

- V. Stiftungen, die vornehmlich im Sozial-, aber auch im Ausbildungs- und Fortbildungsbereich in Konkurrenz zu privaten Akteuren »Dienstleistungen im allgemeinen wirtschaftlichen Interesse« anbieten, werden sich darauf einstellen müssen, daß ihre wettbewerbs- und beihilferechtliche Sonderstellung auf europäischer Ebene immer stärker in Zweifel gezogen wird. Hierzu sollten die Stiftungen der Bundesregierung sehr schnell Argumentationshilfen für ein dringlich noch zu schaffendes Sekundärrecht der Gemeinschaft bereitstellen.

### F. Summary

The title of this report is rather provocative because foundation law is settled national social and cultural policy. But the European Union must respect the national identity of the EU member states (Art. 6, 3 ECT). The valid primary right of the European Community prohibits a global reform of foundation law in the member states as long as this organizational form is used for cultural purposes. In this area, if necessary, only selective supplements are possible, with which the European Community may enrich and support national foundation law.

Foundations that enjoy public privileges should not only render account to the supervisory authority, but additionally to the public in relation to their activities, their property, and to the payments. For this aspect the right of other EC member states could offer an exchange of experiences.

For the foundations concept and its dissemination into the population, it could be favorable, if the law would permit membership-like participation in foundations. This seems to be possible on the basis of valid German civil law; it should, however, be settled expressly by the legislature. For a potential model, a glance at British law could provide helpful suggestions.

Art. 151 ECT makes a recent recommendation of the European Union seem remarkable. According to this recommendation transnational donations for foundations with cultural purposes in other member states should become tax-privileged in the same way as native foundations.

Foundations that offer services »in the common economic interest« primarily in the social interest« – but also in the formation and advanced training area in competition with private participants – will have to resolve themselves to the fact that their privileged position regarding competition and financial aid is being drawn ever more strongly into doubt on the European level. For this reason, foundations should supply very fast assistance to the federal government on argumentation for a secondary legislation of the community, which is in urgent need of creation.

## A Reform Agenda for the Law of Nonprofit Organizations\*

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### A. Introduction

Over the past half century, the body of law that governs nonprofit organizations in the United States has substantially altered in response to the continually increasing size, complexity, and importance of the nonprofit sector itself. The law's evolution has been haphazard, however, and has not always been guided by a clear view of the purposes and problems of nonprofit institutions. The result is a body of law that, while often elaborate in its details, lacks coherence at a structural level, and consequently fails to deal effectively with the most important practical issues facing the nonprofit sector today.

In this essay I explore the potential for basic reform in the law governing nonprofit organizations. I take an expansive view of the potential scope of such a project, assuming that it might appropriately include corporate law, tax law, and various forms of regulatory law. I have, however, largely limited myself to the *general* law of nonprofits

\* This essay has been prepared for the American Law Institute as a focus for discussion on the advisability of developing a project on the reform of the law of nonprofit organizations. The views expressed here are those of the author and not necessarily those of the American Law Institute.

— that is, to aspects of the law that apply to nonprofit organizations in general, rather than to forms of regulation that are confined to particular industries, such as hospital care or higher education. Of necessity, I have not tried to be exhaustive. I have confined myself to major structural aspects of the law—with special emphasis on corporate law and tax law—and do not deal much with details. I both describe what I believe are the fundamental problems with current law and outline a variety of potential reforms. The proposed reforms are not offered as definitive solutions, however, but rather to stimulate and broaden debate concerning this increasingly important and difficult sector.

While most of my discussion is confined to U.S. law, the topic has broader relevance. The law of nonprofit organizations is under stress and in flux in all developed countries. Thoughtful reform of U.S. law can therefore provide helpful guidance abroad as well as at home. At the same time, the U.S. has something to learn from the rather different structural approaches to nonprofit law that have been taken elsewhere.

## B. The Evolution of the Nonprofit Sector

An important reason for considering reform of nonprofit law is that the nonprofit sector itself has evolved. The past fifty years, in particular, have brought substantial changes in the size and character of the sector.

Until the middle of the twentieth century, nonprofit organizations were typically *donative* entities that received a significant portion of their income in the form of gifts, grants, or donations, often of a philanthropic character. Today, in contrast, the nonprofit sector is heavily populated with *commercial* entities that receive all or nearly all of their income in the form of fees for services rendered. This change has been particularly conspicuous in health care, which constitutes roughly half of the nonprofit sector in terms of GNP, but it is also apparent in a variety of other important services industries, including old age (nursing home) care and day care. In the decades immediately to come, it is likely that we will also witness a similar movement from donative to commercial entities in the field of education, which is, next to health care, the largest component of the nonprofit sector.<sup>1</sup>

It is arguable, moreover, that many of today's numerous commercial nonprofits are anachronistic, in the sense that the nonprofit form is no longer well suited to the services they produce. If these organizations were to be formed anew, they would probably be formed as for-profit entities instead.

At the same time, the more traditional donative nonprofits have evolved as well. Charitable organizations today operate increasingly on a national or even international scale, and they use modern communications media and marketing to solicit funds from a broadly dispersed public. The result is a need for ever more effective means of assur-

1 See Henry Hansmann, *The Changing Roles of Public, Private, and Nonprofit Enterprise in Education, Health Care, and Other Human Services*, in Victor Fuchs, ed., *INDIVIDUAL AND SOCIAL RESPONSIBILITY: CHILD CARE, EDUCATION, MEDICAL CARE, AND LONG-TERM CARE IN AMERICA* (University of Chicago Press, 1996).

ing donors, who often have no personal contact with the organizations themselves, that the organizations that seek their support are honest and effective.

Finally, our understanding of the nonprofit sector has also changed. Recent decades have seen an outpouring of scholarship that has substantially refined our understanding of the functions served by nonprofit organizations, the problems they present, and the legal means appropriate to address those problems.

The law of nonprofits has evolved over the past fifty years in an effort to accommodate these changes in the nonprofit sector and in our understanding of the sector. There remains substantial room for further adjustments, however. Moreover, some of the reforms that have already been undertaken appear maladaptive and should be reconsidered.

For convenience, I discuss corporate law first, and then proceed to issues of tax law. For reasons of space, and to concentrate my focus, I leave largely undiscussed several large and important topics of regulatory law, including financial disclosure, bankruptcy, securities regulation, regulation of solicitation, and antitrust.

## C. Corporate Law

Not all nonprofit organizations in the United States are incorporated. Some are formed as charitable trusts, and some are unincorporated associations. The utility and simplicity of the corporate form for nonprofits is so conspicuous today, however, that nearly all nonprofit organizations of any significance are formed as nonprofit corporations under state law. I will therefore largely ignore the law of charitable trusts and unincorporated associations here, and focus on corporate law.<sup>2</sup>

### I. How Many Categories of Nonprofits?

From the mid-nineteenth century, when the first nonprofit corporation statutes were adopted, until thirty years ago, nonprofit corporation law in the U.S. was unitary in the sense that states typically had a single nonprofit corporation statute that was employed for forming nonprofit organizations of all sorts. Those statutes nominally applied the same restrictions and standards to all nonprofits, though the statutes were sufficiently flexible to accommodate a variety of different types of internal organizational structures.

#### 1. Charities and Clubs

In particular, these statutes were employed to form organizations that, at the extremes, had notably different characteristics. At one extreme, there were the traditional chari-

2 The law of unincorporated nonprofit associations has recently been the focus of a new model act, which has been drafted largely for the sake of clarifying tort liability. UNIFORM UNINCORPORATED NONPROFIT ASSOCIATION ACT, 6A U.L.A. 509 (1992). The law of charitable trusts may be taken up in the American Law Institute's current project on the Restatement Third of Trusts.

ties – donatively supported philanthropic organizations that were managed by a self-perpetuating board of directors and that served principally to provide money and services to deserving third parties. At the other extreme, there were clubs – such as country clubs – that were devoted entirely to providing services to their individual members, that received their income entirely from those members, and that were managed by a board of directors chosen by the members.

The result was substantial strain on the interpretation of the nondistribution constraint that we have now come to understand as the defining characteristic of nonprofit organizations. It was reasonably clear to the statute drafters and the courts that those who controlled the traditional charities – their directors and officers – should not be able to appropriate any of the organization's net income or assets, either currently or in dissolution. It seems to have been accepted as well that clubs, like charities, should be barred from making distributions to controlling persons – including members – on a current basis. But an exception to the nondistribution constraint was commonly made for clubs upon dissolution, permitting distribution of net assets to members on that occasion. The rationale for this exception was evidently that it was the members who had contributed the assets in the first place, and that there was nobody else who had a better claim to them.

The difficulty lay in defining which organizations should be treated like charities and which like clubs. For, among the wide range of organizations incorporated as nonprofits, there was no clear dividing line between the two. Many membership organizations – from the Elks and the Chamber of Commerce to the Junior League and the Sierra Club – served philanthropic or public purposes in whole or in part, for a public or a class of beneficiaries of greater or narrower range. How, then, to define which of these organizations should be permitted to distribute net assets to their members?

For most of the nineteenth and twentieth centuries, the law made no particular effort to confront this issue with clarity. The nonprofit corporation statutes commonly permitted net assets to be distributed to members on dissolution in any nonprofit. This was the approach taken, in particular, in the widely-adopted Model Nonprofit Corporation Act, originally drafted by a committee of the American Bar Association (ABA) in 1952.<sup>3</sup> The overbreadth of this approach was limited somewhat by the courts, which sometimes barred distributions to members when the assets involved had clearly been accumulated under representations that they would be used for charitable purposes.<sup>4</sup> Federal tax law also supplemented the corporation statutes by placing clear limits on inappropriate distributions by exempt organizations, as we will discuss below.

To be sure, the problem of liquidating distributions was apparently, at least until recently, not of great practical importance. Highly solvent nonprofit organizations – much less organizations with members – seldom dissolved (although, as we shall discuss below, today the problem may be a larger threat). Yet, at least in principle, the issue clearly revealed a basic tension in the corporate law of nonprofits.

<sup>3</sup> MODEL NON-PROFIT CORPORATION ACT, Section 46.

<sup>4</sup> See, e.g., *Lynch v. Spilman*, 431 P.2d 636 (1967).

Moreover, the tension between the needs of clubs and the needs of charities also arose in other areas. One was fiduciary duties. One might naturally think that fiduciary duties should be stricter for the officers and directors of a charity than for those of a club. The managers of a club, after all, are under the direct control of the members who both supply the organization's income and receive its services, and who are therefore well situated to police the managers. The donors and beneficiaries of a charity with a self-perpetuating board, on the other hand, are in a much weaker position to look out for themselves.

And what about standing to sue? The nonprofit corporation statutes have generally granted standing to members, and only to members, in apparent imitation of the approach taken in cooperatives and business corporations. The result is that donors to the National Audubon Society, who have the (largely formal) status of members in that organization, have standing to sue the officers and directors of that organization for malfeasance, while donors to the Environmental Defense Fund, who do not have the formal status of members, do not – and nobody else does either.

In short, in a rather casual effort to use one general form to accommodate both clubs and charities, as well as everything in between, the nonprofit corporation statutes simply extended special status to members in *all* nonprofit organizations. And, to add to the awkwardness of this approach, the statutes commonly did not define the term *member*.

## 2. Commercial and Donative Nonprofits

In recent decades, it also became apparent that the nonprofit corporation statutes had come to accommodate, not just traditional clubs and charities, but also many organizations that are neither, but rather are simply *commercial* nonprofits – which is to say, nonprofit corporations without members that receive no meaningful amount of donative income and are primarily engaged in the sale of private goods and services to the public.

Since those commercial nonprofits looked much like for-profit firms, and often operated in direct competition with for-profit firms, it was natural to wonder whether the corporation law applicable to them should be different in some respects – such as fiduciary duties – from that applicable to other nonprofits, such as charities, and should instead resemble the law applied to business corporations.

## 3. The New Generation of Corporation Statutes

In apparent response to the developments just described, there have been several large-scale projects to reform nonprofit corporation law over the past thirty years. The Model Nonprofit Corporation Act that had previously represented the state of the art was clearly inadequate. The committee that drafted that act was obviously confused about the nature and purposes of nonprofit organizations.<sup>5</sup> As a consequence, they drafted a largely empty act. For example, in addition to the problems already dis-

<sup>5</sup> Henry Hansmann, *Reforming Nonprofit Corporation Law*, 129 PA. L. REV. 497, 528-30 (1981).

cussed, the Model Act was entirely silent concerning the general fiduciary duties of officers and directors.

The State of New York was the first to act, adopting its own completely new nonprofit corporation statute in 1970. That statute broke away from the unitary approach that had previously been the rule, and provided instead for four different types of nonprofit corporations, each subject to different rules: Type A for, more or less, club-like and mutual organizations; Type B for, more or less, charitable organizations; Type C for an ill-defined category of nonprofits pursuing business-like purposes; and Type D for nonprofits formed under other special-purpose New York corporation statutes. The rules applicable to Type A are the least constraining – permitting, for example, distribution of net assets to members upon dissolution – while Type B is the most closely regulated.

California then followed, in 1980, with its own nonprofit corporation act. That act follows the New York approach of dividing nonprofits into categories, but employs somewhat different categories: Public Benefit Corporations, Mutual Benefit Corporations, and Religious Corporations. The Public Benefit category, like New York's Type B, is essentially designed for charitable-type nonprofits, while the Mutual Benefit category, like New York's Type A, is apparently intended for club-like entities and perhaps, like New York's Type C, for some other types of commercial nonprofits. The Religious Corporations category, however, was entirely new: in effect, it established a lower level of accountability for nonprofit organizations of a religious character.

The drafters of the California act were subsequently invited by the ABA to draft a Revised Model Nonprofit Corporation Act, which was completed and published in 1988. Not surprisingly, the Revised Model Act closely follows the 1980 California act, with its tripartite division of nonprofits. The Revised Model Act, like its predecessor, has been influential, and has now been adopted in some form in a number of states.

The subdivision of nonprofits into separate types, which is the central feature of the new generation of nonprofit corporation statutes, is clearly an effort to deal with the problems created by using a single corporate form to encompass a variety of organizations whose structures and functions differ considerably. The new typologies have not solved these problems, however. Indeed, they have arguably made the problems worse. Because the Revised Model Act is the best and most influential of the new generation statutes, I will make that statute the focus of my discussion.

The Revised Model Act is, in general, a model of draftmanship. It is superb in its details: comprehensive, clear, well organized, and well integrated. Unlike earlier statutes, it carefully defines key terms, such as »member« (which is defined as anyone who has the authority to vote for members of the board of directors). The problem with the Act, rather, is in its overall structure, which seems badly flawed at a fundamental conceptual level. More particularly, the problem is in the Act's tripartite typology of nonprofits.

#### 4. Mutual Benefit Nonprofits

Mutual benefit nonprofits are distinguished from Public Benefit Corporations by being, in general, less closely constrained and regulated. For example, while Public Benefit Corporations are subject to a clear and strong nondistribution constraint that ap-

plies both to current and liquidating distributions, Mutual Benefit nonprofits may distribute net assets to members upon dissolution. Likewise, Public Benefit Corporations are subject to a fiduciary duty of loyalty that – while subject to ambiguities in definition and enforcement as discussed below – is reasonably rigorous, while the managers of Mutual Benefit nonprofits are held to somewhat lower standards.

#### a) The Problems

These distinctions between Mutual Benefit and Public Benefit Corporations might be defensible and workable if the mutual benefit category were clearly confined to club-like entities. But it is not. Rather, the Mutual Benefit category is defined as a residual category that is available to any non-Religious Corporation that must not form as a Public Benefit Corporation. The only nonprofits that must form as Public Benefit Corporations under the Act are, in effect, those that seek federal corporate income tax exemption as a charitable-type entity under Section 501(c)(3) of the tax code.<sup>6</sup> Consequently, any organization that wishes to incorporate as a nonprofit, but does not seek 501(c)(3) status, can choose to form as a Mutual Benefit nonprofit if it wishes. Clearly this includes a lot more than just country clubs.

Indeed, by the specific terms of the Act, an organization need not even have members to form as a Mutual Benefit nonprofit.<sup>7</sup>

Moreover, since the jurisprudence under I.R.C. Section 501(c)(3) by itself imposes a nondistribution constraint and duties of loyalty roughly comparable to those imposed by the Public Benefit provisions of the Revised Model Act, the latter provisions are essentially redundant for any 501(c)(3) organization. Rather, those provisions have meaning only for non-501(c)(3) organizations that *elect* to form as Public Benefit Corporations rather than as Mutual Benefit nonprofits.

Does it make sense to make the more rigorous Public Benefit provisions applicable only to organizations that elect to be subject to them rather than to the weaker Mutual Benefit provisions? It might if somehow donors, beneficiaries, and other parties who deal with a nonprofit were aware whether an organization is a Public Benefit or a Mutual Benefit nonprofit, and if they knew what the difference is; they would then at least be on notice of the degree to which they are protected. But, while the Act requires that a nonprofit indicate in its charter whether it is Public Benefit, Mutual Benefit, or Religious, there is nothing in the Act that requires that this information be disclosed to the public.

Are the resulting problems serious? Consider, for illustration, the following hypothetical scenario: Five unscrupulous people incorporate, as a Mutual Benefit nonprofit, a health insurance company. They provide, in the charter, that they will be the sole members of the corporation, and that the members will elect the organization's five-person board of directors. They then elect themselves as the five members of the board. They also take on the major managerial positions in the organization, at reasonable rates of pay. They finance the organization with bank debt and with personal

6 REVISED MODEL NONPROFIT CORPORATION ACT, Section 17.07.

7 REVISED MODEL NONPROFIT CORPORATION ACT, Section 6.03.

loans that they make to the corporation, at reasonable interest rates. They advertise heavily as »The Consumer's Health Insurance Plan – a nonprofit alternative to ruthless managed care.« They bring in a lot of clients, whom they proceed to squeeze mercilessly, offering in fact the most ruthless form of managed care by cutting costs and quality wherever they think they can get away with it. They make big profits – which they accumulate within the organization – for five years, at which time they sell their entire business as a going concern to another health insurance company and repay the money borrowed by the organization, leaving the nonprofit corporation with tens of millions of dollars in aggregate cash profits. They then dissolve the corporation and distribute the cash to the members of the corporation – namely themselves.

Such behavior would be fundamentally inconsistent with the notion of a nondistribution constraint and with the patron protection function that this constraint is designed to serve. Yet it would clearly be in compliance with the explicit provisions of the Revised Model Act. To enjoin the distribution of profits involved, a judge would have to engage in highly creative interpretation of the Act, imposing on it a strong overlay of judge-made law. The situation, then, is no better than it was under the original, and very empty, Model Act of 1954. Indeed, the situation is arguably much *worse* under the Revised Act than under its predecessor because, under the Revised Act, a judge has the added burden of trying to evade the Act's very clear and elaborate provisions.

For example, under the old Model Act, a judge might enjoin the liquidating distribution in our hypothetical health insurance company by deciding that the corporation's so-called members are not really »members« as that term was intended to be understood in the Act. That would be a plausible decision, since the term »member« is not defined in that Act. But the five rapacious characters in our hypothetical are clearly »members« under the explicit definition of that term in the Revised Act, leaving a judge little room for discretion in interpretation.

Alternatively, under the old Model Act, a judge might try to interpret the distribution and related transactions as self-dealing transactions, and hold that, if they are not ratified by disinterested directors or members – of whom there are none in this case – it must be subject to substantive review by the court under a rigorous standard. But the Revised Act sets out very detailed standards for review of self-dealing transactions for Mutual Benefit nonprofits. And those standards provide that self-dealing transactions in a Mutual Benefit nonprofit (as opposed to a Public Benefit Corporation) can be ratified by members who themselves have a conflict of interest.<sup>8</sup>

In short, by combining great care in the details with great confusion in the overall structure, the Revised Model Act has left the law of nonprofit corporations in a nasty bind.

#### b) Potential Reforms

There are several potential approaches to reform.

*Notice.* One approach is to leave the Act more or less as it is, but just require that organizations disclose clearly whether they are Mutual Benefit or Public Benefit Cor-

porations – for example, by requiring that a nonprofit include the letters »PBC« or »MBC,« for »Public Benefit Corporation« or »Mutual Benefit Corporation,« at the end of its name (or »RC« for Religious Corporation). Then, if potential patrons wish to be assured that the organization is held to a tight nondistribution constraint, they could decline to deal with Mutual Benefit Corporations.

The obvious difficulty with this approach is that the average patron is likely to have difficulty understanding the distinctions between the different types.

*Definition.* Another approach is to tighten up the definition of the types of organizations that can qualify for Mutual Benefit status, confining the category just to organizations of a truly club-like, cooperative, or mutual character.

One step in this direction would be to require that, if an organization is to qualify as a Mutual Benefit Corporation, it must at least have members. As our health insurance hypothetical shows, however, that requirement in itself will not suffice; there needs to be a requirement that the organization not just have formal members, but be in some substantial sense a true membership organization. That requirement might be, for example, that an organization can qualify as a Mutual Benefit Corporation only if it receives at least half of its annual income from transactions with its members. That would clearly stop our hypothetical health insurance scam. More generally, it would assure that the Mutual Benefit category, as its title suggests, is truly confined to organizations that serve primarily their own members.

*Create a Separate Statutory Form for Associations.* Any effort to create two (or more) different types of nonprofit corporations that have markedly different characteristics faces two serious difficulties. The first is defining the types of organizations that fall within one category as opposed to the other. The second is the risk of depriving the term »nonprofit« of any clear connotation, and thus of crippling the nonprofit corporate form in its core bonding and signaling function – which is to serve as a means by which an organization can make a commitment to its patrons that the organization will exhibit a particularly high degree of fiduciary responsibility toward them.

This suggests that, if there are to be special standards for club-like or mutual-type nonprofits, it might be best to create an entirely separate corporate form for those organizations – one that does not use the term »nonprofit.« This new statutory class of organizations might be termed, for example, »Associations« or »Membership Corporations.« Such an Associations statute might require that organizations formed under it have members who elect the board of directors, and might – in the fashion of the Mutual Benefit provisions of the Revised Model Act – impose a prohibition on current distributions to members, but permit liquidating distributions.

By denying to Associations the use of the term »nonprofit,« the separate-statute approach largely avoids the need for a clear functional definition of the types of organizations that fall into one statutory category as opposed to the other. Under this separate-statute approach, the nonprofit corporation statute might appropriately take the form that would result if the Public Benefit provisions of the Revised Model Act were extended to all nonprofits formed under the Act, and the Mutual Benefit provisions were simply eliminated from the Act. The nonprofit corporate form would then be left open to any organization that is prepared to abide by a strict nondistribution con-

<sup>8</sup> REVISED MODEL NONPROFIT CORPORATION ACT, Section 8.31.

straint for both current and liquidating distributions and to be subject to strong fiduciary standards. The Associations statute, in turn, could be left open to any organization that has a board of directors elected by a defined membership and that is prepared to abide by a prohibition on current – but not liquidating – distributions to members. Fiduciary duties could be left at roughly the level that is currently applied to business corporations – that is, roughly similar to (though perhaps in terms of membership ratification, somewhat stricter than) the fiduciary duties applied to Mutual Benefit Corporations under the Revised Model Act.

This is, in essence, the approach taken in civil law jurisdictions, which typically have two separate statutory forms for nonprofit organizations: the *foundation*, which is designed roughly for charitable-type organizations without members, and the *association*, which is designed for membership organizations.<sup>9</sup> The state of New York once also had a separate membership organizations statute, but repealed that statute when it enacted its current nonprofit corporations statute containing special provisions for membership-type organizations as Type A nonprofits.<sup>10</sup>

*Use the Cooperative Statutes.* The two preceding approaches would involve creating, either within or without the nonprofit corporation statute, a statutory category of organizations that look very much like cooperatives. Is this necessary? Would it not make more sense just to have those organizations incorporate under a cooperative corporation statute, where there is no question that liquidating distributions to members are permitted? Indeed, would it not be much *better* to have organizations that wish to make liquidating distributions form under a cooperative statute, since well-drafted cooperative statutes regulate liquidating distributions to assure that they are fair as among the members involved, while the nonprofit statutes impose no such constraints?

This line of reasoning leads us to a third potential approach to reform: Revise the nonprofit corporation act, as under the preceding approach, to make it a unitary statute that universally applies a strong nondistribution constraint. But, instead of enacting a separate Associations statute, use the cooperative corporation statutes to accommodate membership organizations that want to make distributions to their members, whether currently or on dissolution. This would require, in some states, that the cooperative corporation statutes be reformed – for example, by eliminating arbitrary restrictions on purposes for incorporation. But that is a worthy task in its own right, and the preparation of a Model Cooperative Corporation Act might be an excellent companion project to the preparation of a new Revised Model Nonprofit Corporation Act.<sup>11</sup>

*Do We Need a Third Category?* The latter approach, in which membership organizations must form either as pure nonprofits or as cooperatives, differs from the preceding two approaches in that it would not offer a separate statutory form – either

9 For a summary of the laws governing nonprofit organizations in selected European (and other) nations, see Lester Salamon, *THE INTERNATIONAL GUIDE TO NONPROFIT LAW* (1997).

10 The New York Membership Corporations Law was repealed in L. 1969, c. 1066 2.

11 For example, even the better-drafted cooperative corporation statutes (such as Wisconsin's, WIS. STAT. 185.01 et seq. (1999)) might benefit from some revision – or at least a well-developed interpretive gloss – to deal more clearly with the contentious problem of refunding capital contributions.

within or without the basic nonprofit corporation statute – that permits liquidating distributions but not current distributions. Is it important to have this third category, which lies halfway between a true nonprofit and a true cooperative?

An argument in favor of creating this third statutory category of organizations is that there are, in fact, many membership organizations for which it might be appropriate. These are organizations, such as social clubs and business associations, that, though they essentially serve only their members, have no need to make current distributions of cash. Such organizations might be aided by a clear ban on such distributions to help prevent any subgroup of the members from behaving opportunistically toward their fellow members. Yet, upon liquidation of the organization, there is nobody who has a better claim to the organization's assets than its members. Moreover, if the members cannot distribute net assets to themselves on dissolution, they have an inefficient incentive just to waste the firm's assets once it becomes clear that the organization is no longer serving a useful purpose.

The argument *against* having a special statute for this intermediate third category, on the other hand, is that legitimate membership organizations can put a bar on current distributions in their charters even if they form under a cooperative statute; they do not need the special third category to bond themselves to their members and other patrons. At the same time, the fact that an organization has been incorporated under a statutory form that permits only liquidating distributions may not provide much of a guarantee to the organization's potential members or patrons that they can place special trust in the organization: those who effectively control the organization are still free to engage in profiteering, as with our hypothetical health insurance company.

*Can Membership Organizations Ever Be True Nonprofits?* Implicit in the preceding discussion has been the assumption that, even if we exclude from the basic nonprofit corporate form any membership organizations that wish the authority to make liquidating distributions, that statutory form will still be available to membership organizations that provide services to their members, so long as they make neither current nor liquidating distributions in cash.

But one might argue, on the contrary, that a membership organization that provides services to its members should never be permitted to organize under a nonprofit corporation statute, even if it is committed never to make *cash* distributions to its members, because distributions in kind are not meaningfully different from distributions in cash: both can be used to distribute net earnings. A truly rigorous nonprofit corporation statute should prohibit *any* distributions, whether in cash or in kind. Hence, organizations that provide services to their members should be required to form under another statute – either a separate Associations statute, or a cooperative statute.

Indeed, one might even go further. Since all membership organizations presumably serve their members in some fashion, perhaps *no* membership organizations should be permitted to form under a nonprofit corporation statute. Rather, a nonprofit corporation statute should be confined to organizations whose boards are not selected by the organization's beneficiaries.

The latter approach is in essence the approach taken by civil law jurisdictions, which provides separate statutory forms for »foundations« and »associations.« The foundation form is designed for non-membership nonprofit organizations. Membership or-

ganizations are then governed, not by the foundation statute, but rather by the separate associations statute.

A U.S. version of this approach might provide for just two basic statutes: (1) a nonprofit corporation statute, which would impose a rigorous nondistribution constraint and would not permit members (which is to say that persons who are among the organization's beneficiaries could not have a vote in choosing the organization's board of directors); and (2) a cooperative corporation statute, which would have no nondistribution constraint (but which would permit an organization to adopt a nondistribution constraint in its charter that would forbid current or liquidating distributions). Another alternative would be to provide for those two statutes plus a membership organizations statute, which would prohibit current but not liquidating distributions. Yet another alternative would be to add to the preceding three statutory forms, for completeness, a fourth statute – which might have a separate label such as »nonprofit membership organization« or »association« – that would provide for membership organizations that are prohibited by the statute from making either current or liquidating distributions.

*A Suggested Approach.* My own view, offered somewhat tentatively, is that the wisest approach is to employ just two statutes: a nonprofit corporation statute and a cooperative corporation statute.

The nonprofit corporation statute would permit organizations formed under it to have members – that is, persons who vote in elections for the board of directors – who also are among the beneficiaries of the firm's services. The statute would impose a rigorous nondistribution constraint, prohibiting all cash distributions to members (or other controlling persons) either currently or on dissolution. Provision of services to members would be considered improper only if they effectively amounted to a distribution of net earnings – which is to say, if the provision of services was clearly being used as a means of distributing to the members involved the proceeds of profitable transactions with nonmembers or with other, noncontrolling members.

The cooperative statute would be of roughly the form of the better-drafted contemporary cooperative statutes (though perhaps with some reforms that should be made in those statutes in any case). Any membership organization that wished to retain the authority to make liquidating distributions (much less current distributions) would be required to form under that statute, or under a business corporation statute.

This approach would recognize that there are, in effect, two different kinds of membership organizations: the cooperative-type, which exist principally to provide private goods and services to their members, and the nonprofit type, which may in part provide private goods and services to their members but which also serve in important part as philanthropic intermediaries for channeling funds from members and others to worthy third parties or to the provision of public goods.

The nonprofit statutory form would then serve as a clear signal: an organization could state that it is »nonprofit« if and only if it were clearly bound by a rigorous nondistribution constraint.

The redrafting effort required for this approach would be minimal: it would simply involve deleting from the Revised Model Nonprofit Corporation Act all special provi-

sions for Mutual Benefit Corporations, and extending the provisions for Public Benefit Corporations to all organizations formed under the Act.

## 5. Religious Organizations

As noted earlier, the Revised Model Act distinguishes Religious Corporations as a separate category. The effect of this categorization is to impose upon religious organizations rules that are in some ways more restrictive, and in other ways less restrictive, than they might otherwise be under the Act.

For most purposes, the Act lumps Religious Corporations together with Public Benefit Corporations, applying the same rules to both. In this respect, the separate definition of Religious Corporations, together with the Act's assignment to that category, on a seemingly mandatory basis, of any corporation »organized primarily or exclusively for religious purposes,« has the effect of holding religious organizations to the relatively strict standards of Public Benefit Corporations rather than the looser standards of Mutual Benefit Corporations. If the latter category were to be eliminated – as suggested above – then the need to define Religious Corporations separately to achieve this result would also disappear: all nonprofit corporations – religious as well as secular – would then necessarily be subject to the same standards.

There are, however, some points at which Religious Corporations are distinguished from Public Benefit Corporations in the Act, and the reason is always to apply somewhat more relaxed standards to the Religious Corporations. For example, the powers of the Attorney General to review the affairs of Religious Corporations are less strong than they are for Public Benefit Corporations,<sup>12</sup> and Religious Corporations are not subject to the requirement that a majority of the directors of a Public Benefit Corporation be independent.<sup>13</sup>

One potential justification for treating religious organizations less rigorously than other nonprofits, such as secular charities, might be that religious organizations are presumed generally to be more honest, and hence less in need of regulation. Judging from the prominent scandals of recent years, however, this is a dubious presumption.

Another potential justification is that the dangers of inappropriate governmental interference in religious matters are much stronger than the dangers of governmental interference in other types of activities carried on by nonprofit organizations. Consequently, even if the likely level of fraudulent behavior in both secular and Religious Corporations is similar, it might be reasonable to make the controls on that behavior less intrusive in the case of Religious Corporations.

It is not at all obvious, however, that the risks of religious persecution by means of the corporation law are acute today (whatever might have been the case 200 years ago).

12 E.g., the secretary of state must give notice to the attorney general when dissolving a Public Benefit Corporation, but not when dissolving a Religious Corporation, REVISED MODEL NONPROFIT CORPORATION ACT, Section 14.21(a), and Public Benefit Corporations, but not Religious Corporations, must give to the attorney general the names and addresses of the individuals who received the organization's assets, Section 14.03(c).

13 REVISED MODEL NONPROFIT CORPORATION ACT, Section 8.13. Even for Public Benefit Corporations, the Revised Model Act offers this provision only as a statutory option.

Political struggles over religious issues, such as abortion, tend to get played out now in other regulatory arenas. Moreover, it is arguable that, by applying less rigorous standards to religious organizations than to secular organizations, the law effectively impairs the effectiveness of, and in this way discriminates against, religious organizations in general. If the standards that the Revised Model Act applies to Public Benefit Corporations in general are appropriate for organizations such as secular charities, then presumably they should be appropriate for charities of a religious character. To apply less rigorous standards to religious organizations than to charities is simply to make it easier for unscrupulous persons to defraud the public in the name of religion than in the name of secular charity. The result, in turn, is that the public will have reason to be more suspicious of religious organizations than of secular charities, and hence will be less willing to support religious organizations than secular ones. It is rather like making religious organizations immune from suits for breach of contract: whatever the intent of such a rule, the effect might plausibly be to dry up commercial credit for churches. Rules of this character arguably just aid fraudulent religious organizations while harming legitimate ones.

As with Mutual Benefit Corporations, it would arguably be wise just to eliminate the separate category for Religious Corporations and treat them like any other legitimate nonprofit corporation. This does not mean, of course, that courts should not keep a close watch, in situations involving religious organizations, on the Attorney General's use of her authority under the Act to review various transactions.

## II. The Problem of Exit

Arguably the largest practical problem facing the U.S. nonprofit sector today is that it is heavily populated with organizations that should not exist as nonprofit corporations, either because (1) they would more appropriately be organized as for-profit firms or (2) they represent excess capacity in their industry and should simply be dissolved. This gives rise to the problem of »exit«: the need to find efficient and equitable means of converting or dissolving nonprofits that fall within these two categories.

The problem is most conspicuous in the hospital industry, where 150 years of technological and organizational evolution have changed the industry from one that was almost entirely charitable to one that is almost entirely commercial and seemingly best organized along profit-seeking lines. There have already been many conversions of nonprofit hospitals to for-profit form. Nevertheless, nearly two-thirds of U.S. hospitals remain at least formally nonprofit – a fraction that has changed little over the past 35 years, despite the organizational revolution in health care in that period. Primary health care (HMOs), nursing care, child care, and education are other industries where the problem of exit is pressing.

From the legal point of view, there are two relatively distinct – indeed, opposing – problems here. The first is that there are too few conversions and dissolutions of nonprofit firms. The second is that many of the conversions that do take place are inequitable and inefficient. I will deal with these problems here in reverse order.

### 1. Opportunistic Exit

Recent years have witnessed many conversions of nonprofit organizations – particularly hospitals and health maintenance organizations – to for-profit form on terms that can at best be described as opportunistic and at worst as theft. Institutions whose going concern value is in the tens or hundreds of millions of dollars, or even more, are sold to for-profit firms at a fraction of their value, with the remainder of the value ending up in private hands. Part of the problem is simple negligence on the part of nonprofit officers and directors, and part of the problem is self-dealing.

The potential loss of assets to the nonprofit sector through such opportunistic transactions is enormous. It is possible that two-thirds of the assets of the nonprofit sector are represented by organizations that should be, and ultimately are likely to be, converted to for-profit form. If conversions continue to take place on the terms that we have seen in the past, at least half of the net asset value of these organizations could end up in private hands in the course of the transactions. This means an aggregate loss of one-third of the net asset value of the nonprofit sector.

### 2. Discussion and Solutions

#### a) Fiduciary Duties

As others have noted, these are problems that should be controlled much better through the corporate law of nonprofits.<sup>14</sup> The obvious solution is to impose and enforce stronger constraints on nonprofit managers through the corporate law fiduciary duties of care and loyalty.

With respect to duty of care, nonprofit directors can be held personally liable for failure to inform themselves fully about the terms of a conversion transaction, and to seek the best terms for the corporation. With respect to duty of loyalty, courts can apply strict substantive review to transactions where officers or directors of a nonprofit stand to benefit personally by the transaction, either through employment or other affiliation with the purchaser or by, for example, a role as an officer or director of a foundation that is established to administer the funds received by the nonprofit in the conversion transaction.

An obvious refinement of duties of care and loyalty in this context is to impose on nonprofit boards an auctioneering obligation, analogous to the *Revlon* duties now applied to business corporations, requiring that, once it has been decided to sell the nonprofit's business to a for-profit firm, the board must seek the highest price possible for that business. An exception to the highest price rule might, of course, be allowed if the board can bear the burden of making a convincing demonstration that sale to another bidder will in some important way better serve the nonprofit's purposes.

A useful complement to these duties might be mandatory anticipatory disclosure of the terms of any conversion transaction, including any participation by officers and di-

<sup>14</sup> E.g., Harvey Goldschmid, *The Fiduciary Duties of Nonprofit Directors and Officers: Paradoxes, Problems, and Proposed Reforms*, 23 J. CORP. LAW 631 (1998). See also the other articles on nonprofits in the same issue.

rectors, to the state attorney general, with general public availability of the information disclosed.

#### b) Enforcement

In most states, the attorney general is the only person with standing to sue directors or officers of a nonprofit corporation that (like most commercial nonprofits of concern here) do not have members. Policing of conversion transactions by the attorney general's office is now moderately rigorous in some states. But the amount of resources that even the most activist states can devote to these transactions is modest, and many states do little at all.

If conversion transactions are to be better monitored, the obvious solution is to give standing to private parties to challenge them. The logical candidates for this role are competing bidders for the nonprofit's business. It is, after all, competing bidders that bring the great bulk of suits to challenge board decisions regarding mergers and acquisitions involving business corporations. While standing in the latter cases is usually formally justified on the basis that the competing bidder is a stockholder in the target, the better rationale for competing bidder standing – acknowledged by some courts – is that the competing bidder makes an excellent plaintiff in such cases. A frustrated bidder for a business corporation has an incentive to scrutinize closely the board's decision to sell to another firm, detailed knowledge of the transaction, the ability and will to devote substantial financial resources to the suit, and interests that – for the transaction at hand – line up well with those of the target corporation's shareholders. The same is also true of a frustrated bidder for the business assets of a nonprofit corporation; we need only replace »shareholders« with »beneficiaries« in the preceding sentence.

I will return to questions of standing in a broader context below, where I will suggest a substantial broadening of current rules in general. Even for those not willing to follow those suggestions immediately, bidder standing in conversion transactions is very much worth considering as a modest change in the standing rules that offers very large benefits in policing a major class of transactions.

#### c) No Exit

Although more rigorous scrutiny of board decisions in conversion transactions promises to mitigate the hemorrhaging of assets from the nonprofit sector that has been associated with these transactions, such scrutiny promises at the same time to accentuate the other problem of exit that is acute in the nonprofit sector – namely, the common reluctance of nonprofit managers to convert or dissolve their firm even when that would be the best course to pursue.

Reluctance to engage in such transactions is, of course, familiar even in business corporations. But there is every reason to expect it to be even stronger among nonprofits. Managers of nonprofits are very likely to lose their autonomy and even their jobs when such transactions occur. Keeping their organization's nonprofit form, on the other hand, largely insulates them from the market for corporate control; hostile takeovers of nonprofit firms are today essentially impossible.

Moreover, the nonprofit form also shields managers from competitive pressures in the product market. Even without tax preferences, a nonprofit corporation that has already accumulated substantial assets – as, for example, most nonprofit hospitals have – can outcompete for-profit firms even when the latter operate much more efficiently. A nonprofit can survive and even grow at rates of return on investment that would drive a for-profit firm from the market. The reason is not that nonprofit firms enjoy any real economies in capital financing that for-profit firms lack, but rather that nonprofit firms often fail to recognize the opportunity cost of the capital they employ.<sup>15</sup>

The result is that substantial amounts of assets can effectively become trapped in nonprofit institutions. The hospital industry offers a good illustration. That industry is today affected by substantial overcapacity: there are many more hospital beds in the nation than are needed. Yet two-thirds of those beds are in nonprofit institutions that have no incentive to downsize or liquidate their facilities, or to sell their operations to a for-profit firm that will undertake that downsizing.

Reluctance to convert or liquidate the assets of a nonprofit is not, of course, necessarily a sign that the directors or officers of a nonprofit are acting in bad faith. It is natural, and perhaps salutary, that the virtues of the nonprofit form, and of the services provided by their own organization, have a particularly high salience to those individuals. It is simply important that the bias created by this salience be balanced with appropriate pressures from outside the organization.

15 I have elsewhere offered the following illustration: Imagine, for example, that a given community is served by two hospitals, one investor-owned and one nonprofit. Neither hospital provides any research, education, free care for the indigent, or other public goods; rather, they both just sell private medical services to individuals capable of paying for them. Each hospital has \$100 million in net assets, in the form of physical plant and equipment that could be sold on the market for that amount. The nonprofit hospital, let us suppose, benefits from no explicit or implicit subsidies, private or public. Rather, like the investor-owned hospital, the nonprofit hospital is subject to aggregate federal and state corporate income taxes of 50% on net earnings. The for-profit hospital has annual net earnings of \$15 million, representing a 15% gross rate of return on its invested capital, which yields \$7.5 million dollars, or 7.5%, after taxes. This rate of return is just equal to the market rate of return for similar investments, leaving the firm with no incentive to either expand or contract its investment. The nonprofit hospital is substantially less cost efficient, with annual net earnings of just \$6 million, or 6% of net assets, yielding \$3 million, or 3%, after taxes. If the nonprofit hospital were, instead, an investor-owned institution, this below-market rate of return would presumably induce the firm – if it could not otherwise improve its performance – to sell its plant and equipment to another firm that could make them yield a gross return of at least 15%, either in providing hospital services or in some other activity. But the nonprofit hospital is under little pressure to do this. Rather, its managers are free to, and have some incentive to, invest the hospital's net earnings in further plant and equipment. Thus the nonprofit hospital is in a position to expand by up to 3% per year, taking market share from its investor-owned competitor and ultimately, if it chooses, driving the latter out of business entirely, even though the nonprofit firm is clearly the less efficient producer (and even though it benefits from no publicly-provided fiscal or regulatory advantages).  
Henry Hansmann, »The Changing Roles of Public, Private, and Nonprofit Enterprise in Education, Health Care, and Other Human Services,« in Victor Fuchs, ed., *INDIVIDUAL AND SOCIAL RESPONSIBILITY: CHILD CARE, EDUCATION, MEDICAL CARE, AND LONG-TERM CARE IN AMERICA* (1996).

Exposing nonprofit boards to lawsuits if they fail to perform their fiduciary duties in a conversion transaction will, of course, only make the problem of entrenchment here worse – for the best way to avoid such lawsuits is simply to avoid conversion.

We need to seek, then, some countervailing pressure that can be applied through corporate law to encourage conversion when that is the appropriate course. One possibility is to go beyond a simple *Revlon*-type auctioneering rule, which is triggered only when a corporation's board decides to sell the firm, and place a fiduciary duty on a nonprofit corporation's board to entertain seriously any offer to purchase the firm's operations. This would exceed even the duties now imposed on the directors of business corporations, which in effect have generally been permitted to »just say no« to a hostile bidder on their sole discretion. Whatever the merits of giving for-profit boards such authority to avoid acquisitions – and that issue is much debated<sup>16</sup> – there is good reason to deny nonprofit boards the power to just say no, and instead to place a burden on a nonprofit's board to justify, when challenged, a decision not to sell.

Again, to assure enforcement of this obligation, standing could be given to frustrated bidders. The problems facing the courts in administering such an fiduciary duty should not be severe. If, say, a for-profit firm were to offer to purchase a nonprofit hospital's assets for \$100 million, and the nonprofit's board were to refuse, the board would simply have to present evidence to the court that it had carefully considered the advantages and disadvantages of the transaction, and to offer good reasons why it believed the nonprofit corporation could serve the cause of health care better by continuing to operate the hospital rather than having the hospital administered by the bidder and, say, using the proceeds of the sale to establish a foundation with \$100 million in assets that it could devote to subsidizing medical care for the indigent and financing medical research. Of course, if it is clear that the for-profit bidder can operate the hospital as well as – and at no higher prices than – the nonprofit can, then this burden will be very difficult for the nonprofit's board to sustain.

#### d) Competing Fiduciary Duties

The difficult problems of exit facing the nonprofit sector have their source in the essential characteristic of nonprofit institutions – namely, the complete separation of control from the right to appropriate the organization's net returns. The natural consequence of this separation is a strong tendency toward managerialism. So long as a nonprofit organization operates in an industry where the nonprofit form is appropriate – which is to say, where one or another class of the organization's patrons cannot protect their interests adequately through ordinary market contracting – the tendency toward managerialism need not be particularly harmful. Indeed, a bias toward investing funds internally and preserving the organization may be reasonably functional.

When, however, the nonprofit form becomes anachronistic, managerialism becomes more costly. The separation of earnings from control deprives a nonprofit's managers

16 A clear and concise argument that Delaware law has been ill-advised in permitting directors of business corporations to »just say no« is offered in Ronald Gilson, »UNOCAL Fifteen Years Later (And What We Can Do About It),« Pileggi Lecture at Widener University School of Law, October 22, 1999.

of any direct incentive to convert or dissolve the organization, much less to pursue such a restructuring in the most efficient manner. As a consequence, there is good reason for the law to play a more intrusive role in exit decisions than in other aspects of a nonprofit corporation's affairs.

In this regard, fiduciary duties are the principal tool available to the law. To some extent, those tools can be used, as in the law of business corporations, to give leverage to other actors – such as competing bidders for a nonprofit's assets – who will help assure that nonprofit managers pursue efficient policies. But, in contrast to business corporations, nonprofit corporations have no ultimate owners to whom the courts can ultimately refer decisions. The courts themselves must be prepared to take a more activist role in supervising some types of managerial decisions – as in taking a more skeptical response to »just say no« decisions in nonprofit corporations than in business corporations. If a business corporation's board of directors continually frustrates its shareholders' best interests by refusing to sell the firm, the shareholders are ultimately likely to replace the board through a proxy fight. But that cannot happen in a nonprofit corporation that lacks members.

The exit problem facing the law of nonprofits is further complicated by the opposing effects of the fiduciary duties involved. The stronger the law scrutinizes managerial opportunism in conversion transactions, the more the law will inhibit such transactions in general, and thus the more necessary it will be to rely upon the law to impose a strong – and surely controversial – affirmative legal duty on nonprofit managers to entertain purchase proposals seriously.

In short, if we wish to shape the law to help assure efficient restructuring of nonprofits, we must rely more heavily and directly on fiduciary duties than we must in the case of business corporations, and we must engage in a delicate balancing of those duties.

#### e) Purposes for Incorporation

In many nations the law places restrictions on the purposes for which nonprofit firms can be formed. This was also the case in a number of U.S. states in years past. Contemporary U.S. law, in contrast, generally permits formation of a nonprofit corporation to pursue any purpose, so long as the nondistribution constraint is observed.

One might think that restrictions on purposes would help solve the exit problem by assuring that nonprofits are formed only for purposes for which the nonprofit form is suited. But the U.S. experience indicates strongly that this is not true. The serious problems of exit facing the U.S. nonprofit sector today involve organizations, such as hospitals, for which the nonprofit form was clearly suitable when the organizations were formed. Restrictions on purposes for formation will not, therefore, be helpful. As a consequence, it seems best to continue to permit nonprofit corporations to form for any (non-criminal) purpose whatever, and then attack the exit problem separately.

Indeed, experience both in the U.S. and elsewhere suggests strongly that restrictions on the lawful purposes for forming nonprofit corporations will not be used effectively to prevent the formation of inefficient organizations, but rather will be employed only

to prevent the formation of firms that interfere with some established interest – which are usually the nonprofit organizations that have the most to offer society.

### III. Fiduciary Duties in General

I have just suggested that fiduciary duties of care and loyalty must bear a heavier burden in the area of exit decisions than they must in the day-to-day affairs of nonprofits. But this is not to say that they are unimportant in the latter realm. On the contrary: since the boards of nonprofits are often self-perpetuating, fiduciary duties are in many cases the only form of direct accountability that nonprofit directors face.

#### 1. Duty of Loyalty

Restrictions on self-dealing transactions are an important adjunct to the nondistribution constraint. Some years ago I suggested that directors and officers of nonprofit corporations be subjected to a simple prohibition on any form of self-dealing transaction. I have come to believe that such a strong rule is unnecessary – that the advantageous transactions it might frustrate would outweigh in value the costs of the opportunism such a rule would prevent. But I continue to believe that self-dealing transactions involving nonprofit firms should be subject to tight constraints.

The formulation of the duty of loyalty that is applied to Public Benefit Corporations in the Revised Model Nonprofit Corporation Act is arguably appropriate as a general standard, requiring that decisions either be ratified by disinterested directors or members, or be subject to reasonably close scrutiny by a court. (The standard applied in the Model Act to Mutual Benefit Corporations, in contrast, should be rejected, as suggested earlier.)

The nominal statutory standard, however, provides little guidance to appropriate procedures and conduct in specific cases. What constitutes a conflict of interest? What are the standards for determining whether a director is »independent,« or a member is disinterested, for purposes of ratification? What kinds of disclosure are required? What standards of review should courts apply when disinterested ratification is not obtained? To provide clarity, more elaborate rules and standards are needed – such as the specific duties discussed above for managerial behavior when confronted with a hostile acquisition bid. These standards might be elaborated by courts or by other institutions. I will consider further how this might be done below, after addressing the duty of care.

#### 2. Duty of Care

It is frequently argued that, because directors of nonprofit corporations are often unpaid volunteers, they should not be held to high substantive standards of conduct, particularly with respect to their duty of care in transactions in which they have no personal interest. This is, I believe, mistaken. Many nonprofit organizations today are very large and play key roles in our economy. The boards of those firms, unlike the boards of business corporations, commonly are the ultimate repository of responsibility for the firms' fate; there is nobody else, such as shareholders or members, with the

authority to second-guess them or replace them. If unpaid volunteers are unwilling or unable to shoulder this responsibility in a responsible fashion, then nonprofits should perhaps begin compensating their directors, as they do their officers.

This suggests that directors of nonprofits should be held to a duty of care that is at least as rigorous as that applied to the directors of business corporations. The standard applied to Public Benefit Corporations in the Revised Model Act, again, seems roughly appropriate. As with the duty of loyalty, however, that standard alone is not enough: it must be filled out with a more detailed set of standards or representative cases.

In developing those standards, it is very difficult to separate the duty of care from the duty of loyalty. Courts will rarely – nor should they – second-guess managers in making decisions when there is no obvious conflict of interest for anyone inside the firm, no matter how sloppy the managers have been. Rather, directors who are not themselves self-interested commonly are found to have breached their duty of care only when they have failed to exercise even minimal supervision over corporate officers who are themselves self-interested. This has, in fact, been the situation in the few significant cases – e.g., those involving Sibley Hospital, United Way, and Adelphi University – in which directors of nonprofit organizations have been found (though not always under corporate law) to be in breach of their duty to the corporation.

Courts need more guidance, moreover, not just with the substantive standards of review to apply to the conduct of nonprofit officers and directors, but also with the remedies they should grant when those standards are violated. There are the usual problems, for example, of determining the types of misconduct for which a nonprofit should be allowed to insure or indemnify its directors or officers – problems that are arguably not much different from those faced by business corporations. But in dealing with nonprofit corporations, courts should perhaps also be prepared to rely heavily on reputational sanctions. Prominent individuals often serve on nonprofit boards as a means of gaining prestige. It may often be a fitting and sufficient sanction for such individuals to be penalized, not via monetary damages, but rather with removal from the board and perhaps an injunction against their ever serving on the board of another nonprofit corporation. Courts that realize that they can confine their remedies to such reputational sanctions may feel less inhibited in reviewing closely the actions of nonprofit boards of directors.

#### 3. Standing to Sue

An important reason why the law of nonprofit corporations, in contrast to the law of business corporations, lacks a refined jurisprudence of fiduciary duties is that those duties are rarely litigated. The reason there is little litigation, in turn, is that almost nobody has standing to bring suit – and, where standing does exist, there has been little incentive to sue.

As noted earlier, in most states the general rule is that only the attorney general has standing to bring suit against the officers or directors of a nonmembership nonprofit corporation for breach of duty to the corporation. And, as we have noted, even in spectacular cases of malfeasance of the type that have been common in nonprofit con-

version transactions, state attorney generals have in general lacked the resources or the incentive to serve as adequate monitors.

The question of standing was largely avoided by the drafters of the Revised Modal Act, as it had been by the drafters of the Model Act that preceded it. The Revised Model Act explicitly provides for standing for members, as we have noted, but is simply silent as to whether anybody else might have standing. Consequently, standing rules are badly in need of reexamination and reformulation.

What might new standing rules look like? If the corporate law of nonprofits is ever to become a meaningful body of law, standing must surely be expanded. An obvious solution is to expand standing broadly to all donors of a nonprofit, and to all beneficiaries and potential beneficiaries as well. I have argued for such a rule previously,<sup>17</sup> and I still believe that it is appropriate.

But an expansion of standing alone is unlikely to lead to any significant amount of litigation. Several jurisdictions – for example, the state of New Jersey – have in the past adopted generous rules of standing for fiduciary duty suits involving nonprofits yet still have seen little or no litigation in the area. The reason, of course, is that litigation is expensive, and generally there will be no personal financial recovery for the plaintiff in a derivative action involving a nonprofit; all funds recovered will, instead, go to the corporation itself.

This suggests that the only means of facilitating private suits against nonprofit officers and directors is to provide for recovery of attorneys' fees in successful cases. Will this result in a flood of nuisance litigation and strike suits? It need not, if the courts wisely use their discretion to dismiss suits and to deny recovery of attorney's fees when that is the appropriate result. It would be a useful project to establish some guidelines in this area.

#### 4. Interpretation of the Standards

Even if the rules regarding standing and attorneys' fees are altered sufficiently to encourage an appropriate level of litigation regarding the conduct of nonprofit directors and officers, it is likely to be many years before sufficient case law has developed to provide adequately detailed guidance for the actors involved. Consequently, there is much to be said for having a non-judicial body, such as the American Law Institute, develop a well articulated set of conduct standards for nonprofit officers and directors.

#### D. Tax Law

In discussing the potential reform of tax law for nonprofits, I will address only the three principal structural issues involved: exemption, taxation of unrelated business income, and deductibility of donations. First, however, it is important to say something about the relationship between tax law and corporate law.

<sup>17</sup> Henry Hansmann, *Reforming Nonprofit Corporation Law*, 129 PA. L. REV. 497, 606-15 (1981).

#### I. Tax Law as Corporate Law

Perhaps one reason that nonprofit corporation law has to date been largely ineffective in controlling the managers of nonprofit organizations is that tax law has long been the principal tool employed for that purpose. Or perhaps causation runs the other way: we have long relied on tax law to police the conduct of nonprofit managers because nonprofit corporation law has defaulted in this role.

In any event, tax law – and particularly federal corporate tax law – has long served, in effect, as the corporate law of nonprofits in the U.S. In particular, it is in the tax law that the nondistribution constraint is best defined and enforced. Thus, while nonprofit corporation law has long been vague about the permissibility of distributions to controlling persons on dissolution, the tax law has been quite clear that the ability to make such distributions is generally impermissible for organizations seeking exemption. Likewise, it has been the tax code, regulations, rulings, and cases – and not the corporate law duty of loyalty – that have defined the limits on self-dealing transactions by nonprofit managers, and it has largely been the IRS – rather than state attorneys general or private plaintiffs in derivative suits – that have enforced those limits. As a consequence, when citizens want to know whether an organization is legitimately nonprofit, they do not inquire whether it is a nonprofit corporation, or even a Public Benefit Corporation, but rather whether it is »tax-exempt« (or, with even more precision, whether it is a 501(c)(3) organization).

The special federal tax rules for private foundations have been, until recently, the most extreme example of the use of tax law for corporate law purposes. Those rules constitute, in effect, a detailed and rigorous corporations code for private foundations, backed up by a rigorous system of audits and fines. Indeed, the corporate-law nature of those rules is reflected in the fact that the tax code virtually mandates that the individual states adopt them as part of their nonprofit corporation law – which the states have done.

The more recent statutory and regulatory provisions for »intermediate sanctions« constitute another, and even more dramatic, step in the same direction, creating and enforcing under the federal corporate income tax an extremely rigorous, elaborate, and intrusive regulation of self-dealing transactions – in effect, a corporate-law-type duty of loyalty – for important categories of nonprofit organizations.

Reliance on the tax law as a source of corporate law has some advantages: the IRS has substantial expertise in the area; the Treasury has a pecuniary interest in assuring that nonprofits are managed honestly; tax reporting provides a convenient mechanism for bringing malfeasance to notice; and the tax authorities are unlikely to bring frivolous suits.

Yet relying on tax law to serve the role of corporate law also creates some important difficulties. One important source of these difficulties is that the interests of the IRS and the interests of the general public do not entirely coincide when it comes to the behavior of nonprofit organizations.

Private foundations provide a good illustration. The prototypical private foundation (and the type of most concern to the IRS) is an entity that receives all of its income from a single family, and that is directed by a board that is dominated by the donors.

In effect, it is the nonprofit version of a family-owned close corporation. The typical private foundation, moreover, conducts no productive activities of its own, but rather exists only to give grants. It is simply a vehicle through which a family makes donations to causes that the family itself finds worthy.

From a corporate law point of view, such an organization is of little importance. Of what concern is it if the managers of the foundation – the family – engage in self-dealing? It is only themselves that they could be cheating. Tax matters aside, who cares if the family wishes to donate money to the foundation and then steal it back again? Who is relying on the organization's nonprofit form to protect their interests? It could only be the organization's beneficiaries. Yet as a general matter even the beneficiaries are presumably relying, if at all, not on the organization's nonprofit form, but rather on the family that funds and controls it. The fact that the family channels its giving through a foundation could be of significance to a beneficiary, it would seem, only in the highly unusual case in which the beneficiary wishes to rely on a grant that, by its terms, is to pay out over some period of time in the future: if the grant is made by a well-capitalized foundation rather than by the family directly, then future payment of the grant will be less affected if the family should become insolvent and go into bankruptcy.

In consequence, if corporate law were to be the principal means by which self-dealing rules were defined and enforced, one would both expect and desire that virtually no attention be paid to private foundations. Under the federal tax law, in contrast, private foundations have long been by far the strongest focus of attention. This is because, while individual members of the public contribute little to private foundations that they do not control, the Treasury makes a very large contribution to those organizations through the charitable deduction and tax exemption. And the donors' tight control over the organization, which makes it uninteresting for corporate law purposes, makes it especially prone to opportunism for tax purposes.

In contrast, in those transactions in which the interests of the public at large are most at stake today – namely conversion transactions in which a valuable nonprofit facility is sold to a for-profit firm at a fraction of its true value, thus depriving the nonprofit sector of tens of millions of dollars – the IRS has a very strong pecuniary interest in *not* bringing suit. If the transaction goes through at the original artificially low price, the Treasury stands to reap substantial tax revenues when, as commonly happens, the assets are subsequently resold at full value. If, on the other hand, the IRS sues and succeeds in enjoining the transaction, with the result that either there is no sale or that the purchaser pays full price for the assets, the Treasury will be denied its subsequent capital gains. In short, the Treasury has a strong pecuniary interest in *promoting*, not preventing, opportunistic conversion transactions.

Finally, the tax authorities responsible for enforcing the exempt organizations provisions have no interest at all in (or even jurisdiction over) nonprofit organizations that are not tax-exempt. Yet those entities constitute a significant class that may grow substantially in the future. (Consider, for example, the now taxable nonprofit insurance companies.)

Beyond these considerations, the IRS has severely limited resources for enforcement in general, and much more tempting targets for enforcement outside the nonprofit sector than within it. The IRS is also subject to lobbying and congressional interfer-

ence, either to be overzealous (as it arguably was, for example, thirty years ago with the then-politically-sensitive private foundations) or underzealous (as it arguably was at the same time with the then-politically-popular medical sector).

More broadly, it seems bad policy in general to rely heavily on the tax code and tax authorities for non-tax regulatory purposes. By paying too much attention to those other, sometimes competing aims, the ability to collect taxes may itself be impaired, both by distracting the Congress and the IRS and by undermining the simple legitimacy of the tax code in the eyes of the public.

A useful overall aim for a project on the reform of the law of nonprofits, therefore, would be to seek to move the definition and enforcement of corporate law matters – in particular, the responsibilities of controlling parties in a nonprofit toward the organization, its donors, and its beneficiaries – out of the tax law and into the corporate law, where it belongs. Unfortunately, with the IRS's new intermediate sanctions regulations just coming into force, such a project requires recapturing a fast horse that's already well outside the barn doors.

While thus taking corporate law out of the tax law, it would also be a good idea, as suggested earlier, to take tax law out of the corporate law. At present, the category of Public Benefit Corporations defined in the Revised Model Nonprofit Corporation Act explicitly demarcates for separate treatment under corporate law essentially the same subclass of nonprofits that is demarcated for special tax treatment under section 501(c)(3) of the Internal Revenue Code. But there is no direct connection between the reasons for governmental support of an organization – which is what section 501(c)(3) is keyed to – and the reasons for subjecting the organization's officers, directors, and members to unusually strict fiduciary duties.

Having thus disposed of the improper uses of tax law, we can now turn to the tax law's more legitimate concerns.

## II. Tax Exemption

Nonprofit organizations are commonly exempt from taxes of various types, including federal and state corporate income taxes, state and local property taxes, and state and local sales taxes. These exemptions are not given to all nonprofit corporations, but only to those that pursue specific purposes. The major problem for policy in this area is the delineation of those purposes.

### 1. The Evolution of Policy

The problem has never been approached with much coherence. Until recent decades, the practice was effectively to extend exemption – and especially corporate income tax exemption – to nearly all legitimate nonprofit corporations (that is, to all nonprofits that were committed to a strict nondistribution constraint) of financial significance (i.e., with substantial income or assets). The few exceptions – such as the American Automobile Association – were essentially flukes, representing no systematic policy.

There was no reason to be much concerned about this casually inclusive approach so long as most nonprofits of any significance were in large part financed by dona-

tions, as was long the case. Most donatively supported nonprofits could be presumed to be inefficiently underfinanced, and many tended to redistribute income in desirable ways. Consequently, the crude but broad kind of subsidy involved in tax exemption could be easily rationalized. With the rapid growth of commercial nonprofits in recent decades, however, the traditional generous approach to defining the scope of tax exemption has become more conspicuously inadequate. The rationale for exemption is much less obvious for commercial nonprofits than it is for donative nonprofits. At the same time, the scope of the nonprofit exemption has become of far greater consequence to the efficient organization of economic activity, since there are large industries in which the exemption may have important consequences both for the choice of the nonprofit versus the for-profit form and for the overall level of investment.

The shifting composition of the nonprofit sector was clearly the stimulus for the first self-conscious break with the formerly generous approach to exemption, which was the explicit withdrawal of exemption from nonprofit insurance companies in the Tax Reform Act of 1986. Recent efforts to withdraw tax exemption from nonprofit hospitals, at both the state and federal levels, represent an even more important challenge to the traditional approach.

## 2. The Consequences of Exemption

The first problem in addressing the scope of the exemption lies in determining what is at stake. This is a complicated issue that could use further exploration in its own right. Each form of tax – and consequently each type of tax exemption – has its own, sometimes nonintuitive effects on efficiency and distribution. But basic questions concerning the scope of exemption can be effectively addressed without further extensive analysis of the underlying economics of exemption.

Again, the most troublesome cases for exemption today are commercial nonprofits that provide services in competition with for-profit firms. For these nonprofits, exemption from property taxes and sales taxes clearly operates as a subsidy to nonprofit firms vis-a-vis their for-profit competitors. Since the subsidy is tied directly to inputs and outputs, it is directly distortionary. If the nonprofit firms are not providing services of a kind, or to a clientele, that for-profit firms would not, then it is hard to see any justification for the subsidy.

With respect to corporate income taxes, the issue is more complex. The basic corporate income tax itself is poorly rationalized, making the rationale for exemption doubly problematic. Moreover, exemption from the tax may have no distortionary incentive effects for nonprofit activity at the margin – which is to say, it may not, in the long run, alter the nature or scope of nonprofit activity. It is perhaps sufficient to observe, however, that exemption of commercial nonprofits that serve no purpose that cannot be as well served by for-profit firms can be expected to lead to excessively rapid growth of the nonprofit form of organization. While commercial nonprofits might ultimately expand to the same inefficient degree in any given industry even without corporate income tax exemption, the rate of this inefficient expansion will be faster with the exemption.

In short, if there are industries in which commercial nonprofits have a large presence but play no affirmative efficiency (or distributional) role, then tax exemption, by ef-

fectively subsidizing those nonprofits, will create further bias in the choice of organizational form, with potentially serious consequences for efficiency. Since there is reason to believe that, today, there are significant industries that fit this description, it is important to identify those industries and to seek to omit them from the scope of tax exemption.

In approaching this problem, we should keep in mind that tax exemption has not just financial consequences but also symbolic consequences. As noted earlier, tax exemption serves as a signal of legitimacy for nonprofit organizations. Conversely, withdrawal of exemption signals that the nonprofits in question lack legitimacy, and is likely to make the organization's survival more problematic in ways that go beyond the immediate financial consequences of taxation. In particular, withdrawal of exemption is likely to make it more difficult for the managers of a nonprofit to resist conversion to for-profit form or dissolution, since they will be acting in the face of a policy decision that their continuance in the nonprofit form no longer serves an important public purpose.

## 3. Establishing Principles

From the preceding, a minimal operative criterion for extending exemption to a nonprofit organization should presumably be that the organization, by avoiding some problem that affects market or political processes, provides a valuable service that would not otherwise be provided by for-profit or governmental firms. Generally that will mean that the service is either provided to third parties (such as public goods and redistribution to the poor) or are of a quality that would not otherwise be available owing to consumers' difficulties in monitoring the producer's performance (»asymmetric information« or »contract failure«).

A more restrictive approach would require, not only that there be some efficiency justification for the subsidy, but also – given that the subsidy is effectively provided out of public tax revenues – that the group benefitted by the organization's services be either reasonably broad or conspicuously disadvantaged.

The term »charity,« as used in section 501(c)(3), might be understood as encompassing such considerations, but that has never been made clear. Other terms used in the tax code to describe the categories of exempt organizations – such as »scientific« or »educational« – are even less effective in reflecting these considerations. And when even the latter terms are stretched beyond their natural meanings – as when opera companies and symphony orchestras are exempted on the grounds that they are »educational« – the current categories have lost all purpose, becoming just labels to be applied arbitrarily to groups of organizations that have been granted exemption on other unexpressed (and generally unconsidered) grounds.

### a) Defining Statutory Categories

One approach to reform in this area might be to undertake a comprehensive redrafting of Section 501 of the Code (and the similar provisions that appear in state tax statutes), removing the old labels for exempt purposes – such as »educational,« »scientific,« and perhaps even »charitable« – and replacing them with a more functional definition of

the types of purposes that merit exemption. That definition would presumably focus on provision of services that proprietary firms do not provide efficiently: public goods, services for third parties (including in particular aid to the poor), and quality assurance.

An alternative approach would be to proceed in less radical and more piecemeal fashion, leaving the language of section 501 more or less as it is but putting a clearer interpretive gloss on the terms used there – charitable, educational, scientific, etc. – to make it clear, for example, that the »educational« institutions that are exempt are only those that solve some problem of market failure, and do not include nonprofit firms that do nothing more than sell standardized educational goods and services at market prices in direct competition with for-profit firms.

It would also be possible to undertake a hybrid approach, rewriting some of the categorical descriptions while putting an interpretive gloss on all of them. Indeed, this might well be the best course. In any event, the aim of all these approaches is the same: to assure that the institutions receiving exemption are worthy of public support by (1) assuring that they solve some market failure problem that prevents proprietary firms from providing an efficient quantity or quality of services, and (2) assuring that the class of individuals benefitted is broad enough or worthy enough to avoid a distributionally unattractive transfer from taxpayers to the beneficiaries of the exemption.

#### b) Generality of Application

Whichever approach to reform is undertaken, there is a question of the degree of generality with which exemption decisions should be made. At one extreme, decisions can be made at the industry level. For example, it can be decided that all short-term general care hospitals that are organized as (legitimate) nonprofit corporations will be exempt (or, alternatively, will not be exempt). At the other extreme, exemption decisions can be made at the level of the individual firm – for example, by examining the operations of each individual nonprofit hospital to determine if it is financed and operated in a fashion that merits exemption for that particular organization.

Again, an intermediate approach is also possible by providing that all nonprofit firms in an industry will be exempted if they meet some minimal operational standard – for example, by providing (as under current regulations) that a nonprofit hospital will be exempted so long as it maintains an emergency room open to the public regardless of ability to pay.

#### c) Fencing In or Fencing Out

Finally, whatever approach is taken to the preceding problems, there is a broad question of presumptions. The two polar approaches here can be labeled »fencing in« and »fencing out.«

The *fencing in* approach presumes that a nonprofit corporation is taxable unless it is determined to fall within some specifically-defined category of organizations worthy of exemption. The *fencing out* approach is just the reverse: it presumes that nonprofit corporations in general are exempt from tax, and then defines specific categories of nonprofits that are to be denied exemption.

Fencing in is the approach that is nominally taken in the Internal Revenue Code, which presumes that all nonprofit corporations are subject to the corporate income tax unless they fall within one of the various specific categories defined in Section 501. As we have already noted, however, in practice federal tax law has taken an approach that more resembles fencing out. In effect, all financially significant nonprofit firms have been presumed worthy of exemption. Specific industries and types of organizations have then, on occasion, been explicitly singled out and designated as non-exempt, such as the insurance companies denied exemption through statutory amendments in 1986.

The fencing in approach is conceptually neater. As a practical matter, however, there is much to be said for continuing the fencing out approach that now effectively dominates.

The problem with the fencing in approach is twofold. First, we do not know precisely what problems of market failure might lead to the formation of nonprofits in newly developing industries. As a consequence, reformulation of the code or the regulations to encompass new types of nonprofits might come too slowly, denying vital new nonprofit organizations both subsidy and legitimacy in their vital early stages.

Second, the principal problem with the exemption is that it often extends to anachronistic nonprofits that populate industries where exemption was once justified but can no longer be rationalized. Such industries, indeed, receive a very large fraction of all the benefits conferred by exemption because, in comparison to other nonprofits, the nonprofit organizations in those industries often (a) have accumulated large amounts of capital (making property tax exemption highly valuable), (b) have substantial purchase and sale activity (making sales tax exemption highly valuable), and (c) earn substantial net revenues (making income tax exemption highly valuable). What is needed is a systematic approach to defining industries that have reached a level of market maturity where the nonprofit form is no longer needed, and from which exemption – though already long-standing – should therefore be withdrawn. The economic and political influence of firms in such industries naturally makes this a challenging task.

The difficulty in the tax law, as in the corporate law, comes from the cyclic nature of the nonprofit form. Nonprofit organizations often play an important role in the early stages of development of an industry, before private forms and public regulation have become sufficiently well developed. When the industry has become better developed, the nonprofit form is no longer necessary, and the existing nonprofit firms become anachronistic. There then arises the exit problem with which both organizational and tax law must grapple.

The fencing out approach is well suited to this cyclic pattern of evolution. By interpreting exemption generously for any type of nonprofit not explicitly excluded from exemption by the code or the regulations, assistance will be quickly directed to the new types of nonprofits that are most likely to merit support. Analytic effort and political energy can then be focused on delineating, and excluding from exemption, established types of nonprofits for which the exemption is no longer appropriate. Because nonprofits tend to become anachronistic in an industry only when that industry has matured to a high level of standardization, clear definition of the types of services for which exemption will no longer be available (»fencing out«) should be relatively easy – and surely easier than defining the types of services for which exemption is appropriate.

## d) Donations as a Criterion

It has sometimes been suggested that a useful test of whether a nonprofit organization deserves exemption is whether the organization receives a significant fraction of its income in the form of donations.<sup>18</sup> As a strict condition precedent to receiving exemption, this is probably too strong; there seem to be at least a few industries – such as savings banks in the first half of the nineteenth century, and perhaps nursing homes today – in which the nonprofit form serves an important quality assurance role to paying customers even in the absence of donative financing. Nevertheless, donative financing is surely an important indication that a nonprofit organization is serving a valuable and underserved role that for-profit firms would not, and the absence of donative income should at least raise questions.

In pursuing the fencing out approach, then, one reasonably objective approach would be to establish a presumption that classes of nonprofit organizations that no longer receive significant levels of donative support should have exemption withdrawn unless they can bear the burden of establishing clearly that they serve a valuable function in correcting some clearly-identified form of market failure.

## III. Taxation of Unrelated Business Income

It is sometimes argued that fundamental reform is needed in the taxation of nonprofits' unrelated business income. Total repeal of the tax is the reform most commonly offered. My own view, expressed at length elsewhere, is that repeal would be disastrous as a practical matter, and that in fact the tax as currently designed is roughly appropriate. While the scope of the basic exemption needs fundamental reworking, as just described, the UBIT needs only to be adjusted a bit.<sup>19</sup>

That is not to say that there are no difficult issues here. For one thing, clearer consensus on the principles that should guide the choice of the boundaries of the UBIT is needed. For another thing, further attention needs to be given to the practical accounting problems underlying application of the UBIT. A nonprofit's profit-making operations often share costs with the organization's clearly exempt activities. Consequently, there are hard problems of deciding which costs are to be allocated to the profit-making activity. A nonprofit's natural incentive is to allocate as large a fraction of the joint costs as possible to the taxable income. These accounting problems are arguably much more serious than problems of defining the nominal scope of the UBIT. Or perhaps the better view is simply that these two sets of problems are closely related. One reasonable approach to both – and approach I've explored further elsewhere<sup>20</sup> – is to be generous in extending exemption, as »related« income, to commer-

18 Mark Hall & John Colombo, *The Charitable Status of Nonprofit Hospitals: Toward a Donative Theory of Tax Exemption*, 66 WASH. L. REV. 307 (1991); Mark Hall & John Colombo, *The Donative Theory of the Charitable Tax Exemption*, 52 OHIO ST. L. J. 1379 (1991).

19 Henry Hansmann, *Unfair Competition and the Unrelated Business Income Tax*, 75 VA. L. REV. 605 (1989).

20 *Id.*

cial income from activities that have joint costs with clearly exempt activities, on the theory that (1) a nonprofit's discretion in allocating costs would in any case result in very little tax revenue for the Treasury on such income, and (2) there is little at stake in terms of efficiency and incentives, since a nonprofit is likely to undertake such joint commercial activities whether they are taxed or not.

But perhaps this understates the nature of the problems that some forms of joint activity give rise to, such as university participation in commercial ventures in high technology industries.

## IV. Deductibility of Donations

The charitable deduction has been the subject of extensive, thoughtful, and ongoing scrutiny in the academic and policy literature, beginning at least as early as the studies commissioned by the Filer Commission in the 1970s.<sup>21</sup> If there is anything blocking change in this area, it is probably not lack of effort in formulating reform proposals, but rather the lack of political consensus as to the reforms that are appealing (such as substitution of a tax credit for the charitable deduction). That lack of consensus is partly a consequence of the distributional impact of any potential change, both for donors and beneficiaries – with the relatively rich, interestingly, being often among the beneficiaries (as with the performing arts and elite educational institutions), and the relatively poor often among the donors (as with churches). For these reasons, and because others are better situated than I to offer guidance in this area, I will not suggest here a broad reform agenda for the charitable deduction.

## E. Conclusion

The best argument for a broad-based effort at general reform in the law of nonprofits is that many of the important outstanding issues involving the law of the nonprofit sector are closely connected. While taxation might at first seem to be relatively distinct from issues involved in organizational law, in fact tax law and corporate law have been closely intertwined. The tax law has long been used to do the work of corporate law, and more recently the reverse has been true as well. Consequently, we cannot reform corporate law without reforming tax law, and vice-versa.

A general effort at law reform, designed to address the organizational changes in the nonprofit sector over the past fifty years, and building on the scholarship of the past twenty-five years, could place the American nonprofit sector on a much firmer organizational footing. Moreover, it could serve as a very helpful pattern for law reform throughout the rest of the world, which is only now beginning to face the problems that have long been familiar in the better-developed U.S. nonprofit sector.

21 RESEARCH PAPERS (Commission on Private Philanthropy and Public Needs, ed. 1977).

**F. Summary**

Over the past half century, the body of law that governs nonprofit organizations in the United States has substantially altered in response to the continually increasing size, complexity, and importance of the nonprofit sector itself. The law's evolution has been haphazard, however, and has not always been guided by a clear view of the purposes and problems of nonprofit institutions. The result is a body of law that, while often elaborate in its details, lacks coherence at a structural level, and consequently fails to deal effectively with the most important practical issues facing the nonprofit sector today. This essay explores the potential for fundamental improvement, describing the basic problems with current law and outlining a variety of potential reforms, with principle focus on the major elements of corporate law and tax law. While the discussion focuses principally on U.S. law, it is relevant to legal development elsewhere as well.

## 2. Teil: Der gegenwärtige Stand des Stiftungsrechts in Europa

### 1. Kapitel: EU-Mitgliedstaaten