, 50 (1966).

[309] *See* Trust Indenture Act of 1939, 15 U.S.C.A. §§ 77jjj-77ooo, 77qqq (1982). *See* II L. LOSS, SECURITIES REGULATION 720-43 (2nd ed. 1961).

[310] 15 U.S.C. §§ 80a-10(a), - 15(c) (1982). *See* Nutt, *A Study of Mutual Fund Independent Directors*, 120 U. PA. L. REV. 179, 230-65 (1971); Jaretzki, *Duties and Responsibilities of Directors of Mutual Funds*, 29 LAW & CONTEMP. PROBS. 777 (1964).

[311] 15 U.S.C. §§ 80a-2(19), 10(a) (1982).

[312] 15 U.S.C. § 80a-15(c) (1982).

[313] Nutt, *supra* note 310, at 195, 231-32.

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interests. There are weaknesses with the unaffiliated director approach,[314] yet the concept that a group of disinterested outsiders may best evaluate the performance of those managing a corporation and protect a broad constituency is a useful approach for nonprofit governance.

The German experience provides another helpful example of the bifurcated board.[315] The day-to-day conduct of a German corporation's business is in the hands of a managing board. Its members, analogous to a business corporation's inside directors, formulate corporate policy and conduct ongoing corporate business.[316] A Supervisory Council is created for the sole purpose of overseeing management. Unlike the American outside director, members of the German supervisory board have no statutory responsibility for the management of the corporation.[317] Active participation in management decisions is rare. Staying clear of day-to-day business, the Supervisory Council monitors the performance of the Managing Board, and reports to the shareholders. It examines the annual report of the Managing Board after it has been audited, and reports on the results of its examination at the annual shareholders' meeting.[318] The Supervisory Board appoints and can remove members

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[314] Among the criticisms are that investment advisors have hand-picked new directors and that meetings of the board were perfunctory. *Id.* at 216, 220-22.

[315] *See* Vagts, *supra* note 308, at 48-53; Berger, *Shareholder Rights under the German Stock Corporation Law of 1965*, 38 FORDHAM L. REV. 687 (1970); Roth, *Supervision of Corporate Management: The "Outside" Director and the German Experience*, 51 N.C.L. REV. 1369 (1973); Vagts, *The European System*, 27 BUS. LAW. 165 (1972).

[316] Berger, *supra* note 308, at 691-95; Vagts, *supra* note 308, at 50.

[317] Under American corporate principles, the business responsibility is imposed on both officers and members of the board of directors. *See* DEL. CODE. ANN., tit. 8, § 141(a) (1974). In the larger corporation, the management function is normally vested in the principle senior executives. The board of directors selects the senior officers and oversees their performance. A.L.I., PRINCIPLES OF CORPORATE GOVERNANCE § 3.02 comment (Tent. Draft. No. 2, 1984). Board committees may have outside director compensation but the ultimate responsibility over all managerial decisions is invested in the board as a group. It is suggested that the inside and outside directors will have a "watchful but supportive relationship," but the use and impact of independent directors has been criticized. Brudney, *supra* note 291, 616-20, 638-39, 651-52; Solomon, *supra* note 291, at 610. Under this proposal, the bifurcated board may create a more adversarial relationship, difficult if not unrealistic on the corporate board. *See* Brudney, *supra* note 291, at 610-12.

[318] Berger, *supra* note 315, at 696-97; Roth, *supra* note 315, at 1371. Under the German statute the standards of conduct of members of the Managing Board and the Supervisory Council are the same. Vagts, *Reforming the Modern Corporation*, *supra* note 308, at 52. *But*

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of the Managing Board, negotiates compensation of the managers, and brings suit on behalf of the corporation.

The Board of Advisors might work in the following way in the nonprofit corporation. If the nonprofit were a membership corporation, the members would select the initial Board of Advisors. Thereafter, the Board of Advisors would select its successors, who would be removable by the members. For non-membership nonprofits, the Managing Board would select the initial Advisory Board, who would thereafter choose their successors and replacements.There are pitfalls and problems, as the German experience indicates. German Supervisory Councils have been controlled by special interests.[319] In practice it may be difficult to separate the functions of the Management Board and the Advisory Board. When the shares of a German corporation are concentrated in a few hands, the dominant shareholders control the management and supervisory boards. If the shares are widely held, the managing board gains the upper hand.[320] This may occur with the nonprofit board, but the Board of Advisors may be more effective because the primary responsibility of reporting will be to patrons who may be less docile than shareholders and have more influence — the power of the purse.

The role of special interest groups — workers, representatives of bank concerns, suppliers, and large consumers — has been cited as a failing of the German approach.[321] These groups are inherently at odds. We believe that the nonprofit interests on the board, including most funding sources, do not have the same stake in the organization as the German representatives and have less reason for deep disagreement and divisiveness. The Supervisory Councils

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see Vagts, *supra* note 315, at 168 (suggesting that although the Supervisery Board's standard of conduct is essentially the same as the Managing Board's the former's duties are actually more limited).

[319] Vagts, *supra* note 308, at 50-52. Some of the members of the German Supervisory Council are selected by the shareholders; others by workers. Representatives of banks and suppliers may be on the Council. German corporations are often controlled by a few large banks because shareholders deposit their certificates with banks who vote the shares and have usurped the shareholders' function. Roth, *supra* note 315, at 1378-79.

[320] Vagts, *supra* note 308, at 52; Roth, *supra* note 315, at 1378-81.

[321] Vagts, *supra* note 308, at 52-53.

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have few meetings and the problem of outside directors in obtaining information is similar to our system.

One observer has noted that the German approach plays its most useful role in identifying difficulties on the horizon faster than the typical board, which is wrapped up in day-to-day management. Inefficient management thus can be replaced faster.[322] The bifurcated board may provide additional oversight to ensure that charities are fulfilling their responsibilities to the public. It may reduce impermissible self-dealing and will encourage directors and supervisors to devote a reasonable amount of time to their duties. The Advisory Board will be able to focus more upon long range goals and planning. It will obviate the need for more restrictive government regulation and will ensure the organization's compliance with legal requirements.

Despite possible problems, a bifurcated board would more realistically reflect the actual practice in nonprofit board governance. It would promote voluntarism without the great commitment and potential legal liabilities that board members fear. It might improve the lack of regulation and monitoring of nonprofit organizations.

IV. Conclusion

Nonprofit corporation law has developed as an afterthought to business corporation law and without an appreciation of the complexity and diversity of the charitable sector. We have offered several suggestions for reform of nonprofit corporation law which, we believe, will better reflect the diversity of the nonprofit sector and meet the needs of charitable corporations. Whichever way nonprofit corporation law evolves, attention must be given to the realities of nonprofit corporation governance and the development of alternative approaches to the effective monitoring of nonprofits' performance. Nonprofit corporation law should be more than the "hand me down" of business corporation law.

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[322] Vagts, *supra* note 315, at 170.

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