

THE EVOLVING LAW OF NONPROFIT ORGANIZATIONS: DO CURRENT TRENDS MAKE GOOD POLICY?*

Henry Hansmann

THE LAW OF nonprofit organizations is currently in a state of flux. Virtually all forms of law that bear on nonprofits — organizational, fiscal, and regulatory — look considerably different than they did several decades ago. These changes are largely a response — sometimes thoughtful, sometimes misguided — to important changes in the nonprofit sector itself. In turn, these changes in the legal environment are likely to induce further changes in the nature of nonprofit institutions. My objective here is to provide some perspective on these developments by describing the basic patterns of evolution in the law, by analyzing the changes in the nonprofit sector that have stimulated this evolution, and by evaluating the wisdom of continuing to follow the particular paths along which the law has been evolving.¹

Because I shall be dealing with a large subject in a very brief space I shall necessarily paint with broad strokes, neglecting many important qualifications and countervailing themes. In particular, I shall divide the law of nonprofits somewhat arbitrarily into three categories. The first category is organizational law. Since most nonprofits of any significance are incorporated,² the organizational law which will be examined is primarily the law of nonprofit corporations. The second is fiscal law, a category in which I shall

* This paper was prepared for the symposium on "What Is Charity?" at Case Western Reserve University, Cleveland, Ohio, November 4, 1988. It is a considerably revised and expanded version of a paper originally presented at the Independent Sector Spring Research Forum, New York, New York, March 19-20, 1987.

1. This article contains general reflections on the development of a broad area of the law, based in considerable part on my own research and writing in the area. Where possible, I have referred the reader to earlier works of mine that provide extensive documentation for the statements of fact I make here.

2. See generally Rudney, *Scope and Dimension of Nonprofit Activity*, in *THE NON-PROFIT SECTOR: A RESEARCH HANDBOOK* 55 (W. Powell ed. 1987).

include all forms of general taxation (such as corporate income taxes, property taxes, and sales taxes) as well as the special taxes and user fees that support particular programs and services (such as social security taxes, unemployment insurance taxes, and postage fees). The third category is regulatory law, in which I shall include all forms of regulation that bear on the relationships between nonprofit organizations and other private persons (including the law governing labor relations, torts, bankruptcy, securities, antitrust, copyright, and unfair trade practices). In addition, I shall divide the historical development of the law of nonprofits into two very broad periods: a formative period of consolidation and privilege lasting roughly from 1850 to 1950, and a subsequent period of fragmentation and withdrawal of privilege that began around 1950 and is still underway.

I. A CENTURY OF CONSOLIDATION AND PRIVILEGE: 1850-1950

Nonprofit organizations have a long lineage in Anglo-American law. Indeed, in the realm of corporation law nonprofit organizations have a far more ancient history than for-profit firms.³ Nonprofit corporations in the form of monasteries, universities, schools, guilds, and hospitals have been commonplace for nearly a millennium. Joint stock companies, on the other hand, only emerged at the beginning of the seventeenth century.

Nevertheless, prior to the nineteenth century the law of nonprofit organizations had little definition as a distinct subject. In that era corporation law in general, and nonprofit corporation law in particular, were relatively *ad hoc*. Corporate charters were granted individually by the legislature, and tailored to the particular organization in question. One consequence of this particularistic approach to the law was that the boundaries between different types of organizations were left unclear; nonprofit, for-profit, cooperative, and municipal corporations blurred into one another (for example, in guilds). Moreover, many nonprofit organizations were not incorporated but rather were formed simply as charitable trusts, and the law of charitable trusts remained an important source of authority for most incorporated nonprofits as well.

The nineteenth century saw a remarkable explosion in the

3. For a detailed account of the historical evolution of corporate forms in England and the United States through the end of the nineteenth century, see J. DAVIS, *CORPORATIONS* (1905).

number of private organizations in society, both nonprofit and for-profit. Consequently, it was no longer feasible to incorporate or regulate organizations by individual legislative acts. Furthermore, it became important to have standard organizational forms so that individuals could easily determine the type of organization with which they were dealing. As a result, in the middle of the nineteenth century most American states adopted general statutes that provided separately for the formation, as a matter of right and without special act of the legislature, of three different types of corporations: business corporations, nonprofit corporations, and cooperative corporations. The adoption of these statutes marked the beginning of a century-long period, lasting roughly from 1850 to 1950, during which the organizational, tax, and regulatory law of nonprofits achieved clear definition and evolved more or less in a unitary fashion.

A. Organizational Law

The new nonprofit corporation statutes were the first and most essential element in this process.⁴ They gave nonprofit organizations clear legal definition as a class, and they promised a more flexible organizational structure than did the law of charitable trusts.

Moreover, the statutes gave nonprofit organizations a relatively unitary legal identity. Although they were highly flexible, permitting various adaptations of the basic form, the statutes nominally provided for only a single type of nonprofit corporation. To be sure, as time passed, the courts, in their interpretation of the statutes, began to recognize and treat differently one particular class of nonprofits. This class consisted of those organizations that we might loosely refer to as "clubs." In essence, they were cooperative-type membership organizations that had no important activities beyond providing private services to their members, who in turn provided most of the organization's income. Country clubs and automobile service clubs were typical examples. The courts permitted a partial breach for such organizations in the nondistribution constraint that is the essential defining feature of a nonprofit organization and which prohibits the distribution of the organization's net earnings to any controlling person, such as an

4. For a much more extensive analysis of nonprofit corporation statutes, see Hansmann, *Reforming Nonprofit Corporation Law*, 129 U. PA. L. REV. 497 (1981).

officer, director, or member. In particular, the courts sometimes permitted clubs to distribute their accumulated net assets to their members upon their final dissolution, an action denied to other nonprofits, such as charities. Yet, this exception to the unitary character of nonprofit corporation law was not terribly problematic. It was a pragmatic accommodation to the fact that clubs came to be organized under the nonprofit corporation statutes more or less by historical accident. It would probably have been more appropriate to form clubs under the cooperative corporation statutes or to create a separate membership corporation statute for them, rather than creating special loopholes to accommodate them under the nonprofit corporation statutes. Clubs are still formed under the nonprofit corporation statutes; but until recently — and, in particular, until the adoption of the new generation of nonprofit corporation statutes discussed below — this exception seems not to have generated much confusion.

The rationalization and codification of an essentially unitary statutory law of nonprofit corporations reached its peak in 1954 with the promulgation of the Model Nonprofit Corporation Act, a joint product of the American Law Institute and the American Bar Association. The Model Act was quickly adopted in a majority of the states, and remains the prevailing law in most jurisdictions.

B. Fiscal and Regulatory Law

During the period 1850-1950, nonprofits became clearly distinguished from business corporations not only under organizational law but also under fiscal and regulatory law. That hundred-year period saw the enactment of a variety of new taxes and regulatory measures that applied to business corporations. Nonprofit corporations, however, were exempted from or given specially privileged treatment under nearly all of these measures. Thus, nonprofits were exempted from corporate income taxes and sales taxes, while the traditional practice of exempting most nonprofits from property taxes was continued and generalized.⁵ During this period nonprofits were also exempted from federal statutes governing involuntary bankruptcy,⁶ collective bargaining,⁷ securities

5. For the history of the exemption of nonprofits from the federal corporate income tax, see generally Bittker & Rahdert, *The Exemption of Nonprofit Organizations from Federal Income Taxation*, 85 YALE L.J. 299 (1976).

6. The Bankruptcy Act of 1867 exempted nonprofits from both voluntary and invol-

registration,⁸ Social Security,⁹ unemployment insurance,¹⁰ the minimum wage,¹¹ and unfair trade practices,¹² and were given favorable treatment under the copyright¹³ and antitrust laws.¹⁴ In fact, legal favoritism toward nonprofits even went so far as the creation, at the end of the nineteenth century, of the doctrine of "charitable immunity" from tort liability, a doctrine previously unknown to the common law.¹⁵

untary bankruptcy. Act of Mar. 2, 1867, ch. 176, 14 Stat. 517, *amended by* Act of June 25, 1910, ch. 412, § 4, 36 Stat. 838, 839 (the purpose of the amendment was to confine the exemption to involuntary bankruptcy), *repealed by* Bankruptcy Act of 1947, ch. 391, 61 Stat. 652.

7. This exemption was constructed by the National Labor Relations Board through the exercise of its power to define the scope of its own jurisdiction. *See* Sherman & Black, *The Labor Board and the Private Non-Profit Employer: A Critical Examination of the Board's Worthy Cause Exemption*, 83 HARV. L. REV. 1323 (1970).

8. Securities Act of 1933, ch. 38, § 3(a)(4), 48 Stat. 74, 76 (current version at 15 U.S.C. § 77c(a)(4) (1986)).

9. Social Security Act of 1935, ch. 531, 49 Stat. 620, 643, § 907(c)(7).

10. Federal Unemployment Tax Act of 1939, ch. 2, 53 Stat. 183, 187, § 1607(c)(7)(current version at 26 U.S.C. § 3306(c)(8)(1986)).

11. As originally enacted, the Fair Labor Standards Act of 1938, ch. 676, 52 Stat. 1060, *amended by* Fair Labor Standards Amendments of 1961, Pub. L. No. 87-30, 75 Stat. 65 (current version at 29 U.S.C. §§ 201-219 (1986)), did not include a specific exemption for nonprofit organizations. However, to the extent that employees of nonprofits were considered to be engaged in "non-commercial" activities, they were deemed outside the Act's coverage, which extended only to "employees who are engaged in commerce." *Id.* § 5-8 & 12, 52 Stat. at 1062-64 & 1067, *amended by* Fair Labor Standards Amendments of 1961, Pub. L. No. 87-30, § 2(r), 75 Stat. 65, 65 (current version at 29 U.S.C. § 203(r) (1986)). *See also* Mitchell v. Pilgrim Holiness Church Corp., 210 F.2d 879, 885 (7th Cir.), *cert. denied*, 347 U.S. 1013 (1954). The Fair Labor Standards Amendments of 1961, Pub. L. No. 87-30, 75 Stat. 65 (current version at 29 U.S.C. §§ 201-219 (1986)), introduced a separate basis for coverage extending to any "enterprise" operated for a "business purpose." *Id.* § 2(r), 75 Stat. at 65 (current version at 29 U.S.C. § 203(r) (1986)). This coverage has been interpreted not to cover charitable-type nonprofits. 29 C.F.R. § 779.214 (1988).

12. Federal Trade Commission Act, ch. 311, § 5, 38 Stat. 717, 719 (1914)(codified as amended at 15 U.S.C. § 45 (1986)).

13. As originally enacted, the Copyright Act of 1947, ch. 391, 61 Stat. 652, contained no explicit exemptions for nonprofits. Its principal provisions extended only to activities conducted "for-profit." *Id.* § 1(c) & (e), 61 Stat. at 653. The current exemptions for nonprofits were adopted in the Copyright Act of 1976, Pub. L. No. 94-553, §§ 110, 111(a)(4), 112(b) & 118(d)(3), 90 Stat. 2541, 2549, 2551, 2559 & 2567 (current version at 26 U.S.C. §§ 110, 111(a)(4), 112(b) & 118(d)(3) (1986)). Section 110(10), which also contains an exemption for nonprofits, was added by an Act of Oct. 25, 1982, Pub. L. No. 97-366, § 3, 96 Stat. 1759, 1759 (current version at 26 U.S.C. § 110(10) (1986)).

14. *See* Marjorie Webster Junior College, Inc. v. Middle States Ass'n of Colleges & Secondary Schools, Inc., 432 F.2d 650, 654-55 (D.C. Cir.), *cert. denied*, 400 U.S. 965 (1970).

15. *See* W. PROSSER & W. KEETON, PROSSER AND KEETON ON THE LAW OF TORTS 1069 (5th ed. 1984).

Most of the fiscal and regulatory statutes in question here did not by their terms provide special treatment for *all* nonprofits. Instead, the language of the exemptions generally pointed to some vaguely defined subclass of nonprofits. For example, the Social Security Act of 1935 exempted only nonprofits serving "religious, charitable, scientific, literary, or educational purposes."¹⁶ Nevertheless, in practice the statutes were often construed liberally to extend special treatment to most of the important organizations incorporated as nonprofits. This liberal construction was particularly evident in the interpretation of the federal corporate income tax provisions. Although the tax code has always confined exemption to a number of specifically described categories of nonprofits, those categories have been interpreted broadly enough to encompass nearly all nonprofits of any financial significance.¹⁷

II. CHANGES IN THE SIZE AND SCOPE OF THE NONPROFIT SECTOR¹⁸

Given the nature of the nonprofit sector prior to 1950, this pattern of legal development was understandable. Aside from clubs, most nonprofits were donatively supported organizations providing services that had the character of a public good for some substantial segment of the public — that is, they were traditional charities. Therefore, they could be treated as a unitary class. They also could be easily distinguished, both in terms of their finances and the services they provided, from the business firms for which most fiscal and regulatory legislation was primarily designed. Moreover, the nonprofit sector and most of the organizations within it were small. Thus, there was little incentive to work out approaches for extending fiscal and regulatory regimes to them; it was easiest simply to exempt virtually all nonprofits from the legislation in question. Finally, within corporate law, the law of charitable trusts and, more recently, the federal tax law for tax-exempt organizations could be relied upon to deal with most of the difficult questions. Thus, there was little pressure to refine

16. Social Security Act, ch. 531, 49 Stat. 620, 625 (1935).

17. See Hansmann, *The Rationale for Exempting Nonprofit Organizations from Corporate Income Taxation*, 91 YALE L.J. 54, 57-58 (1981).

18. For a far more detailed discussion of the changes in the character and role of nonprofit institutions over time, see generally Hansmann, *The Role of the Nonprofit Enterprise*, 89 YALE L.J. 835 (1980); Hansmann, *Economic Theories of Nonprofit Organization*, in *THE NONPROFIT SECTOR: A RESEARCH HANDBOOK* 27 (W. Powell ed. 1987).

doctrine within nonprofit corporation law.

By 1950, however, the nonprofit sector had begun to have a new look. It was becoming populated with large numbers of "commercial" nonprofits — nonprofits that were neither donatively supported on the one hand, nor clubs on the other, but instead had the sale of personal services as their primary activity and derived nearly all of their income from the prices charged for those services.

In some cases these new commercial nonprofits presumably play a fiduciary role toward their patrons which is analogous to that which the more traditional donative nonprofits play toward their donors and beneficiaries. The nonprofit form provides customers with an extra degree of assurance that the firm will not behave opportunistically toward them when they are in a poor position to police, by themselves, the quantity or quality of services provided by the firm. This may be the case, for example, with at least some of the nonprofits that now populate the new service industries that have developed rapidly in recent decades, including residential nursing care, day care, home health care, and prepaid group medical practice.

In other cases, these new commercial nonprofits evidently serve no function that could not be served as well by for-profit firms. As a result, these nonprofits are either anachronistic or opportunistic. This is arguably the case for many of those commercial nonprofits that have evolved from organizations that were formerly donative. Hospitals are a conspicuous example.¹⁹ Until the end of the nineteenth century, hospitals were philanthropic institutions providing health care almost exclusively for the poor; persons of means were treated in their own homes or in doctors' clinics. Hospitals in that period were therefore charities of the most traditional sort, and the nonprofit form was essential as a fiduciary device for assuring donors that their contributions were being used for the purposes for which they were intended. In this century, however, through a series of technological and financial developments culminating with the enactment of Medicare and Medicaid in 1965, hospitals have become mainstream service institutions providing medical care on a fee-for-service basis to the public at large, while performing little or no role in subsidizing care for the poor. Nevertheless, seventy-five percent of general hospitals re-

19. See Hansmann, *The Role of the Nonprofit Enterprise*, *supra* note 18, at 866-72.

main nonprofit today, presumably in large part as a consequence of institutional inertia. They are anachronistic and perhaps also a bit opportunistic, continuing to trade on whatever goodwill attaches to the image of a nonprofit organization, and enjoying as well the benefits of tax exemption and other fiscal and regulatory privileges that nonprofit status continues to bring. Furthermore, by mid-century the nonprofit sector had begun to expand rapidly in size — not only absolutely, but also as a share of GNP. This expansion accompanied the growth of the service sector (and particularly the health care and education industries) in which nonprofits are primarily found.

III. FROM 1950 ONWARD: A PERIOD OF FRAGMENTATION AND WITHDRAWAL OF PRIVILEGE

In response to these developments, tax and regulatory law began a broad retreat from the consistently favorable treatment that nonprofits had come to enjoy. In all areas, organizational as well as fiscal and regulatory, the law abandoned the largely unitary treatment that nonprofits had received in the past and began to subcategorize them for purposes of applying different legal standards.

A. Organizational Law

Turning first to organizational law, we can see that the breakup of the old order was already presaged by the 1954 Model Nonprofit Corporation Act.²⁰ In spite of the apparent success of that act in securing broad acceptance among the states, it showed serious signs of instability. The act clearly lacked any guiding theory of the functions appropriately served by nonprofit organizations, or of the structure appropriate to those functions. In essence, the drafters simply took the Model Business Corporation Act and deleted from it all provisions that seemed inappropriate for nonprofits, such as those dealing with the issuance of stock. The result was a rather empty enactment. The statute is muddled concerning permissible purposes for incorporation, vague and excessively permissive about distributions of net assets to members on dissolution, and completely silent about the critical issue of directors' and officers' fiduciary obligations.

20. For a more detailed analysis of the Model Act and of the New York and California statutes discussed immediately below, see Hansmann, *supra* note 4, at 527-37.

It is, therefore, not surprising that the Model Nonprofit Corporation Act was only a few years old when the nation's two most populous states, New York and California, abandoned it entirely in favor of newly drafted statutes of their own. Both states' statutes rejected the unitary approach of the Model Act and created multiple categories of nonprofit corporations subject to different rules.

The first to act was New York, which began drafting a new nonprofit corporation law in the early 1960s and enacted the resulting statute in 1970.²¹ That statute created three different categories of nonprofits. The first provides for clubs and similar associative organizations, which are treated permissively in terms of their fiduciary obligations. The second provides for charities, which are subjected to relatively strict fiduciary obligations. The third provides for nonprofits pursuing a "business purpose to achieve a lawful public or quasi-public objective."²² It is unclear precisely what types of organizations were intended to be covered by the latter category; the authors of the statute themselves were apparently confused on the matter. Evidently they intended this category to accommodate nonprofit urban development corporations that use public and private grants to help promote businesses among the poor. But apparently they also intended it to encompass a broader class of the new commercial nonprofits. The fiduciary obligations the act imposes on nonprofits in this third category are intermediate between those imposed on clubs and those imposed on charities. This appears to reflect the theory that since commercial nonprofits perform activities similar to those performed by for-profit firms, they should not be held to markedly higher standards with respect to the duties of care and restraints on self-dealing that are imposed on members, directors, and officers.

California followed in 1980 with the enactment of its own statute,²³ which is completely different from both the Model Act and the New York statute. Like the New York law, the California nonprofit corporation statute provides for three different types of nonprofits. The categories are, however, defined rather differently.

The California statute contains separate provisions for religious nonprofits, which are subjected to weaker fiduciary stan-

21. N.Y. NOT-FOR-PROFIT CORP. LAW §§ 1-1141 (McKinney 1970 & Supp. 1988).

22. *Id.* § 201(b).

23. CAL. CORP. CODE §§ 5000-10841 (West Supp. 1988).

dards than their secular counterparts. Such a provision had never before been enacted by any American jurisdiction. Secular nonprofits, in turn, are divided into two categories which are denominated "Public Benefit" and "Mutual Benefit" nonprofits.

Although the statute is otherwise a model of careful draftsmanship, it is ambiguous as to the types of organizations that are to fall within these two categories. As the names of the categories imply, traditional charities are to be formed under the "Public Benefit" category, while social clubs are to be formed under the "Mutual Benefit" category. In keeping with this intent, Mutual Benefit nonprofits are subject to weaker standards on self-dealing and distribution of profits than are Public Benefit nonprofits. The Mutual Benefit category, however, is defined to accommodate a much broader group of nonprofits than simply clubs. By its terms, its provisions can be used by a wide range of commercial nonprofits that are not membership organizations at all — indeed, that do not even formally have members.

The drafters of the California statute were invited by the ABA to draft a Revised Model Nonprofit Corporation Act, which has just been completed and published.²⁴ It follows the California statute quite closely in nearly all important respects. In particular it embodies the latter act's tripartite division of nonprofits into Public Benefit, Mutual Benefit, and religious nonprofits. Since the Revised Model Act is likely to be enacted in some form in many states, its fragmented approach to nonprofit corporations promises to become the national norm.

B. Fiscal and Regulatory Law

Turning to fiscal and regulatory law, we see changes in the period from 1950 to the present that are even more dramatic than those in the organizational law. The former pattern of more or less automatically granting special treatment to nonprofits under fiscal and regulatory legislation has been sharply reversed, and the privileges that nonprofits previously had enjoyed have been progressively curtailed. Moreover, the pattern of fragmentation seen in the nonprofit corporation law has also appeared in the tax and regulatory law, which increasingly deals differently with different types of nonprofits, or even with different activities carried on by a single nonprofit. As with the corporation law, these changes have

24. REVISED MODEL NONPROFIT CORP. ACT (1987).

evidently been stimulated by the emergence of substantial numbers of commercial nonprofits and by the expanding commercial activities of the more traditional donative nonprofits.

This broad retreat from favoritism toward nonprofits has taken three forms. First, in some areas special treatment or exemption has been withdrawn completely from nonprofits of all types. One of the first examples of this withdrawal was the abolition of the doctrine of charitable immunity in tort, a change that was initiated by the courts in the 1940s²⁵ and has now become nearly universal. Labor law has seen a similar turnaround. In a series of cases between 1970 and 1976, the National Labor Relations Board repudiated the long-standing "worthy cause" exemption that had shielded all nonprofits from federal labor law and adopted a policy of treating nonprofit firms on the same terms as ordinary business corporations.²⁶ Similarly, whereas nonprofit firms originally had the right to decline to pay Social Security taxes, in 1983 the Social Security Act made such taxes mandatory for nonprofits on the same basis as business firms.²⁷ In 1970, the exemption of charitable nonprofits from state unemployment insurance taxes was eliminated, and the employees of such organizations were brought under the unemployment insurance scheme for the first time.²⁸ Finally, antitrust law, from which the courts had until recently established a partial exemption for nonprofits,²⁹ is now applied to them aggressively with little hesitation.³⁰

Second, fiscal and regulatory laws have begun to distinguish among different activities carried on by individual nonprofits. A

25. The collapse of the doctrine was initiated most conspicuously by Judge Rutledge's opinion in *President & Directors of Georgetown College v. Hughes*, 130 F.2d 810 (D.C. Cir. 1942).

26. This process began with the decision in *Cornell University*, 183 N.L.R.B. 329 (1970), and was essentially completed with *St. Aloysius Home*, 224 N.L.R.B. 1344 (1976).

27. Social Security Amendments of 1983, Pub. L. No. 98-21, § 102, 97 Stat. 65, 70-71 (codified as amended in scattered sections of 26 & 42 U.S.C.). There remains an exemption for employees of schools, colleges, or universities. 42 U.S.C. § 410(a)(10)(A) & (B) (1986).

28. Charities (more precisely, nonprofits that fall within § 501(c)(3) of the Internal Revenue Code) remain exempt from the federal level unemployment insurance tax, however, and also still have the benefit of a somewhat preferential scheme of payment of their state tax obligations. See generally Note, *Preferential Treatment of Charities Under the Unemployment Insurance Laws*, 94 YALE L.J. 1472 (1985).

29. See, e.g., *Marjorie Webster Junior College v. Middle States Ass'n of Colleges & Secondary Schools*, 432 F.2d 650, 654-55 (D.C. Cir.), cert. denied, 400 U.S. 965 (1970).

30. See, e.g., *National Collegiate Athletic Ass'n v. Board of Regents*, 468 U.S. 85, 98-120 (1984).

conspicuous example was the passage of the unrelated business income tax in 1950, a provision that effectively withdraws corporate income tax exemption from the commercial activities of all nonprofits, including charities.³¹ Indeed, this enactment can be taken as the legislative event that most clearly inaugurated the new era in the law of nonprofits. Efforts today to withdraw special postal rates from the commercial activities of nonprofits provide another example.³²

Third, fiscal and regulatory laws have begun to differentiate more carefully among types of nonprofit organizations, denying special treatment to certain classes. The most striking example is the withdrawal of tax exemption from life and health insurance companies in the Tax Reform Act of 1986.³³ Formerly, as we have noted, virtually all nonprofits, including most clubs, had been exempt from the corporate income tax with respect to their principal activities. Although there were small classes of nonprofits that were denied exemption, such as automobile service clubs, they seemed to be flukes and special cases.³⁴ The 1986 Act changes this pattern, denying exemption to two very important classes of nonprofits. Moreover, the nonprofits in these classes were ones that had formerly been exempted, not under the peripheral exemption provisions of Section 501(c) of the Code that cover such entities as cemetery associations and business leagues, but rather as charities under Section 501(c)(3), the innermost circle of exempt organizations.

IV. A POLICY EVALUATION

Is the path that the law has been taking for the past forty years the appropriate one? The answer is mixed. The fragmentation of corporate law, with different standards for different types of nonprofits, is in general poor policy. The direction being taken by the fiscal and regulatory law, on the other hand, is salutary, and more of the same would be desirable.

31. Revenue Act of 1950, ch. 994, § 301, 64 Stat. 906, 947-53.

32. See Kielbowicz & Lawson, *Reduced Postage for Nonprofit Organizations: A Policy History, Critique, and Proposal*, 11 HARV. J.L. & PUB. POL'Y 347, 396 (1988).

33. Tax Reform Act of 1986, Pub. L. No. 99-514, § 1012, 1986 U.S. CODE CONG. & ADMIN. NEWS (100 Stat.) 2085, 2390 (codified at I.R.C. § 501(m) (1986)).

34. See Hansmann, *supra* note 17, at 94-95.

A. Organizational Law

The tripartite division of nonprofit corporations embodied in the California Nonprofit Corporation Act, and in the Revised Model Nonprofit Corporation Act that is based on it, is poorly conceived to meet the needs of the nonprofit sector and its patrons.³⁵ This is not to say that the Revised Model Act has nothing to offer. In general, and in conspicuous contrast to the old Model Act, the Revised Model Act is marked by careful and detailed draftsmanship throughout. Moreover, the provisions of the Act applicable to Public Benefit nonprofits are, in general, well thought out. They impose rigorous but by no means unrealistic duties of care and loyalty on the officers, directors, and members of the organizations governed by this section of the act; consequently, they help assure that the nonprofits formed under them will serve effectively as fiduciaries for their patrons, which is the principal function of the nonprofit form. The principal problem with the act is that it does not extend these same standards to *all* the organizations incorporated under it, or at least to all organizations that are not truly clubs.

1. Religious Nonprofits

It is particularly difficult to see the rationale for imposing restraints on self-dealing in religious nonprofits that are substantially weaker than those imposed on secular charities. The financial scandals recently disclosed in some religious organizations make it clear that religion confers no immunity from speculation. Why should we make it easier to defraud people in the name of religion than in the name of charity?

The usual argument offered to justify a lower degree of accountability for religious organizations, in corporate law and elsewhere, is that higher standards would be excessively intrusive and would interfere with the separation of church and state. But this argument is unpersuasive, at least in the context of corporate law. Indeed, one might argue that establishing weaker standards of accountability for religious nonprofits actually *disadvantages* religious organizations relative to secular ones. These low standards result in a greater opportunity for fraud among religious organizations, leading to a spirit of distrust toward such organizations on

35. For an extensive analysis of the California act that applies directly to the Revised Model Act as well, see generally Hansmann, *supra* note 4.

the part of those who would otherwise support them. This distrust handicaps those organizations in raising funds and otherwise securing the commitment and support of the public.

It is a mistake to think of corporation law as a means by which the state burdens organizations with duties to the state or the public. Rather, corporation law serves the function of a standard form contract among the many participants in the corporate enterprise. More particularly, nonprofit corporation law serves as a standard form contract between the supporters of the organization, especially its donors, and the organization's managers. There is no reason to believe that the optimal form of that contract differs between religious organizations and other philanthropically supported organizations, such as secular charities. Thus, if the fiduciary standards chosen for secular charities are the optimal ones, the ones employed for religious organizations must be suboptimal. It then follows that legitimate religious organizations and their supporters will actually be handicapped by the new law. In short, the best way to assure that organizational law neither penalizes nor promotes religion is to keep it from discriminating between religious and non-religious organizations.

Although the Revised Model Act does not go as far as the California Nonprofit Corporation Act in providing weaker fiduciary standards for religious nonprofits than for Public Benefit nonprofits, it still establishes lower standards of accountability in some significant respects.³⁶ As previously discussed, complete uniformity of treatment seems the better course.

2. Commercial Nonprofits

If the nonprofit form has become anachronistic for a particular type of nonprofit institution — for example, hospitals — then presumably those who patronize these institutions no longer need to rely on the special fiduciary constraints of the nonprofit form to protect themselves. They can, and presumably often do, deal with the organization much as if it were a for-profit firm. For several reasons, however, it is not appropriate to hold the managers of such a nonprofit only to the fiduciary standards appropriate for a for-profit.

36. For example, public benefit nonprofits, but not religious nonprofits, must, upon dissolution, provide the attorney general with a list showing the persons to whom the corporation's assets were distributed. REVISED MODEL NONPROFIT CORP. ACT § 14.03(c) (1987).

First, many nonprofits, including most of the new commercial nonprofits, are not membership organizations; consequently, there is no class of members to discipline the organization's management through the exercise of their vote. Moreover, even in nonprofits with members there is no possibility of disciplining managers through a market for corporate control, since unlike business corporations nonprofits have no stockholders with a right to both net assets and control. Fiduciary duties, therefore, are often the only important constraint on a nonprofit organization's managers, and this is as true for anachronistic commercial nonprofits as for any other type of nonprofit. As a result, strong and easily policed fiduciary duties serve an efficiency function even for firms that are, in a sense, inappropriately organized as nonprofits.

Second, there is no easy way to determine which nonprofits should be subjected to high fiduciary standards and which to low standards. That is to say, there is no obvious set of objective criteria that could be embodied in a corporation statute to differentiate among types of nonprofits for this purpose. Furthermore, it is clearly inappropriate to allow the organization that is incorporating to decide which standards will apply to it — though this is effectively the case under the Revised Model Act, which permits a broad range of organizations to opt for the relaxed Mutual Benefit form rather than the more confining Public Benefit form.

Third, if different standards are applied to different types of nonprofits, patrons of those organizations will become confused about the characteristics of the nonprofit form in general, and of individual organizations in particular. This is especially evident where, as under the Revised Model Act, nonprofit organizations do not have to disclose to the public whether they are Mutual Benefit or Public Benefit nonprofits.

Fourth, and finally, anachronistic commercial nonprofits can simply convert to the for-profit form if the fiduciary obligations of the nonprofit form become excessively constraining for them. Indeed, they should be encouraged to do so.³⁷

37. John Hetherington has argued provocatively that managers of mutual insurance companies (which are nonprofit firms' for most practical purposes, though in legal form they are consumer cooperatives) should be permitted to appropriate some of the net worth of the firms' conversion to for-profit form, since this is the only way to give them an incentive to undertake such a conversion. See Hetherington, *Fact v. Fiction: Who Owns Mutual Insurance Companies*, 1969 Wis. L. REV. 1068, 1089-107. Note, though, that this argument does not carry over to raking off profits from the firm prior to dissolution; rather the contrary, since permitting such profiteering within the nonprofit form will reduce the incen-

The better view, in short, is that commercial nonprofits should be subjected to the same fiduciary standards as charities. The only organizations commonly formed as nonprofits for which reduced fiduciary standards are appropriate are clubs, which in functional terms are not really nonprofit organizations but rather are a species of consumer cooperatives that have crept under the nonprofit corporation statutes by historical accident.³⁸ Yet the Mutual Benefit provisions of the Revised Model Act are designed to accommodate much more than just clubs; they are apparently available to a broad range of commercial and even donatively-supported nonprofits.

Perhaps the best defense of the Revised Model Act in this connection is that the drafters of the act seem not to have explicitly considered how the act is to apply to the emerging commercial nonprofits. Instead, the act is drafted, and the commentary that accompanies it is written, as if all nonprofit organizations could be comfortably classified as either: (1) charities of the type covered by section 501(c)(3) of the Internal Revenue Code or (2) private social clubs and other cooperative-type organizations that essentially do business only with their members and do not hold themselves out as being nonprofit.

A few simple amendments to the Revised Model Act would go far toward rectifying the problems discussed here. First, eliminate the special provisions for religious nonprofits; second, make the Mutual Benefit provisions available only to organizations that have members and that receive at least fifty percent of their annual income from transactions with their members.

B. Fiscal Law

One can essentially view exemption from taxes as a form of subsidy to nonprofits. (This is most obvious for the exemption from property and sales taxes, although it is arguably a reasonable statement in the case of corporate income taxes as well.) Seen this way, there is a good argument for removing the exemption from commercial nonprofits that are anachronistic or opportunistic. Or, to put it the other way around, there is no reason to subsidize the nonprofit form of organization in an activity that can be performed as well or better by for-profit firms. With the advent of

tives to convert to for-profit form.

38. See Hansmann, *supra* note 4, at 582-85.

large numbers of commercial nonprofits, it now makes sense to pick and choose among nonprofits when granting tax exemptions.

Much has been said elsewhere along these lines about the rationale for tax exemption, its appropriate scope, and its consequences.³⁹ Perhaps the most interesting question at this point is not whether the scope of tax exemption will be significantly reduced in the future, but how. In particular, it will be important to decide whether the law should proceed by “fencing in” or “fencing out.” The federal corporate income tax has, in form, always taken the “fencing in” strategy — it has presumed that nonprofit corporations are taxable unless they are specifically “fenced in” to the exemption through their inclusion in a specifically defined subsection of section 501(c) of the Code. In practice, however, the exemption has essentially been administered on a “fencing out” basis — all financially significant nonprofits have been considered exempt unless there was a specific determination that they be denied exemption. Thus, automobile service clubs and political organizations have long been denied exemption, the former through judicial decision⁴⁰ and the latter through specific exclusion in the code.⁴¹ The 1986 revisions to the code have followed this same pattern by “fencing out” nonprofits that sell insurance and annuities through specific language denying exemption to commercial nonprofits in those industries.⁴²

The alternative “fencing in” strategy would define, or at least interpret, the existing categories of exempt organizations more narrowly and place a heavier burden on nonprofits in any given industry to demonstrate that, either as a group or in individual cases, they qualify for exemption under one or another of these categories. For example, the courts and the IRS could begin by putting some coherence into the interpretations they give to such broad terms as “charitable” and “educational” rather than routinely stretching these terms to accommodate those organizations that do not fit neatly under another more specific heading.

The “fencing in” strategy is conceptually neater. However, it is probably wise to continue for the present with the “fencing out” approach, contracting the scope of exemption from time to time by specifically excluding nonprofits in designated industries in

39. See, e.g., Hansmann, *supra* note 17.

40. See Hansmann, *supra* note 4, at 852-53.

41. I.R.C. § 527 (1986).

42. I.R.C. § 501(m) (1986).

which the nonprofit form no longer serves a function for which subsidy is appropriate. The reason this approach would be preferable is that, as the economy evolves, there are likely to be more cases of industries in which nonprofits played an important role in the industry's formative stages but have become anachronistic as the industry has matured. Therefore, as each such industry matures, there will come a time at which it is appropriate to remove it from section 501(c) and thus withdraw exemption from a large class of well-established and formerly exempt nonprofits. It will be easiest to deal with this situation simply by making an explicit judgment that, in the future, exemption is to be denied to nonprofits in that industry. Such a decision will often best be taken through legislation, as was done with nonprofit insurance and annuity providers, but might sometimes be undertaken alternatively through IRS rulings or judicial interpretation.

C. Regulatory Law

There are several theories that might be invoked to justify the exemption of some or all nonprofits from regulatory law. The most obvious argument — although one that is seldom specifically invoked — is that nonprofit organizations are by their nature substantially less likely than for-profit firms to exhibit the behavior that the regulation in question is designed to prevent and therefore it makes sense to relieve both the organizations and the public of the expense of the regulation. Specifically, one could argue that, because the nondistribution constraint assures that no one in control of the nonprofit could profit personally by having the firm behave opportunistically toward the public, nonprofits are less likely than for-profit firms to exhibit such behavior. (A related argument is that the managers of nonprofits are more likely than the managers of for-profit firms to behave altruistically, presumably because the nonprofit form with its nondistribution constraint tends to screen for such types.) Thus, exemption of nonprofits from federal labor law, when that was the rule, might have been justified on the ground that the managers of nonprofit firms are less likely than the managers of for-profit firms to drive a hard bargain with workers. Indeed, one might have speculated that if nonprofits were subject to the law governing collective bargaining, they would be excessively inclined to yield to the demands of their workers and would strike inefficiently generous bargains with them. Similarly, one might have speculated that nonprofit organizations would not be inclined to engage in an inefficiently large amount of risk-gen-

erating behavior even if they were not subject to tort law; that they would not make misleading statements about the quality of their securities even if not subjected to securities regulation; that they would not engage in unfair trade practices even if exempted from the Federal Trade Commission Act; or that they would not create or exploit a position of monopoly even if free of the anti-trust laws.

It is, however, an empirical question whether, in fact, nonprofits are significantly less likely than for-profit firms to engage in the types of activities that such regulation is designed to prevent. Theory alone will not provide much guidance here. After all, a zealously managed nonprofit might well exploit its workers, security holders, and potential tort victims in order to serve its principal corporate purpose (provision of hospital care, relief of famine victims, etc.). We do not have good systematic data on this issue. Casual empiricism suggests, however, that nonprofit organizations often behave as aggressively as do for-profit firms in a variety of arenas subject to regulation, including labor relations and anticompetitive pricing.⁴³ This theory seems, therefore, to provide rather weak support for regulatory exemptions, not only for nonprofits that are anachronistic or opportunistic but also for charities.

An alternative theory is that, although the regulation involved might otherwise appropriately be applied to nonprofits in general, exemption is justified as a way of subsidizing the organization. This theory acknowledges that the absence of regulation will bring costs: exemption from tort law will lead to too much accident-causing behavior by nonprofits, exemption from securities regulation will cause some investors to be misled to their detriment, and exemption from antitrust law will lead to some monopolistic price-fixing by nonprofits. But the undesirability of such results would be outweighed by the fact that the increased revenues thereby secured by the exempt nonprofits would go to good causes. Under such a theory, exemption should presumably be extended only to nonprofits that provide substantial external benefits to the public at large; thus, charities should get the exemptions, but business associations should not.

This theory was explicitly invoked to justify charitable immunity from torts, and it is suggested by the title "worthy cause ex-

43. See, e.g., *National Collegiate Athletic Ass'n v. Board of Regents*, 468 U.S. 85, 98-120 (1984).

emption" that was given to the labor law exemption. Indeed, it probably provided at least some of the motivation for all of the various regulatory exemptions granted nonprofits. Yet the theory is subject to the fatal objection that it effectively seeks to finance nonprofits with taxes that are highly inefficient and that have distributional burdens that run from the merely regrettable to the clearly grotesque.

It is, to be sure, possible to construct theories that might justify one or another form of regulatory exemption, at least for particular types of nonprofits. For example, it has been suggested that exemption of donatively-financed nonprofits from involuntary bankruptcy might be justified as an indirect way of establishing an appropriate priority for the claims of donors, which would otherwise receive no recognition in bankruptcy.⁴⁴ For each such rationale that has been offered, however, there appears to be some other, less drastic modification of the regulatory regime besides exemption that would better meet the needs that underlie the rationale. Thus, giving donors a claim in bankruptcy seems clearly superior to exemption if the absence of such a claim is the rationale for the bankruptcy exemption. In short, most of the regulatory exemptions that have been granted to nonprofits seem poorly founded, regardless of the type of nonprofit involved. Continuing the current movement toward their elimination is sound policy.

V. THE LAW'S IMPACT ON THE SHAPE OF THE SECTOR

Withdrawal of fiscal and regulatory privileges for nonprofits in any given industry will, presumably, lead to fewer and smaller nonprofits in that industry.⁴⁵ It will not, however, necessarily lead to the disappearance of the nonprofit form from the industry. For example, if tax exemption and other forms of special treatment were to be withdrawn for most nonprofit hospitals, it is still quite possible that the hospital industry would long continue to be dominated by nonprofit firms. In this respect one might expect the hospital industry to become somewhat like the life insurance industry

44. K. Mason, *Exempting Nonprofit Corporations From Involuntary Bankruptcy: Misplaced Compassion?* (1983)(unpublished, Yale Law School).

45. There is empirical evidence suggesting that the availability of tax exemption for nonprofit firms in some industries has led to the expansion of the market share of nonprofit *vis-a-vis* for-profit firms in those industries. See generally Hansmann, *The Effect of Tax Exemption and Other Factors on the Market Share of Nonprofit Versus For-Profit Firms*, 40 NAT'L TAX J. 71 (1987).

is today. In that industry, roughly half of all insurance is written by mutual firms (which are effectively nonprofits rather than true mutuals) that have arguably been anachronistic for more than half a century but that continue to survive and prosper without the benefit of a tax or regulatory regime that favors them over stock life insurance companies.⁴⁶

CONCLUSION

As the nonprofit sector matures, the law governing that sector has been maturing as well. Despite the growing diversity of the nonprofit sector, from a policy perspective it seems appropriate, in general, to subject the sector to organizational law and regulatory law that is unitary. The law should not discriminate among nonprofit organizations according to the purposes they serve, and in particular according to whether or not they are charities. In fiscal law, on the other hand, and especially in the area of taxation, there is a good case for discriminating among different types of nonprofits according to the functions they serve, and in particular for being more discriminating than in the past by granting exemption only to organizations that are truly charitable.

In general, these are the lines along which the law has in fact been evolving over the past four decades. Still, there are some conspicuous instances in which a less salutary direction is being taken — most notably in the area of corporation law.

46. See generally, Hansmann, *The Organization of Insurance Compounds: Mutual Versus Stock*, 1 J.L. ECON. & ORGANIZATION 125, 142 (1985).

