

Charity Law's Essentials

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ABSTRACT

The boundary between charity and business has become a moving target. Social enterprises, philanthropy divisions of for-profit companies (most notably at Google), and legislation creating hybrid nonprofit/for-profit forms all use business models and practices to mold and pursue charitable objectives. This article asserts that charity law must be streamlined in order to respond to these and other dramatic charitable innovations. My new vision of charity law centers around two essential requirements. First, charity law must continue to demand that charities maintain an other-regarding orientation, pursuing benefits for someone other than their own leaders and managers. Second, existing charity law must be revised and supplemented to mandate that charities utilize group governance. Additionally, this dual focus should be intensified by removing the limits on commercial and political activity that currently clutter charity law. These reforms will enhance charity law's ability to regulate traditional charities. Moreover, focusing charity law on its essentials will reveal the tools necessary to respond to the exciting developments blurring the boundary between charity and business.

The boundary between charity and business has become a moving target. Google's philanthropic efforts are located within its for-profit company, rather than in a traditional nonprofit foundation. Social entrepreneurs are forming for-profit companies to pursue environmental, educational, and public health objectives. Jurisdictions are creating hybrid forms of organization, which blend elements of a charity and those of a business enterprise. Scions of business speak of the need to incorporate social goals and responsibility into their models, in order to generate sustainable success. The cluttered state of current charity law thwarts its ability to respond to innovations like these. Focusing on the two essentials for promoting fidelity to charitable mission, maintaining an other-regarding orientation and utilizing group governance, can improve charity law for traditional charities and reveal the tools necessary to respond to the exciting and sometimes vexing trend blurring charity and business.

To be a charity, an organization must pursue a charitable mission as its dominant and overriding purpose. Notably, such charitable missions go well beyond almsgiving.

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They include a broad array of purposes, each pursuing some vision of the good.² The ways an individual charity achieves its charitable mission can and should evolve in response to changing times and circumstances. Yet, the mission imperative remains the touchstone of what is a charity. The problem with this touchstone is that it is exceedingly difficult to measure and enforce accountability to mission externally. Public enforcement of mission also raises the uncomfortable specter of attorneys general and IRS agents determining whether a charity's mission has legitimately evolved or gone off course. The autonomy charities experience allows them to be innovators, to take counter-majoritarian positions, to serve the underserved.³ These important roles would be undermined if charities' missions were controlled by government actors. Private actors may provide some external enforcement of fidelity to mission, such as if donors or patrons are willing to withhold their support and patronage, but it will be insufficient.

Thus, charities must ultimately be trusted to police mission themselves. The goal of charity law should be to assist charities, their leaders, and their stakeholders to do so. Until now, discussions of charity law have argued the essential way that charity law does this is through the nondistribution constraint. This insight, so named by Henry Hansmann in an influential 1980 article, refers to the legal bar on nonprofit organizations distributing profits to individuals or entities maintaining control positions within them.⁴ Current charity law embodies this rule and the slightly more general idea that charities must be other-regarding, rather than self-regarding. A charity must reinvest its residual earnings in its mission to serve others, rather than route these earnings to individuals or entities outside its intended benefitted class, whether or not those individuals or entities possess organizational control. It must embody at least this basic level of altruism. This requirement that charities maintain an other-regarding orientation is one of only two truly essential principles of charity law.

The other essential legal principle that can help charities remain accountable to their missions is the requirement of group governance. Each charity must be composed of and governed by a group, rather than by a single individual. Unfortunately, this second principle has been largely overlooked by current charity law. Again, the

² The diverse range of charities includes, therefore, such institutions as Massachusetts General Hospital, the American Red Cross, the Avalon Theater (a nonprofit community theater in Washington, D.C.), the Nature Conservancy, and most accredited U.S. law schools.

³ See, e.g., ALEXIS DE TOCQUEVILLE, *DEMOCRACY IN AMERICA* 513-17 (George Lawrence trans., J.P. Mayer ed., 1969); David Horton Smith, *The Impact of the Volunteer Sector on Society*, in *THE NONPROFIT ORGANIZATION: ESSENTIAL READINGS* 347-55 (David L. Gies et al., eds., 1990); Barbara K. Bucholtz, *Reflections on the Role of Nonprofit Associations in a Representative Democracy*, 7 *CORNELL J.L. & PUB. POL'Y* 555, 572 (1998).

⁴ See Henry Hansmann, *The Role of Nonprofit Enterprise*, 89 *Yale L.J.* 835 (1980) ("A nonprofit organization is, in essence, an organization that is barred from distributing its net earnings, if any, to individuals who exercise control over it, such as members, officers, directors, or trustees.")

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tension between the mission touchstone and the challenge of its enforcement is the key. Society cannot and should not rigorously police the content of a charity's mission or the activities pursued in furtherance of it. Rather, society needs some alternative method to encourage charities to pursue a mission that will ultimately generate societal benefits and to do so by appropriate means. The collaboration and dialogue required by a group model of governance offers a structural solution for policing charitable mission. It creates a means for dialogue about how a charity meets and evolves its mission. To best enable this structural solution to function, charity law's commitment to group governance requirement should be reinforced.

While the group governance norm is insufficiently expressed in current charity law, this law is replete with attempts to define and block categories of activities regulators fear might corrupt a charity's mission. Rather than promoting structures to encourage dialogue regarding how best to pursue mission, these doctrines orient charities away from certain types and manners of activity. They go far beyond avoiding self-regarding behavior, chilling charities' pursuit of legitimate mission-related programs. In addition, they set up vague categories filled with exceptions that are easy for charities to avoid and nearly impossible for courts and regulators to police. This ill-fated attempt to guard the border⁵ of what will serve charitable mission has generated a substantial body of law limiting the commercial and political activities of charity. This body of law might be read to suggest two further essentials: that charities should sharply limit their commercial undertakings, and that they should eschew involvement in politics. Such limitations, however, are not essential to promoting the mission imperative and the current charity law expressing them is, for the most part, wasted effort.

In addition to improving charity law generally, focusing charity law on the other-regarding orientation and group governance requirements will offer valuable insights for understanding and responding to today's innovations on the boundary between charity and business. Often, it is the constraints current charity law sets up against commercial and political activity that have driven innovators to create and advocate new forms. When an innovator envisions pursuing the good by creating a social enterprise, the restrictions on charities' commercial activities may propel her to seek alternative forms. A founder who believes his public health mission will be hampered by the constraints on charities' political activities will do likewise. Jettisoning the law constraining charities commercial and political activities will remove some major impediments, allowing many innovators to use traditional charity forms.

⁵ See John Simon, Harvey Dale and Laura Chisolm, *The Federal Tax Treatment of Charitable Organizations*, in THE NONPROFIT SECTOR RESEARCH HANDBOOK, 267 (Walter W. Powell & Richard Steinberg eds; 2d ed. 2006) (noting this "border patrol function" of tax exemption law).

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For those innovators who still desire new forms, focusing charity law on other-regarding orientation and group governance will make it easier to discern and enforce the line between charity and business. Those innovations that embrace these essential principles are sufficiently protective of the mission imperative to be permitted to stand as charities. New forms and entities that allow for self-regarding activity, allow for individual control, or both should not be admitted to this privileged category. The charitable activities of these organizations may be laudable, and perhaps merit encouragement or an award of benefits as a new or separate class. Yet, a self-regarding organization or one controlled by a single individual poses risks to mission that charity law should not countenance.

Part I reviews how current charity law distinguishes charities from businesses. Its summary of charity law will draw on statutory pronouncements, regulatory activity, and common law decisions based on state organizational law and federal and state tax law. The other-regarding orientation requirement is fully expressed in these sources. The group governance norm's grip on current charity law is more tenuous, and this part will identify several gaps that must be filled for it to fulfill its potential as a structural solution to the challenge of enforcing mission accountability. Finally, this part reviews the substantial body of law restricting the commercial and political activities of charities, which might lead one to believe that these limitations are likewise essential to safeguarding charitable mission. Charting the contours of these rules and doctrines reveals a landscape in need of reform.

Part II introduces some of the myriad ways innovations blending charity and business are pressuring charity law, and argues these innovations can best be understood and regulated by refocusing charity law on the other-regarding orientation and group governance requirements alone. Using for-profit or hybrid organizational forms to pursue charitable goals challenges the nondistribution constraint and other prohibitions on self-regarding behavior. The social enterprise trend also deeply challenges the group governance norm, as the structures used to maintain social goals within a for-profit business rely on preserving control with a founder. These challenges are serious and cut to the core of charity law – promoting self-regulation of mission. They highlight the need to continue charity law's vigilance regarding other-regarding orientation and to amplify its commitment to group governance. New trends like social enterprise, microfinance, and creative or philanthrocapitalism, however, also challenge the anti-commerciality position found in current charity law. Likewise, the decisions of social entrepreneurs to opt out of charitable forms in order to avoid their political restrictions challenge these constraints. These challenges do not implicate charity law's mission imperative. Here, the experiences of innovators demonstrate the gains to be made by removing many of current charity law's limitations on commercial and political activity. Doing so will allow charities the autonomy to articulate and evolve their own missions. Part III briefly concludes.

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I. CURRENT CHARITY LAW

At the outset it is important to clarify and limit my claims. I argue the other-regarding orientation and group governance requirements are the appropriate basis for *the law's* definition of a *charity*.⁶ The concept of a charity is more limited than that of a nonprofit organization more generally. Non-charitable entities may form as nonprofits, most commonly to pursue the mutual benefit of their members, such as in social clubs and trade associations.⁷ These entities may engage in some charitable activities, but they are not charities. The limitations I argue are essential to charity status do not seriously constrain mutual benefit organizations. The limited focus on the proper emphasis of charity law also will not necessarily line up precisely with the general public's conceptions of charity. Indeed, gaps between any shared lay sense of charity's meaning and purpose and the essentials of charity law could signal a need for charity law to change.

It is equally important to be clear about the sources of charity law I utilize. I look to the statutory, regulatory and case law that defines and constrains a charitable entity, as opposed to some other type of entity (often a business). This body of charity law differentiates charities from other entities of various types that happen to engage in charitable activities. This set of constitutive charity law, in my view, includes two important sets of regimes. The first is the state law that limits access to charitable forms of organization – principally, state nonprofit corporation and charitable trust law.⁸ The second is tax law that defines the charity category that entitles an entity to exemption. State property tax exemption is provided to charities by various state constitutional provisions or statutes.⁹ Federal income tax exemption law includes multiple classes of exempt entities.¹⁰ References to federal tax-exemption refer to the most-favored such status, granted under Internal Revenue Code § 501(c)(3).¹¹ It

⁶ This approach contrasts starkly with Professor Hill's proposal that federal tax law should abandon the treatment of exempt organizations as entities, in favor of treating them as aggregates. See Frances R. Hill, *Targeting Exemption For Charitable Efficiency: Designing A Nondiversion Constraint*, 56 SMU L. REV. 675, 700 (2003). Although I share Prof. Hill's conviction that avoiding diversion of charity resources should be an important goal of charity law, I believe that an entity approach remains helpful.

⁷ See MARILYN E. PHELAN, NONPROFIT ENTERPRISES §§ 23:01, 26:01 (2003) (discussing the nature of social clubs and trade associations generally).

⁸ Although a nonprofit organization may take the legal form of a charitable trust or an unincorporated association, most U.S. nonprofits are formed as nonprofit corporations. See PHELAN, NONPROFIT ENTERPRISES at § 1:03. This article primarily addresses this and the other formal type of organization a charity may take, the charitable trusts. See *id.* Charities can also be formed as unincorporated associations, but there is very little legal authority regarding such entities, which typically operate under agency principles. See *id.* Therefore, I leave this form aside for now.

⁹ See Janne Gallagher, *The Legal Structure of Property-Tax Exemption*, at 3, in PROPERTY TAX EXEMPTION FOR CHARITIES (ed. Evelyn Brody 2002).

¹⁰ See I.R.C. § 501.

¹¹ I.R.C. § 501(c)(3).

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is important to distinguish this tax exemption regime from federal tax law delineating the types of entities entitled to receive deductible contributions from donors.¹² These rules are of great importance to charities and certainly motivate their behavior; they also often contain limitations resonant of the essentials I articulate. Yet, the deductibility regime is aimed at encouraging behavior by donors and does not explicitly guard access to charity status. Therefore, I do not treat it as a primary source for the charity law concepts considered here.

Of course, one might view only organizational law as constitutive of charity. Some commentators view all tax law as comprising political choices about what types of activities to subsidize,¹³ without necessarily including forceful statements on what is a charity. In large part, I share this view of the deductibility regime. Like other deductions, the charitable deduction is an expression of the government's decision about what activities to subsidize. I view the exemption regimes under federal and state tax law, however, as quite different. These exemptions are basic expressions by our legal, political, and social system about what types of entities are fully and truly charities. Likewise, they screen out those types of entities that, while perhaps deserving favor or praise for various reasons, are not charities. The charity category identifies entities it would be improper to subject to taxation, not merely those the government might desire to subsidize.¹⁴ Thus, to reiterate, when this article speaks of charity law, it refers both to state organizational law and federal and state exemption law as its critical sources.

A. Other-Regarding Orientation

The requirement that charities maintain an other-regarding orientation is ultimately a product of the basic tension between charity law's commitment to mission and its inability to adequately patrol that commitment. This principle says that a charity must direct itself toward a charitable class and provide the benefits of its success to

¹² See I.R.C. §§ 170(c) (income tax deduction); 2055 (estate tax deduction); 2522 (gift tax deduction).

¹³ See Rob Atkinson, *Altruism In Nonprofit Organizations*, 31 B.C. L. REV. 501, 606 n. 292 (1990) (cataloguing statements of courts and commentators articulating the subsidy position); see also *Regan v. Taxation With Representation*, 461 U.S. 540, 544 (1983) (describing tax exemption as a subsidy for charities' contributions to public welfare).

¹⁴ See Evelyn Brody, *Of Sovereignty and Subsidy*, 23 J. CORP L. 585, 587-96 (1998) (articulating a "sovereignty perspective" on the tax benefits received by charity, arguing they derive from the treatment of charities as quasi-sovereigns). Notably, Brody cautions that a sovereignty approach to designing charitable tax benefits can both benefit and harm charities, as government may enact rules in order to control or limit the rival, charity quasi-sovereign. See *id.* at 606. My view also shares some aspects with the "community interest" theory of charity tax benefits. Johnny Rex Buckles, *Not Even A Peep? The Regulation Of Political Campaign Activity By Charities Through Federal Tax Law*, 75 U. CIN. L. REV. 1071, 1083-84 (2007); Johnny Rex Buckles, *The Community Income Theory of the Charitable Contributions Deduction*, 80 IND. L.J. 947 (2005).

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them, not to equity investors, not to leaders or managers, not even to unrelated parties if they are outside the benefitted class. While it does not identify the particular content that will comprise a charity's mission, this essential principle mandates at least this basic level of altruism. As noted above, society cannot monitor and police every activity or purpose that a charity might undertake; indeed, it would be undesirable for it to do so even if such regulation were possible. However, the charity law that mandates an other-regarding orientation tells charities that there are, indeed, some limits on the behavior in which they may engage. When a charity's leaders forsake the pursuit of benefits for others and turn instead to attempts to accrue benefits for themselves, the entity veers off the permissible course and loses its entitlement to charity status.

For much of the last three decades, legal academics have recognized a single defining legal characteristic of charities: the nondistribution constraint.¹⁵ This insight, so named by Henry Hansmann in an influential 1980 article, refers to the legal bar on nonprofit organizations distributing profits to individuals or entities maintaining control positions within them.¹⁶ By limiting its application to those with organizational control, the nondistribution constraint is a slightly more limited statement of the other-regarding orientation requirement. The core mandate that a charity reinvest its residual earnings in its mission to serve others, rather than route these earnings to individuals or entities outside its intended benefitted class, is the same. This nondistribution constraint and the broader other-regarding orientation requirement are strongly expressed by a plethora of legal rules: the restrictions on inurement, private benefit, and excess benefit transactions under federal tax exemption law; state organizational law barring self-dealing by fiduciaries and limiting distributions more generally; and the various tax, corporation and trust law doctrines addressing charitable purpose and charitable class. This part offers a basic

¹⁵ See, e.g., Rob Atkinson, *Unsettled Standing: Who (Else) Should Enforce The Duties Of Charitable Fiduciaries?*, 23 J. CORP. L. 655, 665 (1998) (referring to the nondistribution constraint as the “defining feature” of nonprofits); John D. Colombo, *Federal And State Tax Exemption Policy, Medical Debt And Healthcare For The Poor*, 51 ST. LOUIS U.L. REV. 433 (2007) (referring to the nondistribution constraint as “the chief requirement” for nonprofit status); Deborah A. DeMott, *Self-Dealing Transactions In Nonprofit Corporations*, 59 Brook. L. Rev. 131, 132 (1993) (“The defining difference between a nonprofit and a for-profit corporation is the nondistribution constraint”); Iris J. Goodwin, *Donor Standing To Enforce Charitable Gifts: Civil Society vs. Donor Empowerment*, 58 VAND. L. REV. 1093 (2005); Daniel Halperin, *Income Taxation Of Mutual Nonprofits*, 59 TAX L. REV. 133 (2006) (noting the nondistribution constraint as the distinguishing feature of nonprofit, versus for-profit, entities); Geoffrey A. Manne, *Agency Costs And The Oversight Of Charitable Organizations*, 1999 Wis. L. Rev. 227, 230 (describing the nondistribution constraint as the “[t]he defining characteristic of a charitable nonprofit”).

¹⁶ See Henry Hansmann, *The Role of Nonprofit Enterprise*, 89 Yale L.J. 835 (1980) (“A nonprofit organization is, in essence, an organization that is barred from distributing its net earnings, if any, to individuals who exercise control over it, such as members, officers, directors, or trustees.”)

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review of these rules, and how they embody the other-regarding orientation requirement.

Federal tax law limits those entities eligible for charitable exemption to those in which “no part of the net earnings [] inures to the benefit of any private shareholder or individual.”¹⁷ Three doctrines embodying the other-regarding orientation requirement arise out of this statement: inurement, private benefit and excess benefit. Inurement doctrine targets organizational insiders, banning those with control from receiving profits.¹⁸ This legislative mandate is a virtual restatement of the nondistribution constraint. The companion private benefit doctrine focuses on those without organizational control, but outside the charitable class served by the entity.¹⁹ It prohibits any substantial benefit accruing to a private individual not provided as part of the entity’s charitable activities. Insubstantial benefits, presumably, are unavoidable and no cause for penalty. In contrast, substantial benefits threaten to be favors for those with control or a diversion from the other-regarding mission of the organization. Infringing these prohibitions carries the ultimate sanction: loss of exemption and exclusion from the charity category.²⁰

Congressional statute amplified by IRS regulations put forward the excess benefit framework. When individuals with some level of control engage in transactions with their charities that result in receipt of excessive benefits, penalty taxes apply.²¹ Initial excise taxes require a percentage of the excess benefit accrued to be paid to the Treasury as a penalty.²² In addition, if restitution is not timely made to the charity at issue, second-level confiscatory taxes apply; these require a multiple of the benefit to be paid to Treasury as well.²³ In addition to these taxes on benefitted parties, penalty taxes are imposed on participating charity managers “unless such participation is not willful and is due to reasonable cause.”²⁴ Under this framework, those directly benefitted by self-regarding activity are given clear incentives to avoid it, as are

¹⁷ I.R.C. § 501(c)(3).

¹⁸ See MARION R. FREMONT-SMITH, *GOVERNING NONPROFIT ORGANIZATIONS: FEDERAL AND STATE LAW AND REGULATION* 248-49 (2004); James J. Fishman, *Wrong Way Corrigan and Recent Developments in the Nonprofit Landscape: A Need for New Legal Approaches*, 76 *FORDHAM L. REV.* 567, 584-85 (2007).

¹⁹ See John Simon, Harvey Dale & Laura Chisolm, *The Federal Tax Treatment of Charitable Organizations*, in *The Nonprofit Sector: A Research Handbook* 267, 282-83 (Walter W. Powell & Richard Steinberg eds., 2d ed. 2006) (describing the private benefit doctrine and comparing it with both inurement and excess benefit).

²⁰ See John Simon, Harvey Dale & Laura Chisolm, *The Federal Tax Treatment of Charitable Organizations*, in *The Nonprofit Sector: A Research Handbook* 267, 282-83 (Walter W. Powell & Richard Steinberg eds., 2d ed. 2006).

²¹ See I.R.C. § 4958; Treas. Reg. §§ 53.4958-1 to 53.4958-8 (2008).

²² See I.R.C. § 4958(a)(1).

²³ See I.R.C. § 4958(b).

²⁴ I.R.C. § 4958(a)(2).

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managers in a position to prevent it. The charity itself is made whole, not penalized with loss of status, and may go on pursuing its other-regarding mission.

The expressive value of the statute's limitation on the destination of net earnings and the message of these doctrines could not be clearer. An other-regarding orientation is an essential requirement for status as a charity under federal tax exemption law. Yet, the sanctions available for breaching the inurement and private benefit bans – loss of such status – is draconian and, more importantly, it will often miss the mark. If applied, this sanction puts a charity whose controlling parties breached it out of business, deserting any charitable class the charity might have helped. Yet, it leaves untouched the individuals who were inappropriately benefitted. The excess benefit transaction rules better align available remedies with the aim of maintaining charities' other-regarding orientation.

State law issues similar mandates embodying the other-regarding orientation requirement. Fiduciary obligations of charity fiduciaries bar unfair self-dealing transactions.²⁵ More general prohibitions on distributions can also be found, some in state nonprofit corporation statutes. The Revised Model Nonprofit Corporation Act (RMNCA), on which many state statutes are based, provides a good example. It pointedly prohibits any distributions other than by mutual benefit corporations,²⁶ which fall outside the scope of charities as discussed in this article. A distribution is defined as “the payment of a dividend or any part of the income or profit of a corporation to its members, directors or officers.”²⁷ Directors and officers exercise organizational authority as fiduciaries. Statutory members,²⁸ when they exist, also possess some organizational control. They must approve amendments to the articles of incorporation, mergers, and dissolutions and can initiate changes in ongoing organizational operations through bylaw amendments.²⁹

State law prohibitions on self-dealing and distributions tend to epitomize the more specific nondistribution constraint by limiting their application to those with control. Yet, when these are taken along with other state law doctrines addressing charitable

²⁵ See FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS at 195-99, 219-25; Harvey J. Goldschmid, *The Fiduciary Duties of Nonprofit Directors and Officers: Paradoxes, Problems, and Proposed Reforms*, 23 J. CORP. L. 631, 646 (1998).

²⁶ See Revised Model Nonprofit Corporation Act (RMNCA) §§ 13.01-.02.

²⁷ RMNCA § 1.40(10).

²⁸ Members under relevant nonprofit corporate statutes, who are granted rights to vote for corporate directors and on major organizational changes, should be distinguished from affinity members. This former title is not, however, used exclusively when granting governance rights. Rather, the term “member” may be used by a charity for purposes of recognizing the financial or other contributions of particular individuals or to build the organization's connection to them.

²⁹ See, e.g., RMNCA §§ 10.03, 11.03, 12.02, 14.02 (requiring member approval in order for a nonprofit corporation to amend its articles, merge, sell all or substantially all of its assets, or dissolve); see also *id.* § 6.03 (noting that nonprofit corporations need not have members at all).

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class and purpose, the more general requirement of other-regarding orientation comes into view. For example, to create a charitable trust, its benefits must be dedicated to some class of beneficiaries.³⁰ This class of others must be benefitted by the trust, rather than the trustee or settlor him or herself, or the private beneficiaries of the settlor's largesse. These alternative objects might be validly served by a private trust. The advantages of charitable status, including exemption from the Rule Against Perpetuities and eligibility to pursue tax-favored status, are limited to those *charitable* trusts that form and operate in this other-regarding fashion.

Charitable purpose requirements, found in both federal tax exemption and state organizational law, also speak to other-regarding orientation. Federal tax exemption is limited to entities formed for "charitable, religious, educational, scientific, literary," and a few other specialized purposes.³¹ State statutes also frequently describe the purposes for which charitable corporations may properly form. Some offer long lists of purposes that are appropriate, such as New York's which includes "civic, patriotic, political, social, fraternal, athletic, agricultural, horticultural, animal husbandry"³² purposes, others repeat (sometimes with slight variation) the federal exempt purposes categories, and some do both.³³ Those statutes based on the RMNCA require charitable corporations to declare themselves to be public benefit corporations or religious corporations.³⁴ To qualify as a public benefit corporation, an organization must either be deemed as such by state statute, be exempt under § 501(c)(3), or be "organized for a public or charitable purpose"³⁵ The statute defines neither "public" nor "charitable," but instead relies on the common law to determine their meaning in specific cases. Charitable trust law permits formation for a range of purposes, generally including relief of poverty, advancement of education, religion, health and governmental or municipal purposes, as well as a catchall category of "other purposes beneficial to the community."³⁶ State property tax exemptions granted by constitutional mandate or legislation are likewise varied in their descriptions of the exempt category, but often speak of "purely public charity," educational or religious purposes.³⁷

³⁰ See REST. SECOND OF TRUSTS, § 375; AM. JUR. CHARITIES § 69.

³¹ I.R.C. § 501(c)(3).

³² N.Y. N-PCL § 201.

³³ See FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS at 127.

³⁴ RMNCA §17.07.

³⁵ RMNCA

³⁶ The Uniform Trust Code (now adopted in 21 states and under consideration in three more), permits charitable trusts to be formed for "for the relief of poverty, the advancement of education or religion, the promotion of health, governmental or municipal purposes, or other purposes the achievement of which is beneficial to the community." UTC § 405(a). See also Fremont-Smith, *Governing Nonprofit Organizations*, at 120 (offering a similar list and citing, additionally, the Second and Third Restatements of Trusts).

³⁷ See Gallagher, *The Legal Structure of Property-Tax Exemption*, at 4-6.

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The law has struggled to provide a conclusive definition of charitable purpose. This struggle will not be resolved by my identification of charity law's essentials here. Indeed, the search for a conclusive definition of charitable purpose is a fool's errand, as the bounds of charity must evolve over time in order to serve the changing needs of society and the public. Yet, one can see the influence of the other-regarding orientation requirement in the core of the charity category that various legal sources stake out. In each of the descriptors chosen, one sees the idea of serving a greater or qualitatively different purpose than one's own self-regarding needs. Sometimes this is expressed with general notions of serving the public, or government purposes, or pursuing what is charitable, whatever that might be held to mean in a given time and context. Other times the description is more specific, such as pursuing education, a mission that will include the teaching of others or at least generating knowledge that could somehow serve the community. By its demands on charitable purpose, vague as they may be, the law expresses the idea that charity is appropriately directed toward enriching the lives of others rather than enriching oneself.

Significant portions of current charity law are taken up by embracing and expressing the other-regarding orientation requirement. A wide range of sources articulate the nondistribution constraint, as well as many other clear and forceful legal limitations on self-regarding activity. These are pivotal concepts, but they do not provide a sufficient prescription for how the law should define and limit the charity category. Charity law must also block access to charity status to single individuals or organizations controlled by a single individual, even if they effectively restrain their ability to benefit personally from their organizations. It is to the contours of this other vital essential that we now turn.

B. Group Governance

Charity law can powerfully defend its mission imperative by requiring charities to use a group governance model. This essential principle says that while a business can be formed and governed individually, a charity fundamentally requires more than one person's desire to pursue some view of the good. A charity must be composed of and governed by a group.

Again, understanding that charities' accountability to mission must ultimately be self-policed is crucial to grasping the importance of group governance. A charity is an entity pursuing some mission that is of value (or at least potential value) to society (or some segment of it). But, society cannot and should not rigorously police the content of this mission or the activities pursued in furtherance of it. It needs, instead, some internal method to encourage charities themselves to pursue a mission that will ultimately benefit society and to do so by appropriate means. This method is the dialogic process, among a group, whereby a charity formulates its mission and transforms this mission and its practices over time. A single person cannot be

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trusted to challenge the continuing benefit of an articulated mission. An individual cannot be counted on to challenge whether particular programs or activities appropriately serve it. The model of individual governance simply does not offer a solution to the challenge of regulating mission. The collaboration and dialogue required by a group model of governance is such a solution.³⁸

The group governance requirement is expressed most forcefully in state nonprofit corporation law, which generally requires at least a three-member board of directors to govern an incorporated charity.³⁹ A few states permit a single director, though this minority rule has been criticized.⁴⁰ Charitable trust law generally permits a single trustee, though again this has been criticized.⁴¹ Existing critiques point out that a single trustee (or director in those states that permit it) is vulnerable to fraud – by the actions of others or her own baser motives.⁴² Additionally, governance by a single individual leaves little opportunity for the vetting of decisions to ensure they are efficient and wise.⁴³ More importantly here, though, the group governance concept maps onto concerns that charity not be enabled and ennobled to create a personal fiefdom, but rather to pursue some mission for the benefit of society. A charity governed by a single individual offers no proxy for articulating or monitoring the public or common good in whose name it is created and maintained.

The group governance norm is also more subtly at work in state law provisions requiring independent directors. Five states specifically require a set percentage (usually a majority) of nonprofit corporate directors to qualify as independent.⁴⁴ The Revised Model Nonprofit Corporation Act includes such a requirement as an optional provision.⁴⁵ These requirements focus on and attempt to limit the family

³⁸ See Norman I. Silber, *Anticonsultative Trends In Nonprofit Governance*, 86 OR. L. REV. 65 (200) (criticizing the trend away from “consultative” or “collaborative” governance models as potentially impoverishing both the governance and mission achievement of individual charities as well as contributing to a loss of social capital).

³⁹ See, e.g., RMNCA § 8.03 (requiring that a board of directors “must consist of three or more individuals”); Evelyn Brody, *Charity Governance: What's Trust Law Got To Do With It?*, 80 CHI.-KENT L. REV. 641, 645 (2004).

⁴⁰ See PANEL ON THE NONPROFIT SECTOR, PRINCIPLES FOR GOOD GOVERNANCE AND ETHICAL PRACTICE: A GUIDE FOR CHARITIES AND FOUNDATIONS (October 2007) (noting, in a report produced in response to a Senate Finance Committee request, that a panel of experts had recommended that a minimum of three directors be required for an incorporated charity to qualify for federal tax exemption).

⁴¹ See Brody, 80 CHI.-KENT L. REV. at 672 (“single-director and single-trusteed charities seem to invite failures of proper independence and protection of the public interest”).

⁴² See Panel on the Nonprofit Sector, 21-22; Brody, 80 CHI.-KENT L. REV. at 661-58.

⁴³ See Panel on the Nonprofit Sector, 21-22; Brody, 80 CHI.-KENT L. REV. at 668-72.

⁴⁴ See CAL. CORP. CODE § 5227(a) (West 2006); ME. REV. STAT. ANN. tit. 13-B, § 713-A(2) (2005); N.H. REV. STAT. ANN. § 292:6-a (1999); N.D. CENT. CODE § 10-33-27(2) (2005); VT. STAT. ANN. tit. 11B, § 8.13(a) (1997).

⁴⁵ See RMNCA § 8.13.

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and financial connections between a director and her charity and its other directors and leaders. For example, the RMNCA requires that no more than 49 percent of directors be “financially interested,” that is, receiving compensation from the charity or having a close family relationship with someone who does.⁴⁶ Independence requirements do, in part, respond to the concerns underlying the other-regarding orientation requirement. They seek to avoid financial conflicts whereby individuals personally benefit from the charity rather than directing its resources toward the good of others, or at least to preserve the charity’s ability to manage such conflicts when they occur.⁴⁷ The other major concerns underpinning independence requirements, however, are to ensure objectivity of board members and prevent domination by one or more interested individuals.⁴⁸ These concerns are linked to the need for group governance. A board with a mix of members allows for a true give-and-take on all topics, including questions of mission. A single dominant individual surrounding herself with relatives or cronies will not.

Of course, the group governance norm would be more strongly embodied by a requirement that charities have voting members and a representative and deliberative method of governance including them. Current charity law does not embrace this view. Instead, a voting member governance structure is optional for nonprofit corporations and, in practice, little used by them.⁴⁹ When a charity does opt for a voting member model, however, courts can hold them to the structures and methods required by their formative documents, empowering the group and backstopping its importance in the process.⁵⁰ The very nature of the trust would make it difficult to create a large-group democratic governance process in a charitable trust. Trust law does offer settlors considerable freedom to alter the means of trust governance as they desire. Still, going beyond the customary appointment of trustees by the settlor and provision for personnel changes in trust documents or by courts would be highly unusual.

Federal tax exemption law is agnostic among the organizational forms qualifying charities might take, and likewise takes no strong position on exempt organizations’ commitment to group governance. A § 501(c)(3) tax-exempt entity may be a “corporation (or unincorporated association), community chest, fund, or

⁴⁶ RMNCA § 8.13.

⁴⁷ See Dana Brakman Reiser, *Independent Directors and the Independent Sector*, 76 FORDHAM L. REV. 795, 807-09, 814-15 (2007).

⁴⁸ See Brakman Reiser, 76 FORDHAM L. REV. at 809-11, 814-15.

⁴⁹ See Fremont-Smith, *Governing Nonprofit Organizations* at 159. Even in groups with nominally voting members, these individuals are often the same individuals who serve as directors.

⁵⁰ See Dana Brakman Reiser, *Nonprofit Takeovers: Regulating the Market for Mission Control*, 2006 B.Y.U. L. Rev. 1181, 1231-45 (describing and critiquing court enforcement of member voting processes).

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foundation.”⁵¹ No preference is given to any one organizational form or governance structures. These state forms require the bare level of group activity and governance described above. A few years ago, the federal government considered requiring incorporated exempt charities to have at least three directors, a majority of whom were independent.⁵² The proposals were not adopted, but the IRS’ recent guidance on good governance for charities does include recommendations that charities consider the perils of small boards and the desirability of independence.⁵³ Additionally, the newly revised Form 990, the principal charity tax reporting form, now inquires as to the number and independence of the members a charity’s governing body.⁵⁴ These developments express support for the group governance norm, but fall short of mandating it.

State law too extends its property tax exemption only to organizations that qualify as charities, including the organizational forms already addressed and incorporating their basic group governance demands. Other than this, however, state property tax exemption law does not speak to group governance.

Current charity law makes far too weak a commitment to group governance. The trust form allows charities to avoid group governance altogether. Even where a norm of group governance is articulated relatively strongly, as in nonprofit corporate law, the group required need not be large, nor must it be particularly diverse or democratically governed. Federal and state tax exemption law incorporates these requirements and federal law has made some gestures toward a stronger commitment. Yet, unlike the other-regarding orientation requirement, current charity law does not express the group governance norm robustly. In order for charity law to effectively defend the mission imperative, it must be augmented to more fully and ardently commit to group governance.

C. *Anti-Commerciality*

In contrast, current charity law is cluttered with restrictions on categories of charities’ activities. Current charity law constrains commercial activity, even if the profits it generates are fully committed to reinvestment in charitable mission. It also restricts political activity, even when undertaken in service of a charitable class. These limitations are so substantial and so complex as to suggest that avoiding commercial and political activities is likewise essential to safeguarding charities’ missions. This subpart and the next take up the commercial and political limitations in turn,

⁵¹ I.R.C. § 501(c)(3).

⁵² See Staff of S. Fin. Comm., 108th Cong., Staff Discussion Draft 13 (2004), available at <http://finance.senate.gov/hearings/testimony/2004test/062204stfdis.pdf>.

⁵³ See Internal Revenue Service, Governance and Related Topics - 501(c)(3) Organizations 3 (2007), http://www.irs.gov/pub/irs-tege/governance_practices.pdf.

⁵⁴ See Internal Revenue Service, Form 990, Part 1, Questions 3&4 (revised form released 2008).

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identifying the current charity law embodying them, and revealing their tenuous links to mission accountability.

Current charity law subjects charities' conduct of commercial activities to skepticism, if not suspicion. This is particularly true when the type or mode of commercial activity cannot be persuasively related to an entity's charitable mission. Of course, this is not to suggest that charities may not conduct commercial activities, whether or not related to mission. Indeed, the scope of the commercial activities in which charities engage is large and growing.⁵⁵ Moreover, although a few state nonprofit corporation statutes include limits on charities' conduct of commercial activities, these statutes typically permit such activities outright.⁵⁶ Charitable trust law likewise takes a permissive tone, setting no general limitations on charitable trusts' pursuit of commercial activities, though it tends not to speak specifically to the desirability of charitable trustees running businesses.⁵⁷ Thus, organizations may take the legal forms used by charities with little concern regarding their commercial activities.⁵⁸

In contrast, qualifying for state property and federal income tax advantages will subject a charity's commercial activities to significant scrutiny.⁵⁹ Property tax exemption is often founded on state constitutional provisions exempting property belonging to charities, public charities or institutions of purely public charity.⁶⁰ In addition, jurisdictions require property to be used solely for such purposes; exemptions for property owned by charities but not used for charitable purposes can be refused, revoked, or apportioned.⁶¹ The conduct of commercial activities,

⁵⁵ See Elizabeth T. Boris & C. Eugene Steurle, *Scope and Dimensions of the Nonprofit Sector*, in THE NONPROFIT SECTOR RESEARCH HANDBOOK, *supra* note __, at 74-76 and tbl. 3.6 (describing and tabulating the considerable share of nonprofit revenues generated from fees for services); Dennis R. Young and Lester M. Salamon, *Commercialization, Social Ventures, and For-Profit Competition*, in THE STATE OF NONPROFIT AMERICA 430-36 (cataloguing the nonprofit sector's "growing reliance on earned income" as well as the trend of nonprofits "integrating the market into the pursuit of their social missions in a more fundamental way") (ed. Salamon 2002); Burton A. Weisbrod, *The Nonprofit Mission and its Financing*, in TO PROFIT OR NOT TO PROFIT 16 (ed. Weisbrod 1998) (describing the increasing dependence of nonprofits on revenues from commercial activities); Weisbrod, *The Pitfalls of Profits* at 43.

⁵⁶ RMNCA §§ 3.01(a), 3.02(17) (setting the default purpose of nonprofit corporations as to "engage[e] in any lawful activity" and empowering them "to carry on a business").

⁵⁷ UTC § 404, Comment to Article 10 (requiring charitable trusts to pursue purposes that are "lawful, not contrary to public policy, and possible to achieve" and noting an intention to encourage third parties to engage in commercial transactions with trustees).

⁵⁸ See Evelyn Brody, *Business Activities of Nonprofit Organizations*, in NONPROFITS & BUSINESS 84 (Cordes & Young ed. 2008) ("nonprofit corporation law has surprisingly little to say about business activity as such.")

⁵⁹ See Brody, *Business Activities of Nonprofit Organizations*, at 84.

⁶⁰ See Gallagher, *Property-Tax Exemption for Charities*, at 10.

⁶¹ See Gallagher, *Property-Tax Exemption for Charities*, at 7-10.

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particularly unrelated businesses, is key among non-charitable purposes that might scuttle exemption.

Various states use a multifactor test to determine eligibility for property tax exemption.⁶² The factors differ across jurisdictions somewhat and include some significant distinctions from the approach of federal tax exemption law. Two frequent factors bear directly on charities' commercial activity. First, these tests exclude property operated for profit, reserving special scrutiny for those entities supported by fees charged for their services.⁶³ Second, a few tests explicitly consider whether a charity seeking property tax exemption competes with for-profit businesses.⁶⁴ Using these and other theories, a wide range of states have mounted challenges to property tax exemption for property used for nursing homes and retirement centers, day care centers and, most prevalently, hospitals and other healthcare activities.⁶⁵ Such challenges often complain that the entity in question charges market rates for services, with some noting that they are "indistinguishable" from commercial entities.⁶⁶

Many of these challenges are also tied to concerns about the level of free care provided and whether the entities in question in fact lessen the burdens to be borne by government.⁶⁷ While not directly turning on the question whether an entity is engaged in commercial activities, these questions do look to a sense of difference. This dichotomy bolsters the concept that charity must be something qualitatively distinct from commercial activity, perhaps by providing some of its services gratis or by engaging in quasi-governmental activity that businesses would presumably shun.

⁶² See Gallagher, *Property-Tax Exemption for Charities*, at 11; Evelyn Brody, *The States' Growing Use of a Quid-Pro-Quo Rationale for the Charity Property Tax Exemption*, 56 EXEMPT ORG. TAX REV. 269, II(B) (2007).

⁶³ See Evelyn Brody, *The States' Growing Use of a Quid-Pro-Quo Rationale for the Charity Property Tax Exemption*, 56 EXEMPT ORG. TAX REV. 269, II(D) (2007) (collecting cases applying a prohibition on high user fees for entities qualifying for the charity property tax exemption).

⁶⁴ See Evelyn Brody, *The States' Growing Use of a Quid-Pro-Quo Rationale for the Charity Property Tax Exemption*, 56 EXEMPT ORG. TAX REV. 269, II(D) (2007) (finding "[t]he existence of for-profit competitors is generally not enough to render property taxable, although courts do consider competition a factor" and again collecting cases from various states).

⁶⁵ See Gallagher, *Property-Tax Exemption for Charities*, at 12-14; Evelyn Brody, *The States' Growing Use of a Quid-Pro-Quo Rationale for the Charity Property Tax Exemption*, 56 EXEMPT ORG. TAX REV. 269, II(E) (2007).

⁶⁶ See, e.g., *Surtees v. Carlton Cove, Inc.*, 974 SO.2D 1013, 1017 (Ala. Civ. App. 2007); *Presbyterian Residence Center Corp. v. Wagner*, 66 A.D.2D 998, 999 (N.Y.A.D. 1978); see also *Under the Rainbow Child Care Ctr., Inc. v. County of Goodhue*, 741 N.W.2d 880, 883 (2009) (upholding an assessor's denial of property tax exemption to a child care center providing its services "at or just below market rates").

⁶⁷ See Evelyn Brody, *The States' Growing Use of a Quid-Pro-Quo Rationale for the Charity Property Tax Exemption*, 56 EXEMPT ORG. TAX REV. 269, II(C) (2007).

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Throughout state property tax exemption law, the skepticism around commercial activity by charities is prominent, relevant and, sometimes, determinative.

Federal tax exemption law further reflects fundamental skepticism regarding charities' commercial activity in at least two sets of doctrine. Entities found to be overly "commercial" will be ineligible for exemption as charities.⁶⁸ In addition, the unrelated business income tax (UBIT) taxes income generated from unrelated business activities at the highest corporate or trust rate.⁶⁹ Much of this area of federal law is murky; indeed, it has become a commonplace to describe it as such.⁷⁰ Yet, it is worth reviewing to reveal its anti-commerciality bent.

Although outright prohibition of commercial activity can be found,⁷¹ federal tax law concerns itself mostly with the extent and nexus of this activity with an entity's exempt purposes – tax law's term for permissible charitable missions.⁷² Regulations allow for exemption despite a charity's operation of

a trade or business as a substantial part of its activities, if the operation of such trade or business is in furtherance of the organization's exempt purpose or purposes and if the organization is not organized or operated for the primary purpose of carrying on an unrelated trade or business.⁷³

⁶⁸ See BRUCE R. HOPKINS, *THE LAW OF TAX-EXEMPT ORGANIZATIONS* §25.1-2 (1998); John D. Colombo, *Reforming Internal Revenue Code Provisions On Commercial Activity By Charities*, 76 *FORDHAM L. REV.* 667, 669-79 (summarizing current tax rules on commerciality); Hill, 56 *SMU L. REV.* at 695-700 (similar); see also MARION FREMONT SMITH, *GOVERNING NONPROFIT ORGANIZATIONS* at 247-48 (noting that the so-called "commerciality doctrine" was one "extrapolated from cases upholding the Service's denial of exemption on the basis that the operation of the charity in question was more in the nature of a commercial business operating in competition with for-profit companies," rather than one expressed in the Internal Revenue Code).

⁶⁹ See IRC §§ 511. Tax rules also address how related entities will be treated for exemption and UBIT purposes. These rules, generally not created specifically for the exemption context, have created incentives for charities to create complex structures in order to minimize risks of exemption and tax payments due. See Colombo; see also Douglas M. Mancino, *Managing Complex Structures* 3-31 ((2008 paper prepared for conference on The Architecture of Charities' Commercial Activities at the NYU Law School's National Center on Philanthropy and the Law, on file with author); Stephen Schwarz, *Structural Reactions: Basic Structures* 15-65 (2008 paper prepared for conference on The Architecture of Charities' Commercial Activities at the NYU Law School's National Center on Philanthropy and the Law, on file with author).

⁷⁰ See JAMES J. FISHMAN & STEPHEN SCHWARZ, *NONPROFIT ORGANIZATIONS: CASES AND MATERIALS* 596 (3d ed. 2006) (summarizing these concerns with the characterization of this doctrine as "untidy").

⁷¹ See Treas. Reg. § 1.501(c)(3)-1(b)(1)(iii) (using "a manufacturing business" as an example of non-exempt activity precluding exemption).

⁷² See Treas. Reg. § 1.501(c)(3)-1(e)(1).

⁷³ Treas. Reg. § 1.501(c)(3)-1(e)(1).

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Further, the regulations explain that it is relevant to compare “the size and extent of the trade or business and the size and extent of the activities which are in furtherance of one or more exempt purposes.”⁷⁴ This would appear to allow commercial activities, so long as they are insubstantial in comparison to exempt activities, and even substantial commercial activities, so long as they are in furtherance of exempt purposes. Substantial commercial activities not in furtherance of exempt purposes, however, raise the specter of a primary non-exempt purpose and jeopardize exemption.⁷⁵

Practically, though, the IRS and the courts tend to focus instead on how a charity conducts its commercial operations and whether this manner of operation appears similar to that of a for-profit.⁷⁶ A charity takes on an impermissible “commercial hue” when it uses a commercial pricing structure, selects products for their market appeal, advertises to a mass market, etc.⁷⁷ The size of the charity’s profits is also often relevant. Too much income from commercial activity, especially relative to its expenditures on charitable activities, endangers exemption.⁷⁸ Neither of these strains of analysis directly focuses on whether commercial activity is “in furtherance of exempt purposes” and even this general summary suggests more consistency than one finds in regulatory and judicial rulings.⁷⁹

Federal tax law also hampers charities’ unrelated commercial activity even when it is not sufficiently substantial to exclude an entity from the charity category altogether. Rather than prohibiting or limiting this behavior outright, the UBIT taxes income derived from it. UBIT taxes income generated by a “trade or business.”⁸⁰ Almost anything done for income will qualify,⁸¹ and the regulations define trade or business activities narrowly. Therefore, when sales are made to distinct groups, or of distinct products, or an entity sells advertising within a related publication, each is treated as

⁷⁴ Treas. Reg. § 1.501(c)(3)-1(e)(1).

⁷⁵ Stephen Schwarz, *Structural Reactions: Basic Structures* 10-11 (2008 paper prepared for conference on The Architecture of Charities’ Commercial Activities at the NYU Law School’s National Center on Philanthropy and the Law, on file with author) (noting this “conventional wisdom”).

⁷⁶ See Brody, in *NONPROFITS & BUSINESS* at 93 (“case law tends to support the perhaps unfortunate result that nonprofits are often punished for efficient commercial operations”).

⁷⁷ See BRUCE R. HOPKINS, *THE LAW OF TAX-EXEMPT ORGANIZATIONS* 77-82(1998); Brody, in *NONPROFITS & BUSINESS* at 93-95; Colombo, 76 *FORDHAM L. REV.* 675-79.

⁷⁸ See BRUCE R. HOPKINS, *THE LAW OF TAX-EXEMPT ORGANIZATIONS* 80-82 (1998); Brody, in *NONPROFITS & BUSINESS* at 93-95; Colombo, 76 *FORDHAM L. REV.* 675-76.

⁷⁹ John D. Colombo, *Reforming Internal Revenue Code Provisions On Commercial Activity By Charities*, 76 *FORDHAM L. REV.* 667, 675 (2007) (“[T]he case law has evolved into asking whether a particular activity has a commercial hue, and if so, whether it is substantial. Positive answers to these questions generally lead to loss of tax exemption, though even here the analysis is variable.”).

⁸⁰ I.R.C. § 511.

⁸¹ See Treas. Reg. § 1.513-1(b) (defining a trade or business as “any activity carried on for the production of income from the sale of goods or performance of services”).

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a separate trade or business activity under UBIT. The activity must also be “regularly carried on,”⁸² defined as frequent and continuous as compared with the conduct of the activity in its usual course.⁸³ Finally, the activity must not be “substantially related to [the charity’s] exempt purposes.”⁸⁴ Substantial relationship depends on whether an activity “contributes importantly” to the accomplishment of exempt purposes.⁸⁵ This test is one of facts and circumstances, but the activity’s size, extent, and potential to compete with commercial firms are all important factors.⁸⁶ Various exceptions limit UBIT’s application,⁸⁷ and a UBIT-paying charity may take all of the deductions that would otherwise be available to a taxable entity paying tax on the relevant income.⁸⁸ As a result of the sophisticated use of exemptions, deductions, and separate entities, and perhaps charities’ fears about entering commercial ventures due to exemption risk, the UBIT collects relatively little revenue.⁸⁹ Yet, its message remains obvious: commercial activity is suspect and charities who engage in it will be subject to scrutiny and doubt.⁹⁰

Current charity law is not as strident about charities’ commercial activities as it is about self-regarding ones. It says commercial activities are suspect, not forbidden. Yet, the law speaks volumes on the subject, evaluating gradations of acceptable activity and imposing measured penalties. Despite the complexity and sometimes confusion of this body of law, it articulates a strong distrust of charities’ commercial activities, whatever the use of the funds they generate. This message might lead one to believe an anti-commerciality position is essential to charity law.

The question remains, however, whether charity law’s focus on identifying and restricting commercial activities is indeed necessary to enforce its mission imperative. Society wants charities to focus on their missions, so they can generate the societal

⁸² I.R.C. § 512.

⁸³ See Treas. Reg. § 1.513-1(c). For example, summertime ice cream shop at a northeastern community center will be regularly carried on. A sundae-selling event once a year will not.

⁸⁴ I.R.C. § 513.

⁸⁵ See Treas. Reg. § 1.513-1(d)(1)-(2).

⁸⁶ See Treas. Reg. § 1.513-1(d)(1)-(2).

⁸⁷ See I.R.C. §§ 512(b), 513(d)-(j). For a more detailed discussion of the UBIT, see FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS at 289-95 and Brody, in Nonprofits & Business at 96-100.

⁸⁸ See I.R.C. §§ 511(a)(1).

⁸⁹ See FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS at 295 (reporting the consensus of the conferees attending a 1999 meeting “that UBIT has in effect ‘become a voluntary tax’”); Grant Williams, *Many Charities Avoid Business-Income Tax*, CHRON. OF PHILANTHROPY at 36 (Apr. 23, 2009) (reporting studies showing only 40% of taxes reporting receiving UBI in 2005 paid any tax on it and that 51% of charities in a 2008 study listed their UBTI as zero following deductions and other calculations).

⁹⁰ See Brody, in NONPROFITS & BUSINESS at 113 (mentioning UBIT’s “symbolic value to policymakers and the public”); Stone, 54 EMORY L.J. at 1544 (proposing the purpose of UBIT is to “deter[] charities from engaging in activities that look bad”).

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gains for which they are prized and privileged. When a charity engages in commercial activities, concerns arise that this focus and these gains could be lost. First, there is the diversion concern.⁹¹ If the charity and its leaders begin engaging in commercial activities, perhaps they will become distracted from their core mission and overly involved with the entity's business activities.⁹² A community theater that opens a coffee house to enhance its revenue stream might lose track of its cultural mission while embroiled in the day-to-day operations of the business. When the commercial activity is an inherent part of a group's charitable mission, such as with schools that sell education services or hospitals that sell healthcare, the diversion concern is subtler. Individual product lines that compete with for-profit providers or are offered to paying students or patients paying market rates may be launched to generate revenue to subsidize mission-related programs. Yet, these activities could possibly take over leaders' attention and distract from goals and activities closer to the core of a charity's mission.

In each case, of course, the converse could also be true and the commercial activities could reinforce the charity's pursuit of its mission.⁹³ The coffee house could raise needed revenue to allow the theater group to put on more productions or to reduce ticket prices to encourage a more socio-economically diverse audience. It could even draw new artists and theatergoers through the theater's doors. Schools' and hospitals' market product lines could likewise subsidize their less profitable teaching and healing activities, improve the skills of their faculties and physicians, or spread the word about their core mission offerings to a wider community. Current charity law restricting commercial activities is, if anything, a highly imperfect proxy for addressing the mission question charities can best answer for themselves.

A second concern about charities' commercial activities also casts charity law's limits on commerciality in this proxy role. This concern suggests that commercial businesses that do not generate the social goods expected of charities could elide the relatively lax enforcement apparatus and thereby improperly obtain benefits intended only for charities. They would be "for-profit[s] in disguise."⁹⁴ This would inappropriately drain the public fisc, reducing societal resources without obtaining

⁹¹ See John D. Colombo, *Commercial Activity and Charitable Tax Exemption*, 44 WM. & MARY L. REV. 487, 534-38, 541-44 (2002) (describing the diversion concern, and the related concern regarding whether commercial activities might signal that a charity does not deserve various tax benefits); see also Hill, 56 SMU L. REV. at 700-01 (arguing for a new tax regime imposing a "nondiversion constraint" to limit the use of exempt resources for nonexempt purposes, including commercial and political activities).

⁹² See SEEDCO POLICY CENTER, *THE LIMITS OF SOCIAL ENTERPRISE* 7 (2007); Colombo, 44 WM. & MARY L. REV. at 534-35; Burton A. Weisbrod, *The Pitfalls of Profits*, STAN. SOC. INNOV. REV. 40, 44 (Winter 2004).

⁹³ See J. Gregory Dees, *Enterprising Nonprofits*, HARV. BUS. REV. 5, 8-12 (Jan.-Feb. 1998).

⁹⁴ See BURTON A. WEISBROD, *THE NONPROFIT ECONOMY* 11 (1988).

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the social return that expenditures on charities would.⁹⁵ It also could result in reputational costs for true charities, as the public would become less trusting that charities are beneficial to society and deserving of the benefits they enjoy.⁹⁶ Again, current charity law warns against commercial activities and limits and penalizes them when they are undertaken as a messy proxy for arresting mission-threatening activities.

Under current charity law, commercial activities raise a red flag as to whether a charity is truly focused on its charitable mission or has become at best distracted, and at worst, a front for an entirely business enterprise. Commercial activity is easier for regulators to observe and superficially appears more appropriate for them to regulate than the harder questions of whether a charity has veered from its legitimate mission. But, ultimately, it is the mission question that charity law cares about. The anti-commerciality position articulated by current charity law chills potentially useful activity, as well as each charity's own dialogue about how best to pursue its mission.

D. *Limitations on Political Activities*

Like the anti-commerciality thread in current charity law, a significant body of cases, statutes and regulations devote themselves to restricting or barring charities from engaging in the political process. Federal tax law takes a fairly prophylactic approach. Section 501(c)(3) admits to exempt status only charities for which "influencing legislation" is "no substantial part" of their activities.⁹⁷ Regulations do not offer a measure of substantiality,⁹⁸ but the few cases addressing the topic suggest these activities are subject to a fairly low ceiling.⁹⁹ The chilling effect of this uncertainty leads some charities to elect a series of optional and complex, but more quantifiable, restrictions.¹⁰⁰ These restrictions require lobbying expenditures to be maintained below a maximum twenty percent of the entity's operating budget.¹⁰¹

⁹⁵ See WEISBROD, *THE NONPROFIT ECONOMY* at 11-13; Colombo, 44 WM. & MARY L. REV. at 532-34.

⁹⁶ See WEISBROD, *THE NONPROFIT ECONOMY* at 13-14.

⁹⁷ I.R.C. § 501(c)(3).

⁹⁸ See generally *Developments in the Law: Nonprofit Corporations*, 105 HARV. L. REV. 1578, 1662 (1992).

⁹⁹ See, e.g., *Seasongood v. Commissioner*, 227 F.2d 907, 912 (6th Cir. 1955) (holding less than five percent of political activity not substantial); *Haswell v. United States*, 500 F.2d 1133, 1142 (Ct. Cl. 1974) (eschewing a percentage rule, but finding an organization with political actions comprising approximately twenty percent of its activity ineligible to receive tax deductible contributions).

¹⁰⁰ See Oliver A. Houck, *On the Limits of Charity: Lobbying, Litigation, and Electoral Politics by Charitable Organizations Under the Internal Revenue Code and Related Laws*, 69 BROOK. L. REV. 1, 62-67 & n.379 (2003) (noting groups' claims that the "no substantial part" test chilled lobbying made in the hearings on the new regime).

¹⁰¹ See I.R.C. § 4911(c)(2). The statute imposes a sliding scale, permitting lobbying expenditures up to twenty percent of an organization's exempt purpose expenditures, provided these are \$500,000

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Private foundations, which are generally charities with a small group of funders, are not permitted to engage in any lobbying whatsoever.¹⁰² In addition to the lobbying limits, all categories of federally-exempt charity are banned from electioneering activity.¹⁰³ The IRS will apply penalty taxes or revoke a charity's exempt status for supporting or opposing candidates.¹⁰⁴

As sweeping as the federal political limitations might seem, charities of sufficient size and sophistication can use a range of techniques to work around them. If an otherwise charitable entity wishes to engage in greater political activity than § 501(c)(3) will allow, it may form instead as a social welfare organization under § 501(c)(4).¹⁰⁵ Once this status is accepted, an entity may attempt to influence legislation, so long as these attempts are germane to its social welfare purposes.¹⁰⁶ In fact, germane attempts to influence legislation may even be the primary purpose of an entity exempt under § 501(c)(4).¹⁰⁷ Status under § 501(c)(4) does not, however, throw open the door to unfettered involvement in politics. If political campaign activities become the primary activity of a § 501(c)(4) organization, it will no longer qualify for exemption under that section.¹⁰⁸ Indeed, if a § 501(c)(4) exempt organization makes political campaign expenditures, it becomes subject to federal income tax on the lesser of its net investment income or the amount it spends on political campaign activity.¹⁰⁹ The purpose of this tax appears to be to place § 501(c)(4) organizations on an equal tax footing with § 527 organizations,¹¹⁰ which are devoted specifically to political campaign activity and are taxed on their investment income.¹¹¹

or less, and lower percentages of an such expenditures as the overall budget rises. *See id.* Overages result in penalty taxes; repeat offenders can lose exemption. *See* Treas. Reg. § 1.501(h)-3.

¹⁰² *See* I.R.C. § 4945(d)(1) (subjecting any lobbying expenditure by a private foundation to prohibitive penalty taxes).

¹⁰³ *See* I.R.C. § 501(c)(3) (“no part of the net earnings of” a tax-exempt public charity may be used to “participate in, or intervene in . . . any political campaign on behalf of (or in opposition to) any candidate for public office”).

¹⁰⁴ *See* I.R.C. § 4955 (taxing campaign expenditures by any exempt organization); § 4945(d)(2) (subjecting campaign activity by a private foundation to additional prohibitive penalty taxes); *see also e.g.*, *Branch Ministries v. Rossotti*, 211 F.3d 137, 141–42 (D.C. Cir. 2000) (affirming IRS revocation of a church's exempt status due to campaign activities).

¹⁰⁵ I.R.C. § 501(c)(4).

¹⁰⁶ *See* Gen. Couns. Mem. 33,495.

¹⁰⁷ *See* Gen. Couns. Mem. 34,212; Rev. Rul. 71-530 (stating that “[t]he fact that the organization's only activities may involve advocating for changes in the law does not preclude the organization from qualifying under section 501(c)(4) of the Code).

¹⁰⁸ *See* Treas Reg. § 1.501(c)(4)-1(a)(2)(ii).

¹⁰⁹ *See* I.R.C. § 527(f).

¹¹⁰ *See* Report of Senate Finance Committee on Pub. L. 93-625, S.Rep.No. 93-1358, 93d Cong., 2d Sess., 29 (1974), 1975-1 C.B. 517, 533.

¹¹¹ *See* I.R.C. § 527(b),(c), (e).

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Relegating charities with substantial political activities to a different category sends a strong message that such activities are inappropriate for charities. This second class status provides § 501(c)(4)s with some level of exemption, but does not entitle them to receive tax-deductible contributions. Indeed, enforcing the prohibition on receiving such contributions may well be the major reason they are shunted into this lesser category. The existence and contours of the § 501(c)(4) category express the conviction that charity and politics should remain distinct.

A sophisticated charity with political objectives may also split into multiple entities to maximize the tax advantages the charity can attain and the political activities in which it can engage. The split entities are then linked together to the extent permissible without jeopardizing this delicate balance. Dual and triad structures are common. In the dual structure, an entity exempt under § 501(c)(3) affiliates with one exempt under § 501(c)(4).¹¹² In a triad structure, a § 527 political organization is added. In each case, the § 501(c)(3) exempt entity engages in permissible exempt activities and, perhaps, an insubstantial amount of lobbying. The § 501(c)(4) forms with social welfare purposes strikingly similar to the (c)(3) exempt purposes of its sister organization, but with the additional purpose of engaging in germane lobbying activities and, perhaps, some limited political campaign activity. The §527 is formed specifically to engage in election-related activities, and may be set up as a separate corporation or a segregated fund within the § 501(c)(4) exempt entity.¹¹³ In dual or triad structures, the affiliated (c)(3) and (c)(4) organizations can be linked through overlapping boards or by placing the authority to appoint board members of the (c)(4) in the hands of the (c)(3) entity.¹¹⁴ When a triad structure is used, the (c)(4) can create and influence § 527 organization through board membership,¹¹⁵ but the (c)(3) cannot directly control the § 527.¹¹⁶ Also, no matter which affiliated structure is utilized, intermingling of funds is prohibited, and the organizations must be separately incorporated and have separate books.¹¹⁷ These complex structures permit charities to maintain their charity status under federal tax exemption law and engage in a substantial, though still not unlimited, political activity. Still, the burden of creating and maintaining such affiliated structures is one that many charities

¹¹² See Simon, Dale and Chisolm, *The Federal Tax Treatment of Charitable Organizations*, at 285 (discussing this “sibling option”). The dual structure has been blessed, and some would say made constitutionally mandatory, by the United States Supreme court in *Taxation With Representation*, 461 U.S. 540 (1983), discussed *infra*.

¹¹³ See Simon, Dale and Chisolm, *The Federal Tax Treatment of Charitable Organizations*, at 285 (describing this as a “double sibling structure” and noting its blessing in *Branch Ministries v. Rosotti*, 211 F.3d 137, 143 (D.C. Cir. 2000).

¹¹⁴ See FISHMAN & SCHWARZ, *NONPROFIT ORGANIZATIONS* at 555.

¹¹⁵ See Simon, Dale and Chisolm, *The Federal Tax Treatment of Charitable Organizations*, at 285

¹¹⁶ See FISHMAN & SCHWARZ, *NONPROFIT ORGANIZATIONS* at 556.

¹¹⁷ See FISHMAN & SCHWARZ, *NONPROFIT ORGANIZATIONS* at 555.

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cannot bear, and imposing it demonstrates again the disfavor charity law has for political activity.

State law instructing charities to eschew politics is more limited and varied. Most often, state courts presented with the question have resolved that a nonprofit corporation or charitable trust may be formed with the partial or exclusive purpose of changing existing law.¹¹⁸ Even as they make these pronouncements, however, state judges often seem leery of political activities by charities. And, a few old precedents remain on the books branding such purposes outside the charitable category.¹¹⁹ Even if nonprofit corporate or charitable trust status will not be threatened by political purposes, qualification for state property tax exemption is another story. Although state statutes do not tend to call out political activities as a threat to property tax exemption, precedents in a variety of states assert that political activities will scuttle exemption for particular organizations or property uses.¹²⁰

A significant body of law expresses distaste for political activity by charities. Federal tax law imposes severe limitations based on it, though routes exist for some charities to partially avoid these restraints. State law is more equivocal. Engaging in politics will rarely block access to formation as a charity under state law. Still, property tax exemption may be threatened by such activities, and the overall concern about these activities somehow corrupting charities remains clear. Again, one might take from this reading the idea that eschewing politics is essential to protect charitable mission. Even without comprehensive and consistent prohibitions, charities have received the message that they should eschew politics. That message is loud and clear, and it chills charities' enthusiasm for engaging even in permitted political activities.¹²¹ Yet, it remains debatable whether charity law needs to direct charities to avoid politics in order to safeguard the mission imperative.

The law directing charities to avoid politics seems inextricably tied to a quite cynical view of the political system as flawed and somewhat shady. The fear here is that a

¹¹⁸ See, e.g., *Register of Wills for Baltimore City v. Cook*, 216 A.2d 542, 549 (Md. 1966)..

¹¹⁹ See, e.g., *Workmen's Circle Educational Ctr. v. Board of Ass'rs*, 314 Mass. 616, 618-20 (Mass. 1943); *Jackson v. Phillips*, 96 Mass. (14 Allen) 539, 555 (1867); but see *Elias Clark, The Limitation on Political Activities: A Discordant Note in the Law of Charities*, 46 VA. L. REV. 439, 447-48 (discussing *Jackson* and similar cases and deeming them a dead letter nearly half a century ago).

¹²⁰ See, e.g., *In re Westboro Baptist Church*, 189 P.3d 535, 554 (Kan. Ct. App. 2008) (noting that "our Supreme Court has determined that political action or activities are not considered a religious activity" in affirming a denial of tax exemption for personal property owned by a religious group, but used for political purposes); *New England Legal Found. v. City of Boston*, 670 N.E.2d 152, 158-59 & n.8 (Mass. 1996) (asserting that its state law also precludes tax exemption for organizations at some level of political activity); *Mich. United Conservation Clubs v. Twp. of Lansing*, 378 N.W.2d 737, 743 n.6 (Mich. 1985) (noting that "certain forms of lobbying may preclude a tax exemption").

¹²¹ See *Mark Chaves, Laura Stephens & Joseph Galaskiewicz, Does Government Funding Suppress Nonprofits' Political Activity?*, 69 AM. SOC. REV. 292, 297 (2004); *Clark*, 46 VA. L. REV. at 452-54.

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charity that becomes enmeshed in politics, or does so to a significant degree, will become sidetracked by this involvement to the detriment of its charitable mission.¹²² Alternatively, of course, a charity might reasonably see lobbying, appealing to the public engage with the political system, or campaigning for candidates for public office as vital components of pursuing its charitable mission. Regardless, current charity law warns charities to abstain from or limit political involvement, lest their leaders be diverted, their reputations sullied, or both. Public enforcement is, of course, uniquely unsuited to police whether a charity's political activity has begun to detract from its charitable mission. The restrictions on political activity again serve as merely a convenient proxy for the real concerns regarding charities' mission accountability.

Legal requirements limiting or prohibiting charities' involvement in political activity have been linked to other goals, of course. Perhaps the most common explanation for restricting charities' political activity is that government needs to remain neutral in the benefits it provides to charities.¹²³ This neutrality argument, however, is undermined by the ability of charities to engage in limited political activities and by government's apparent willingness to forego neutrality when granting businesses deductions for political activity.¹²⁴ Some have also raised concerns that expanding these benefits to politically active charities would generate an intolerable loss in tax revenue.¹²⁵ This argument posits that a concern for the diversion of government resources, and by extension taxpayer dollars, is the problem with charities' political activity, rather than the diversion of charity leaders. This argument, though, eventually leads back to concerns about charitable mission. If political activity is an appropriate action for charities, as relevant to their programs to feed the hungry, putting on cultural events, or improving neighborhood relations, one should not worry that government resources are being expended on these activities. Indeed, the tax benefits for charities are intended to recognize the value of these contributions to society.

The political nature of lobbying and electioneering activities do not inherently pose risks to mission accountability. Political activities raise mission concerns when they lead charities to pursue purely private purposes or magnify the power of individuals

¹²² See Donald B. Tobin, *Political Campaigning by Churches and Charities: Hazardous for 501(c)(3)s, Dangerous for Democracy*, 95 GEO. L.J. 1313, 1337-39 (2007); see also Laura B. Chisolm, *Exempt Organization Advocacy: Matching the Rules to the Rationales*, 63 IND. L.J. 201, 248 (1987/88) (describing this view critically); Buckles, 75 U. CIN. L. REV. at 1085-91 (similar).

¹²³ See Buckles, 75 U. CIN. L. REV. at 1079-85; Chisolm, 63 IND. L.J. at 249-52; Miriam Galston, *Lobbying and the Public Interest: Rethinking the Internal Revenue Code's Treatment of Legislative Activities*, 71 TEX. L. REV. 1269, 1286-1314 (1993).

¹²⁴ See Chisolm, 63 IND. L.J. at 250-52; Galston, 71 TEX. L. REV. at 1286-1314.

¹²⁵ See Clark, 46 VA. L. REV. at 460-61).

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within charities, while screening them from observation and regulation.¹²⁶ Rather than attempting to determine whether charities have veered off-course in such damaging ways, however, current charity law uses broad political restrictions as a messy proxy.

* * *

The purpose of charity law is to focus charities and their leaders on the mission imperative. Current charity law partially, but not optimally, pursues this goal. It already forcefully demands that charities maintain an other-regarding orientation. Self-regarding activity, which uses the charity to provide benefits to its leaders or other private individuals outside the class benefitted by its charitable mission, should continue to disqualify an entity from charitable status. In contrast, current charity law demonstrates only a weak commitment to group governance. A charity must be composed of and governed by a group, rather than by a single individual, in order to provide a means for monitoring and evolving charitable mission. Therefore, charity law should be revised to more consistently embrace a strong group governance norm. Current charity law's attempts to define and limit charities' commercial and political activity at best operate as messy proxies for mission enforcement. These activities are not inherently destructive of mission, and chilling them may damage charities' autonomy and vitality. Thus, the commercial and political restrictions are ripe for relaxation or removal.

II. CHALLENGES TO THE ESSENTIALS

The constraints created by current charity law attempt to train the eyes of charity leaders on their missions. As with any constraint, however, they also impose real costs. They limit possible innovations in charity financing, working methods, and governance. Charity innovators are bumping up against these constraints, and challenging them in creative and interesting ways. Many of these challenges derive from the increasing trend toward activities and entities that blend charitable motivations with business methods and forms. This Part will offer a series of examples of sector-blending activity, suggest how these phenomena challenge current charity law, and address how charity law should respond to them. This review reinforces the notion that charity law embodying the other-regarding orientation requirement remains crucial and that charity law expressing the group governance requirement should be amplified. It also offers further support for easing the restrictions on charities' commercial and political activities.

¹²⁶ See Buckles, 75 U. CIN. L. REV. at 1085-89; David A. Brennen, *A Diversity Theory Of Charitable Tax Exemption—Beyond Efficiency, Through Critical Race Theory, Toward Diversity*, 4 PITT. T. REV. 1, 17 (2006) (arguing the purpose of tax law's political limitations, among others, is to “to mediate between the private individual tendency for authoritative control and the public interests advanced by the charitable entity”).

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A. Self-Regarding Charity

Several recent proposals and innovations would permit self-regarding behavior by charities. In one such ambitious proposal, Dan Palotta calls for a finite break with the past and a new model for charities to operate with a profit-distribution motivation.¹²⁷ Charities should be permitted to raise capital by promising investors a financial return.¹²⁸ Palotta argues his reform will help charities raise crucial funding, beyond what donations, loans, and fees for services can provide.¹²⁹ First off, these existing sources simply do not provide enough total financing to fund the projects the charitable sector can and should put forward.¹³⁰ Second, these funding sources come with inherent limitations on their use.¹³¹ Donors tend to want their investments to be used to create programs immediately or to be placed in an endowment and left untouched. Bank loans and tax-exempt bond financing are options, but loan officers will require collateral and will not lend to charities in order to support innovative new programs. Fees for service are not available to all charities, by any means; they are a feasible source of income only to those charities who serve relatively wealthy beneficiaries with the ability to pay. Investment capital, on the other hand, is a huge untapped resource charities can use to pursue innovation and take risks, limited only by what the market is willing to fund.¹³² Thus, equity capital can be used to fund innovation and risk-taking activities in a way that other sources of charity capital cannot.¹³³

Today, of course, charity law's other-regarding orientation requirement blocks this financing resource. Palotta argues this restriction should be removed to allow charities to seek equity investors and pay them for access to their capital.¹³⁴ In the absence of such changes (or until they happen), he suggests that entrepreneurs with charitable missions legally form their organizations as for-profit corporations to avoid these restrictions – as he did.¹³⁵

¹²⁷ See DAN PALOTTA, UNCHARITABLE: HOW RESTRAINTS ON NONPROFITS UNDERMINE THEIR POTENTIAL 17(2008).

¹²⁸ See PALOTTA, *supra* note __, at 116-25. This proposal is part of Palotta's broader agenda of reform. Other items including expanding the magnitude and types of compensation nonprofits may pay, encouraging them to take greater risks and look to the long term, encouraging them to engage in paid advertising. See *id.* at 47-116.

¹²⁹ See PALOTTA, *supra* note __, at 117-18.

¹³⁰ See PALOTTA, *supra* note __, at 117-18.

¹³¹ See PALOTTA, *supra* note __, at 118-20.

¹³² See PALOTTA, *supra* note __, at 121.

¹³³ See PALOTTA, *supra* note __, at 123-24.

¹³⁴ See PALOTTA, *supra* note __, at 124.

¹³⁵ See PALOTTA, *supra* note __, at 124.

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Where Palotta reasons from experience, law professors Anup Malani and Eric Posner use economic analysis.¹³⁶ They, too, contest the need to restrict charities from utilizing equity capital. In a challenge to federal tax law's expression of the other-regarding orientation requirement, they argue that the right to tax exemption should be uncoupled from the nonprofit form and its nondistribution constraint.¹³⁷ Rather, when for-profit entities engage in socially-beneficial activities, they too should be eligible for tax benefits currently reserved only for nonprofit charities.¹³⁸ Malani and Posner take issue with various arguments that might justify coupling. They argue that if tax subsidies are useful to augment the production of public goods, these subsidies should be made available to any entity that produces public goods, regardless of their nonprofit or for-profit form.¹³⁹ Likewise, they argue that the nondistribution constraint is not necessary to solve the agency problems that arise in producing charitable goods or services, and assert that it will often be ineffective in doing so.¹⁴⁰ Further, Malani and Posner claim that, at least outside the case of true public goods, encouraging altruists to produce charitable goods and services will often result in inefficient overproduction.¹⁴¹ Finding each of these justifications wanting, they argue that any government subsidization of community benefit activities available to nonprofits should be made equally available to subsidize such activities by for-profits.¹⁴²

¹³⁶ See Anup Malani & Eric A. Posner, *The Case for For-Profit Charities*, 93 VA. L. REV. 2017 (2007).

¹³⁷ See Malani & Posner, 93 VA. L. REV. at 2064-65.

¹³⁸ See Malani & Posner, 93 VA. L. REV. at 2064-65.

¹³⁹ See Malani & Posner, 93 VA. L. REV. at 2029-31.

¹⁴⁰ See Malani & Posner, 93 VA. L. REV. at 2031-39.

¹⁴¹ See Malani & Posner, 93 VA. L. REV. at 2042-50. The authors also dispatch with the idea that coupling protects consumers suffering from inadequate information about the producers of charitable goods or avoids the administrative burden that policing tax benefits for community benefits of for-profits would create for the IRS. See *id.* at 2050-54. They suggest that enforcement of consumer protection laws should be sufficient to deal with the former problem and user fees could offset the impact of the latter. See *id.*

¹⁴² Of course, these ideas have not gone without challenge. Victor Fleischer noted the significant regulatory challenges involved in executing Malani and Posner's proposal. See Victor Fleischer, "For Profit Charity": *Not Quite Ready for Prime Time*, 93 VA. L. REV. IN BRIEF 231 (2008). Further, Hines, Horwitz and Nichols dispute the authors' theoretical claims. See James R. Hines, Jill R. Horwitz and Austin Nichols, *The Assault on Nonprofit Status: A Charitable Assessment* (Oct. 2008 draft on file with author). First, they note that it may be unnecessary to extend tax benefits for the community benefit activities undertaken by for-profits, as any loss in profitability that occurs as a result of these activities will be accompanied by an equivalent decrease in tax liability. See *id.* at 10. They assert that Malani and Posner's proposal will create opportunities for tax arbitrage that will be difficult to police. See *id.* at 11-13. Furthermore, additional tax benefits will create incentives for for-profits to enter or increase their presence in industries populated by nonprofits, which the authors predict will negatively impact competition in these industries. See *id.* at 14-15, 22-24. Relying on studies principally in the health care context, they argue that for-profits will crowd out nonprofits as

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These proposals do not exist solely in the realm of theory. Even without the carrot of tax breaks, Google Inc. has taken up the idea of pursuing charitable endeavors by for-profit means. It formed Google.org, the philanthropic arm to which it will devote 1% of the company's equity and profits, as a division of for-profit Google Inc.¹⁴³ Although the company originally founded a traditional nonprofit, tax-exempt foundation to pursue its philanthropic vision, it soon found charity law's restrictions on this mode of operations too constraining.¹⁴⁴ It moved its philanthropy in-house, within its profit-generating and profit-distributing public company. As such, Google.org directly invests in companies and projects that are in line with its conservation, public health, and poverty reduction mission.¹⁴⁵ While it makes grants to nonprofits as well, Google.org emphasizes direct investment and use of Google Inc. resources, where it feels it can produce the greatest social good.¹⁴⁶ If and when these investments generate returns, the returns will go to Google itself and are, at least in theory, available for distribution to the company's shareholders.¹⁴⁷ However, even Google.org's founders do not appear to support a complete reversal in the commitment to the other-regarding orientation requirement. Thus far, while its for-profit philanthropy model would permit equity returns from its charitable activities, Google.org leaders fervently claim that any such gains would only be reinvested in future philanthropy.¹⁴⁸ Still, Google.org nicely demonstrates the frustration of charity innovators with the limitations of charity law, and how they are seeking to escape it.

Although the founders of social enterprises generally do not seek charity status, reasoning like Palotta's or Malani and Posner's could also bring these organizations within the charity fold. These companies gauge their success by two metrics – earning profits for owners and achieving some measure of social or community

they enter mixed industries and will influence the behavior of nonprofits away from their other-regarding missions. *See id.* at 22-24.

¹⁴³ See Google.org, *How Google.org Got Started*, at <http://www.google.org/about.html>.

¹⁴⁴ See *id.*; see also Posting of Sheryl Sandberg, Vice President, Global Online Sales & Operations, Google.org, to The Official Google Blog, <http://googleblog.blogspot.com/2005/10/about-googleorg.html> (Oct. 11, 2005, 9:02 PM) (stating that Google does not “expect to make further donations to the Foundation for the foreseeable future”).

¹⁴⁵ See Google.org, *How Google.org Got Started*, at <http://www.google.org/about.html>.

¹⁴⁶ See Posting of Dr. Larry Brilliant, Chief Philanthropy Evangelist, Google.org, to The Official Google.org Blog, <http://blog.google.org/2009/02/next-chapter-for-googleorg.html> (Feb. 23, 2009 4:17 PM).

¹⁴⁷ See Dana Brakman Reiser, *For-Profit Philanthropy*, 77 *FORDHAM L. REV.* 2437, 2466-67 (2008); James J. Fishman, *Wrong Way Corrigan and Recent Developments in the Nonprofit Landscape: A Need for New Legal Approaches*, 76 *FORDHAM L. REV.* 567, 607 (2007).

¹⁴⁸ See Katie Hafner, *Philanthropy Google's Way: Not the Usual*, *N.Y. TIMES*, Sept. 14, 2006, at A1; Harriet Rubin, *Google's Searches Now Include Ways to Make a Better World*, *N.Y. TIMES*, Jan. 18, 2008, at C1.

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benefit, perhaps doing the former to enable the latter.¹⁴⁹ Current charity law rejects a double-bottom line approach to charity due to the taint of profit distribution. These enterprises are unable to form as nonprofit corporations or charitable trusts; they cannot obtain federal or state tax exemption. By distributing profits to shareholders or other owners, social enterprises clearly breach the nondistribution constraint and pursue self-regarding objectives. Yet, the founders of these entities tout their combination of other-regarding and self-regarding objectives as their hallmark.¹⁵⁰ When an entity and its owners can “do well by doing good,” they see a strong hand forcing entities classed as charitable to pursue charity alone as short-sighted.¹⁵¹

Legislative innovations also figure here. Last year, Vermont became the first state to permit a form of legal organization that hybridizes for-profit and nonprofit forms.¹⁵² The low-profit limited liability company (L3C) tweaks the LLC form of organization. An L3C is formed to pursue traditionally charitable activities, but also intends to make some, albeit low, profit.¹⁵³ The legislation prohibits the income production from being a “significant purpose of the company ... provided, however that the fact that a person produces significant income or capital appreciation shall not, in the absence of other factors, be conclusive evidence [that income production is] a significant purpose.”¹⁵⁴

Individuals or entities may be members of the L3C, with rights in governance and to distributions. Any rights to distributions and the distributions themselves, however, need not be identical across members.¹⁵⁵ This flexibility enables some L3C members

¹⁴⁹ See J. Gregory Dees & Beth Battle Anderson, *For-Profit Social Ventures*, in SOCIAL ENTREPRENEURSHIP (Marilyn L. Kourisly & William B. Salstad eds., 2003) at 2 (referring to these entities as “for-profit social ventures”).

¹⁵⁰ See, e.g., Steve Lohr, *A Capitalist Jolt for Charity*, N.Y. Times, Feb. 24, 2008 at B1 (quoting one social enterprise founder saying his company “needs to be a large business to have a really significant social impact ... [w]e couldn’t do what we’re doing as a nonprofit”); Marci Alboher, *A Social Solution, Without Going the Nonprofit Route*, N.Y. Times, Mar. 5, 2009, at B5 (quoting another founder’s position that “We could have done it as a nonprofit over a hundred years, but if we wanted to do it in five or 10 years, then we believed it needed to be fueled by profit.”)

¹⁵¹ See JOHN ELKINGTON & PAMELA HARTIGAN, *THE POWER OF UNREASONABLE PEOPLE* (2008).

¹⁵² See 11 V.S.A. § 3001(23) (2008). A handful of additional jurisdictions have already followed suit, and several others are considering similar measures. See Nicole Wallace, *Tough Economy Offers New Opportunities for Charity-Run Businesses*, CHRON. OF PHILANTHROPY at 33 (May 7, 2009) (describing Michigan, Wyoming, Utah, and the Crow nation’s adoption of legislation recognizing the L3C); Ann Meyer, *Firms With Social Bent See Payoff In New Law*, CHICAGO TRIB. at 19 (Aug. 10, 2009) (noting Illinois’ enactment of L3C legislation); Americans for Community Development, *L3C Legislative Watch*, at <http://americansforcommunitydevelopment.org/legislativewatch.html> (listing states considering L3C legislation).

¹⁵³ See 11 V.S.A. § 3001(23)(A)(i).

¹⁵⁴ 11 V.S.A. § 3001(23)(B).

¹⁵⁵ See Robert Lang, *Americans for Community Development L3C Overview 3-4*, available at <http://americansforcommunitydevelopment.org/supportingdownloads/ACDOverview.pdf>.

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to contribute capital to the entity as investors; they seek and are entitled to a share in the entities' midstream or residual profits.¹⁵⁶ Other L3C members can contribute capital in a transaction financially akin to a donation, making contributions with little or even no likelihood of financial return.¹⁵⁷ The pass-through nature of federal taxation of LLCs means that the L3C entity itself will not be taxed; individual members' earnings will be taxed according to their independent tax status.¹⁵⁸

Therefore, the L3C may seek tranches of investors. One set of individuals and taxable entities can invest for a market-like return. Another set of such individuals can agree to take below-market returns in return for the social or psychic value produced by the entity. Finally, tax-exempt private foundations can make program-related investments in the L3C, for which contemplation of a return as a motive is specifically barred.¹⁵⁹ Indeed, the explicit goal of this legislation is to provide an organizational form that will signal to foundations that an entity is an appropriate recipient of program related investments.¹⁶⁰ Yet, the L3C form has potential to challenge the other-regarding orientation requirement beyond the foundation context.¹⁶¹ By permitting at least some tranches of L3C members to operate as investors, whether they seek market or below market rates of return, the L3C form explicitly melds other regarding and self-regarding modes of operation.

Across the Atlantic, the United Kingdom also has begun to offer a hybrid form of organization that poses some challenges to the other-regarding orientation requirement. The community interest company (CIC) is an entity formed under UK company law, and may be either limited by shares (similar to our for-profit conception) or limited by guarantee (similar to our nonprofit conception).¹⁶² However, CICs have several important characteristics that differentiate them from typical UK companies. A CIC must pass a community interest test, showing "that its purposes could be regarded by a reasonable person as being in the community or wider public interest"¹⁶³ and it must report on its community interest achievements

¹⁵⁶ See Lang, *L3C Overview* at 3.

¹⁵⁷ See Lang, *L3C Overview* at 4.

¹⁵⁸ See Lang, *L3C Overview* at 2.

¹⁵⁹ See I.R.C. § 4944(c) (mandating that "no significant purpose" of a program related investment "is the production of income or the appreciation of property"). Qualified program related investments count toward a private foundation's five percent annual payout requirement.

¹⁶⁰ See Lang, *L3C Overview* at 2.

¹⁶¹ See Tom Kelley, *Law and Choice of Entity on the Social Enterprise Frontier*, (unpublished manuscript on file with author) (arguing the major potential benefit of the L3C would be in branding social enterprises for a broad spectrum of investors).

¹⁶² See CIC Regulator, *Frequently Asked Questions – Registering a Community Interest Company*, at <http://www.cicregulator.gov.uk/faq.shtml#one>.

¹⁶³ See CIC Regulator, *FAQ–Community Interest Test*, at <http://www.cicregulator.gov.uk/faq.shtml#Test>.

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annually.¹⁶⁴ A CIC must also “confirm that access to the benefits it provides will not be confined to an unduly restricted group.”¹⁶⁵ If a CIC is limited by shares, it may have shareholders entitled to dividends, though these dividends are subject to a cap. Shareholders will not, however, share in the residual profits on winding up of the company. A CIC’s assets are subject to an “asset lock” whereby on dissolution all assets must go to a charity or another CIC.¹⁶⁶ All of this is overseen by a dedicated CIC regulator.

In the CIC, again, other-regarding and self-regarding modes are intentionally blended. On the one hand, the CIC must provide its benefits to some relatively large class and some core of a CIC’s assets must be irrevocably dedicated to community interest or charitable purposes. These requirements are intentionally broader than the UK law’s definition of charity.¹⁶⁷ In fact, CICs expressly fall outside the UK’s charitable category, and existing charities converting to CIC form will lose charity status.¹⁶⁸ On the other hand, the CIC entails a kind of equity investment where the shareholders are permitted to engage in profit-taking. Investors may purchase shares in a CIC, shares that entitle them to capped dividends that will vary depending upon the entity’s profits, though not to residual earnings on dissolution. Thus, the CIC offers observers an alternative model for hybridization and weakening of the other-regarding orientation requirement, though one the UK has deemed to fall outside the charity category.

The B Corporation initiative also attempts to create a hybrid brand for enterprises blending self- and other-regarding modes of operation, but without legislation. A B Corporation or for-benefit corporation incorporates under traditional state for-profit corporation law, but commits itself to “use[] the power of business to solve social and environmental problems.”¹⁶⁹ This commitment is solemnized by adoption of relevant language stating these dual purposes in the corporation’s charter and bylaws. Further, before an entity may use the “B” designation, it must be vetted by B Lab, a nonprofit third party certification entity that controls the trademark.¹⁷⁰ This private

¹⁶⁴ See CIC Regulator, *FAQ— Regulation*, at <http://www.cicregulator.gov.uk/faq.shtml#Regulation>.

¹⁶⁵ See CIC Regulator, *FAQ— Community Interest Test*, at <http://www.cicregulator.gov.uk/faq.shtml#Test>.

¹⁶⁶ See CIC Regulator, *FAQ— Community Interest Test*, at <http://www.cicregulator.gov.uk/faq.shtml#Assetlock>.

¹⁶⁷ See CIC Regulator, *FAQ — Charities and Community Interest Companies*, at <http://www.cicregulator.gov.uk/faq.shtml#charities>.

¹⁶⁸ See CIC Regulator, *FAQ — Charities and Community Interest Companies*, at <http://www.cicregulator.gov.uk/faq.shtml#charities>.

¹⁶⁹ B Lab, *Introducing the B Corporation*, at 3 (2009), available at http://www.bcorporation.net/resources/bcorp/documents/2009%20B%20Corp_Intro_Package.pdf.

¹⁷⁰ See B Lab, *Introducing the B Corporation*, at 3 (2009), available at http://www.bcorporation.net/resources/bcorp/documents/2009%20B%20Corp_Intro_Package.pdf

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contracting and certification system has not yet been fully tested in courts, but it provides a framework for institutionalizing and standardizing a form blending self-regarding and other-regarding behavior.

Some commentators see these and other developments as sufficiently scalable that they predict a potential market for charity.¹⁷¹ The over \$150 billion market for socially responsible investments suggests that at least some segment of consumers are interested investing funds in entities that blend the desire for profits with the desire for social good.¹⁷² Experiments with charitable or social “initial public offerings” (IPOs) further demonstrate the growing cache attached to challenging the other-regarding orientation requirement.¹⁷³ These efforts purport to sell ownership and use the trappings of an IPO, but in fact offer investment units that are economically indistinguishable from donations, with no profit-sharing element.¹⁷⁴ Of course, these IPOs are in reality little more than marketing ploys, but initiating charities believe the message of ownership will be salient enough to publicize it. This belief is quite astounding if one believes in the unassailability of other-regarding orientation.

Developments blending charity and business challenge the wisdom of charity law’s other-regarding orientation requirement, its strongest and most fundamental policy prescription. Commentators question its utility. Innovators sidestep it by forming entities as for-profits, pursuing hybrid forms through legislation or otherwise. Even some traditional charities have taken on programs that may suggest comfort with relaxing the other-regarding essential. Although these challenges to the other-regarding orientation requirement offer valuable insights on charities and charity law, they should ultimately be rebuffed.

The other-regarding orientation requirement is core to enforcing the mission imperative of charity law. For fiduciaries and members, the law expressing this essential serves as a useful prophylactic. Determining mission and the appropriate way to pursue it is a challenge for every charity and its constituents. But, the other-regarding orientation requirement warns directors, officers and members away from attempting to serve two masters – one of whom is themselves. This adds at least some boundaries to notoriously muddied decision-making. While charities are and should be given great autonomy in selecting the means by which their sundry charitable missions are met, the mission imperative is what gives the charitable category its utility for society and for its stakeholders. The other-regarding essential

¹⁷¹ See, e.g., PALOTTA, *supra* note __ at 121; Lang, Jr., *L3C Overview*, *supra* note __ at 4-7, Kelley, *supra* note __ at 42-43.

¹⁷² See DAVID VOGEL, *THE MARKET FOR VIRTUE* 60 (2005) (reporting that in 2003 \$151 billion was under management with investment funds that screen companies for social impact).

¹⁷³ See *The Business Of Giving: Non-Profit Capitalism*, *THE ECONOMIST*, at 79 (Sept. 13, 2008).

¹⁷⁴ See *The Business Of Giving*, *supra* note __ at 79.

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plays a vital reinforcing role in mission accountability, to which already stretched external enforcement mechanisms will and should rarely address their efforts.

The other-regarding essential also helpfully delineates the charity category for other major charity stakeholders. Charity law defines those entities solely devoted to achieving a charitable mission, staking them out as safe places for donors and the public to send their contributions and tax dollars without concern they will someday be diverted to private ends. Of course, donors will never obtain complete assurance that their particular charitable goals will continue to be met by charities, which can go in and out of existence and change their purposes over time (sometimes with and sometimes without regulatory supervision). Yet, charity stakeholders rely on the legal prohibitions of self-regarding behavior to provide some minimal assurance of a charity's enduring mission to benefit society, which the available enforcement architecture will have some reasonable ability to police. The Palotta and Malani/Posner proposals should therefore be resisted. Equity share ownership of charities should not be permitted, nor should for-profit entities be admitted to the ranks of charitable entities.

Yet, there are important lessons to be learned from recent charitable innovations, particularly their forceful demonstration that charitable activities and purposes are not and should not be the sole purview of charities. Again, the key distinction is that between being a charity and being an entity that engages in charitable activities or has, among others, charitable purposes. For-profit or mixed entities make valuable contributions to society, for which they should be lauded. Moreover, clinging to the other-regarding orientation requirement will necessarily limit the types and quantity of charity funding available. Perhaps by broadening the range of entities empowered and encouraged to engage in charitable activities, though not deeming all of them charities per se, some of these funds for conducting charitable activities could be accessed. Tax and other benefits may also be warranted to provide greater encouragement for non-charities to undertake charitable activities and to blend their self-regarding purposes with other-regarding ones. Even if some potential resources are left on the table, it would be unwise to briskly admit self-regarding organizations to charity status. The other-regarding essential should be maintained and conspicuously enforced.

B. Singular Charity

As noted, the group governance requirement is only weakly expressed in current charity law. Incorporated charities generally must be run by boards and those organized as unincorporated associations must have members. Yet, a voting membership is optional for incorporated charities and many practitioners recommend structuring charities without voting members precisely to avoid the complications and complexity created by group operation. More shockingly,

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charities taking the trust form may be governed by a single trustee and this course too has its advocates in practice. Charity law should be reformed to take better account of the critical role group governance plays in enforcing mission accountability. A single individual's vision of the good is insufficient to merit treatment and favor as a charity. While not every group needs to have members and be democratically governed, a group governance model is vital to encourage the dialogic process of evaluating and evolving mission. The idea that charitable mission will be something identified by a group and legitimately evolved by it is fundamental to enforcing the mission imperative.

Where currently permitted by state organizational law, the single director incorporated charity and the single trustee charitable trust should be prohibited. Federal and state law currently incorporates state governance rules in their requirements for charity tax exemption. Thus, changing state organizational law alone will align all three sources of charity law with a strong group governance norm. It will be more politically difficult to remove the possibility of a single trustee charitable trust than a single director charitable corporation, though both are laudable goals. Single trustee trusts are used to entrench donor control, limit evolution of charitable purpose, and speed formation. Speeding formation is an understandable and reasonable goal; worthy charitable missions can arise in an instant and there must be a way to address them swiftly. However, the corporate form can be very speedily acquired in many states. States with slow corporate registration facilities should speed them up for independent reasons. Even when a trust is the only option for speedy creation, finding two additional trustees should not impose too difficult a burden.

The other reasons to use a single-trustee trust, entrenching donor control and limiting evolution of charitable purpose, are not likewise appropriate aims. When a donor makes a donation to a charity with perpetual life, the donor does and should lose control to the entity charged by society to pursue the charitable mission defined by its documents and as legitimately evolved over time. The group essential stands in opposition to the idea that this mission may be bound to the views of a single person. The group it envisions is important precisely because of the need for charities to evolve their missions, and thus enforces the mission imperative.

Charity law's commitment to group governance should also be shored up by strengthening its commitment to fiduciary independence. It must be understood, of course, that statutory independence requirements for nonprofit boards will necessarily make only rather limited demands. Those crafting them must avoid insulting important nonprofit constituencies, maintain a suitable pool of directors, and issue mandates that can be followed and, at least in some cases, enforced. Balancing these concerns will result in requirements that either demand a majority of directors be screened only for financial or family conflicts or mandate a much lower

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percentage of independent directors screened for a wider array of potential conflicts.¹⁷⁵ A board with a majority of related or financially interested members may nominally utilize group governance, but the group members can be too easily dominated to serve the purpose of promoting dialogue on issues of mission. An independence requirement demanding a majority of unrelated and financially unconflicted directors will avoid situations where the group governance model is egregiously undermined. An independence requirement might alternatively demand that some percentage of directors have no relationships that might suggest a conflict or represent the charities' benefitted class. These more sweeping requirements should target a percentage of directors large enough to be relevant in board discussions and building coalitions. Yet, screening out all categories of conflicts will eliminate too many categories of qualified and interested board candidates to demand that this group form a majority. Moreover, while it may be possible to reach consensus on a few directors as representative of a benefitted class, beyond this core it will become very difficult to enforce such a requirement. Best practice guides, self-regulatory programs, training efforts, and practitioner advice should also encourage charities to consider independence when screening fiduciary candidates, as a complement to statutory mandates.

Finally, charity law could more forcefully embrace the group governance norm by mandating voting membership structures in incorporated charities. I would stop short of recommending this course. Charities often opt not to use voting members because of the practical difficulty of attracting individual members, tracking them over time, and obtaining sufficient participation by them to achieve a quorum for necessary corporate decisions.¹⁷⁶ Amending nonprofit corporate statutes to require all incorporated charities to empower members to elect directors would likely stimulate a wave of charity transformations into trust form, or simply result in directors being named members as well.¹⁷⁷ Neither of these effects would cause charities to be more accountable to their missions. This is a place where charity law may be able to do only so much. Many other forces are at work in shaping charities' operation, keeping them relevant and vital. Practitioners, as well as those authoring best practice guides and training materials should promote the use of democratic governance structures,¹⁷⁸ as well as encouraging the development of other means to promote dialogue about organizational mission.¹⁷⁹

¹⁷⁵ See Brakman Reiser, 76 *FORDHAM L. REV.* at 829-31.

¹⁷⁶ See Dana Brakman Reiser, *Dismembering Civil Society*, 82 *OR. L. REV.* 829, 887-90 (2003).

¹⁷⁷ See Brakman Reiser, 82 *OR. L. REV.* at 887-90.

¹⁷⁸ See Angela M. Eikenberry, *Refusing the Market: A Democratic Discourse for Voluntary and Nonprofit Organizations*, 38 *NONPROFIT & VOLUNTARY SECTOR Q.* 582, 591-92 (2009).

¹⁷⁹ See Dana Brakman Reiser, *Filling the Gaps in Nonprofit Accountability: Applying the Club Perspective in the U.S. Legal System*, in *NONPROFIT ACCOUNTABILITY CLUBS* (Aseem Prakash and Mary

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Reinforcing charity law's commitment to group governance can also helpfully guide its response to developments shading the boundary between charity and business. If unincorporated for-profit forms could be used to create charities, the group essential would be seriously undermined. The most obvious challenge is the sole proprietorship, which is a form currently available to businesses but not to charities, and which is pervasive throughout the for-profit sector.¹⁸⁰ The sole proprietorship would offer a charitable innovator the greatest control, in fact the ability to create a singular charity. The partnership form sets group governance as its default model, whereby all partners have equal rights to participate in management.¹⁸¹ However, the group may be as small as two, and the default may be changed significantly. The enabling nature of partnership statutes also allows founders to retain considerable control through agreements and variations in governance structure. They may retain management rights and limit the governance rights of new partners to a substantial degree. In an LLC, the level of commitment to group governance will depend on whether a member- or manager-managed structure is employed.¹⁸² Still, if any of these unincorporated for-profit forms become permissible methods of organizing a charity, their inherent flexibility would undercut the group governance norm.

Serious, though somewhat different, challenges to the group essential would arise from permitting incorporated for-profit forms for charities. The details here in part depend on whether the for-profit corporation is private and closely-held or is a publicly-held entity. The corporate architecture of a close corporation introduces risks that non-founder shareholders may dilute a founder's commitment to her charitable mission, in favor of instead pursuing profit for themselves. The number and proximity of closely held shareholders, however, may blunt these risks of group governance. Additionally, founders of close corporations may be able to protect their charitable orientation by aggressively screening potential investors, maintaining a control position, crafting defensive shareholder agreements, or a combination of these strategies. These are not foolproof tactics, of course, as even carefully screened new shareholders might deceive founders or may change their minds over time. Shareholder agreements can create significant limitations on shareholder

Kay Gugerty, eds., forthcoming Cambridge University Press 2009) (suggesting a role for self-regulation in stimulating dialogue on charitable mission).

¹⁸⁰ See U.S. Bureau of the Census, Statistical Abstract of the United States, tbl. 722 (listing the "Number of Tax Returns, Receipts, Business: 1990 to 2005," with sole proprietorships outnumbering corporations and partnerships four to ten times).

¹⁸¹ See, e.g., UNIFORM PARTNERSHIP ACT § 18(e) ("All partners have equal rights in the management and conduct of the partnership business").

¹⁸² See UNIFORM LIMITED LIABILITY COMPANY ACT § 404 (describing members' rights in management in each alternative form); Revised Uniform Limited Liability Company Act; Delaware Limited Liability Company Act.

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actions, but can be held invalid if they restrict transferability unreasonably¹⁸³ or “clear[ly] conflict with the governing corporate statute.”¹⁸⁴

If an incorporated for-profit charity becomes a publicly-held corporation, further challenges to the group essential will arise. Bringing on a broad group of public shareholders creates significant dangers for a social enterprise and its founders. Common shareholders endowed with voting powers can obtain board representation, exert veto power on major transactions, or even engage in takeover action. All of these means could be used to shift an entity’s mission away from social enterprise and toward more typical for-profit objectives. They would do so precisely by using the group governance model mandated by corporate law. Again, to protect their position, founders will likely try to maintain a strong majority position.

Founders of a corporation about to go public may also adopt governance structures to protect its charitable mission. Again, these structures will enhance founder control at the expense of empowering a larger and more diverse group in governance. For example, Google Inc.’s equity structure uses two classes of stock, one held by founders and one held by ordinary common shareholders.¹⁸⁵ The founders’ stock class holds a significant voting advantage. This structure was established prior to the inception of Google.org, motivated by its founders’ desire to maintain their authority despite a move to public share ownership, and to stave off takeover threats.¹⁸⁶ It was made known to shareholders in the stock’s initial public offering and has remained a matter of public notice.¹⁸⁷ This two tier structure now offers substantial security for the founders’ mission, including their commitment to for-profit philanthropy.¹⁸⁸ Yet, it also undermines group governance. With incorporated for-profit corporate models, the law’s commitment to group governance becomes a risk to its founders’ charitable motives and founders respond by maintaining tight control.¹⁸⁹

The advent of for-profit philanthropy and social enterprise make it ever more important to appreciate and fill the gaps in charity law’s commitment to group governance. While these concepts and entities should likely be encouraged, they should not be designated as charities. There is too much pressure on these entities

¹⁸³ See JAMES D. COX, THOMAS LEE HAZEN, & F. HODGE O’NEAL, CORPORATIONS § 14.9 at 374-75 (1997).

¹⁸⁴ COX, HAZEN, & O’NEAL, *supra* note __ § 14.5, at 369.

¹⁸⁵ See DAVID A. VISE & MARK MALSEED, THE GOOGLE STORY 172 (2005)

¹⁸⁶ See Google Inc., Letter from the Founders: “An Owner’s Manual” for Google’s Shareholders (Amendment No. 9 to Form S-1), at 29-30 (Aug. 18, 2004), *available at* <http://www.sec.gov/Archives/edgar/data/1288776/000119312504142742/ds1a.htm>

¹⁸⁷ See Google Inc., Letter from the Founders, *supra* note __, at 29-30.

¹⁸⁸ See Brakman Reiser, *For-Profit Philanthropy*, 76 FORDHAM L. REV. at 2467-68.

¹⁸⁹ See, e.g., Dees & Anderson, *supra* note __ at 17-19.

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to entrench control with founders. Mission accountability requires retaining and enforcing the idea that a charity is a group, not an individual endeavor. This is fundamentally incompatible with existing for-profit organizational forms.

The hybrid forms of organization described above express various levels of commitment to group governance. The charter amendments required to obtain B corporation certification require directors to consider the interests of employers, suppliers, the community and society in making decisions on behalf of the corporation.¹⁹⁰ This language would appear to shield directors making decisions to maintain a B corporation's social enterprise mission from shareholder challenge. As B corporations must incorporate in states with constituency statutes permitting directors to consider nonshareholder interests in exercising their duties, such language would perhaps provide a safe harbor from fiduciary liability in situations where short-term shareholder interests were sacrificed for some broader social purpose. Even assuming these provisions are viable, if a sufficient number of shareholders change their minds about the B corporation approach, or are willing to sell their shares to buyers holding a different view, these amendments can be undone. Moreover, the B corporation amendments seek to change the standards for director governance, not to empower shareholders to do more or give governance rights to some broader stakeholder group.

The L3C, structured as it is on an LLC model, envisions a role for members in some type of group governance, at least as a default. If an L3C uses a member-managed structure, its members will have the right to participate in governance.¹⁹¹ A manager-managed model delegates power for most management decisions to the manager, but retains members' governance rights over certain major company decisions as well as empowering them to recall the manager.¹⁹² Part of what makes the L3C attractive, however, is the extreme flexibility of its LLC base when it comes to governance.¹⁹³ L3C founders concerned about maintaining the organization's hybrid orientation can use this flexibility to adopt governance structures providing them with power and additional safeguards. A manager-managed model, with its limited role for the larger governing constituency, is the most straightforward of these. A structure could also be crafted to privilege one class of members with a role in governance, while disempowering other member classes, again in the hopes of protecting the entities'

¹⁹⁰ See B Lab, *B Corporation Legal Roadmap*, at <http://survey.bcorporation.net/become/legal2.php> (requiring directors to consider the interest of a wide range of stakeholders, the community and broader society in determining actions that will be in the company's best interests).

¹⁹¹ See, e.g., UNIFORM LIMITED LIABILITY COMPANY ACT § 404(a) (providing each member equal rights in managing LLC and that most matters "may be decided by a majority of the members"); Revised Uniform Limited Liability Company Act; Delaware Limited Liability Company Act.

¹⁹² See, e.g., UNIFORM LIMITED LIABILITY COMPANY ACT § 404(b)-(c); Revised Uniform Limited Liability Company Act; Delaware Limited Liability Company Act.

¹⁹³ See Lang, *L3C Overview*, *supra* note __, at 3-4.

double bottom line or social enterprise orientation. Available model operating agreements demonstrate the allure of designing structures such to entrench the power and views of founders.¹⁹⁴

The L3C also carries limits on transferability of memberships. Like in LLCs generally, while memberships likely may be transferred, governance rights do not automatically follow sale and are instead contingent on existing members accepting the transferee.¹⁹⁵ The impact of this potential restriction on group governance and its mission-based goals is uncertain. Locking members into the entity may make them more interested in engaging in group governance, bolstering it. Yet, limiting transferability could also curtail the range of potential stakeholders for the organization and its ability to evolve its mission over time. It is difficult to measure the impact of the L3C on group governance yet, as it is so novel. The range of governance options is now limited only by the creativity of operating agreement drafters and their ability to obtain investors.

The UK community interest company goes furthest to enshrine group governance in a hybrid form. CICs are required to have members, which will typically be shareholders in a CIC limited by shares and donors or others admitted to membership under corporate documents in a CIC limited by guarantee.¹⁹⁶ Yet, the CIC regulator also directs CICs to include a broad range of stakeholders beyond share owners or statutory members, in governance.¹⁹⁷ Recognizing that different techniques will succeed in different CIC types and sizes, the regulator does not demand a specific form of stakeholder involvement. Rather, it offers various suggestions of how the mandate to include stakeholders in governance might be achieved, and requires CICs to report on their efforts to do so in their annual community interest report.¹⁹⁸ Its guidance document explains:

The provision of adequate information is clearly the starting point for the consultation process together with the provision of easily used methods of feedback. This can be achieved by simple methods such as circulating news letters and holding stakeholder meetings or more

¹⁹⁴ See Americans for Community Development, *Legal*, at <http://americansforcommunitydevelopment.org/legal.html> (providing links to model operating agreements).

¹⁹⁵ See, e.g., UNIFORM LIMITED LIABILITY COMPANY ACT §§ 502, 503; Revised Uniform Limited Liability Company Act; Delaware Limited Liability Company Act.

¹⁹⁶ See CIC Regulator, *Information and Guidance Notes*, Chapter 9, at [http://www.cicregulator.gov.uk/CIC%20guidance/Chapter%209%20%20corporate%20governance/Chapter%209%20%20August%202008%20\(version%203\).pdf](http://www.cicregulator.gov.uk/CIC%20guidance/Chapter%209%20%20corporate%20governance/Chapter%209%20%20August%202008%20(version%203).pdf).

¹⁹⁷ See CIC Regulator, *Frequently Asked Questions - Stakeholder and Community Interest Company Governance*, available at <http://www.cicregulator.gov.uk/faq.shtml#Stakeholder>.

¹⁹⁸ See CIC Regulator, *Frequently Asked Questions - Stakeholder and Community Interest Company Governance*, available at <http://www.cicregulator.gov.uk/faq.shtml#Stakeholder>; CIC Regulator, *Information and Guidance Notes*, Chapter 8.

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sophisticated methods such as setting up a web site with dialogue facilities or issuing formal consultation documents before taking a major policy decision. Alternatively, stakeholder groups can be given official standing under a company's constitution (for example, by requiring that they are consulted before the directors or members make certain types of decisions). Other stakeholders could be included with the members in the circulation of the company annual report and accounts and invited to attend an open forum linked to the company's annual general meeting.

In many organisations the setting up of user and advisory groups or a club committee separate from the board of directors can be an effective way of bringing stakeholders into the running of the organisation.¹⁹⁹

In terms of the group that will actively manage the corporation, the CIC offers a bit of a mixed bag. CICs organized as private companies may have only one director; other companies must have two or more, still not a large group.²⁰⁰ Like B corporation directors, CIC directors must take decisions not only to pursue share owner interests, but also with the goal of preserving the CIC's ability to meet the community interest test. Thus, founders can perhaps rely on directors to maintain the entity's social orientation and share owners will not be able to discipline CIC directors away from it by making or threatening fiduciary challenges. Share owners in a CIC may also have less interest in directing their company away from a social enterprise orientation, as they have no right to residual earnings and even their ability to receive dividends is capped.

Innovations melding business and charity seriously challenge charity law's commitment to group governance. Permitting charities to adopt a for-profit framework would threaten complete abandonment of the group essential. In order to protect their control over a social enterprise vision, for-profit founders will select structures that approach singular governance. Hybrid forms of organization may offer opportunities to reassert the group governance norm, and the forms that have emerged are experimenting with this idea in different ways. Still, their commitment to group governance is tempered by a common flexibility as to governance structure. As hybrid forms are proposed and enacted, attention to group governance is crucial as charitably-minded hybrid enthusiasts may remain understandably interested in entrenching founder control.

¹⁹⁹ See CIC Regulator, *CIC Guidance – Chapter 9, Corporate Governance*, available at [http://www.cicregulator.gov.uk/CIC%20guidance/Chapter%209%20%20corporate%20governance/Chapter%209%20-%20August%202008%20\(version%203\).pdf](http://www.cicregulator.gov.uk/CIC%20guidance/Chapter%209%20%20corporate%20governance/Chapter%209%20-%20August%202008%20(version%203).pdf).

²⁰⁰ See CIC Regulator, *Frequently Asked Questions - Stakeholder and Community Interest Company Governance*, available at <http://www.cicregulator.gov.uk/faq.shtml#Stakeholder>.

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C. Commercial Charity

One need look no further than the most traditional charities to find challenges to charity law's anti-commerciality position. Charities already engage in substantial levels of commercial activity, and have done so for quite some time.²⁰¹ The decision to do so is driven at times simply in order to make up funding gaps in order to run their operations.²⁰² Other times these activities are viewed as meshing with charitable mission and become an integral part of a charity's programs.²⁰³ Evidence of the blending of commercial and charitable activity can also be found in the for-profit arena. Over several decades, one finds a continuing trend toward proprietary firms offering traditionally charitable services.²⁰⁴ The social enterprise movement also exerts pressure on the anti-commerciality position. If charity is fundamentally different from commercial enterprise, and commercial endeavors by charities (and charitable ones by business) should be looked at skeptically, why does this blending appear so pervasive and so attractive to charities and businesses?

Of course, current charity law does not render all kinds of commercial activity equally suspect. Its suspicion is principally reserved for commercial activities of questionable relation to charitable mission. The commerciality and UBIT doctrines variously seize upon the content of commercial as compared with charitable activities, the relative size of a charity's commercial operations, and the manner of commercial business' operation. The real impact of the commerciality limitations is thus to skew the choices a charity makes regarding commercial activity, to ensure its size, content, and manner will conform to charitable mission. While charities generally are propelled to engage in commercial activities by their need for additional funding streams,²⁰⁵ they do not simply engage in whatever commercial activity appears most likely to earn income.²⁰⁶ Instead, charities choose lines of business that will coalesce with their mission, make operational choices that will appear to align

²⁰¹ See Eleanor Brown & Al Silvinski, *Nonprofit Organizations and the Market*, in NONPROFIT SECTOR RESEARCH HANDBOOK, *supra* note __, at 140, 146; see generally TO PROFIT OR NOT TO PROFIT: THE COMMERCIAL TRANSFORMATION OF THE NONPROFIT SECTOR (Burton A. Weisbrod, ed. 1998) (examining the commerciality of nonprofit organizations by industry and over time).

²⁰² See Brown & Silvinski, *supra* note __, at 146-47.

²⁰³ See Brown & Silvinski, *supra* note __, at 146-47.

²⁰⁴ See Joseph J. Cordes & C. Eugene Steurle, *The Changing Economy and the Scope of Nonprofit-Like Activities*, in NONPROFITS & BUSINESS, at 51 (Joseph J. Cordes & C. Eugene Steurle eds. 2009); Joseph J. Cordes & C. Eugene Steurle, *The Undivided Self: Are the Business Body and the Nonprofit Soul Separable?* at 5 (unpublished manuscript on file with author).

²⁰⁵ See Burton A. Weisbrod, *The Nonprofit Mission and its Financing*, in TO PROFIT OR NOT TO PROFIT, *supra* note __ at 1, 9; Weisbrod, *The Pitfalls of Profits*, *supra* note __ at 43.

²⁰⁶ See Burton A. Weisbrod, *The Nonprofit Mission and its Financing*, in TO PROFIT OR NOT TO PROFIT, *supra* note __ at 1, 12-13.

with it, or both.²⁰⁷ Further, they use related entities to structure their activities in ways that will avoid charity law's restrictions and penalties.²⁰⁸ Charities skew their commercial activities toward efforts they can defend as related to avoid commerciality challenges, the UBIT regime, or both.

Parallel to the significant commercial activity charities engage in today, one finds businesses more and more often pursuing traditionally charitable models.²⁰⁹ Indeed, the current economic crisis has produced proposals to combine for-profit businesses with charities. One commentator suggested that the Ford Foundation be used to salvage Ford Motor Company.²¹⁰ More serious arguments have been made that struggling newspapers or periodicals might be sustainable if operated as charities.²¹¹ Although no widespread trend can yet be seen toward converting particular businesses or industries into charities, some real life examples have arisen. For example, when the for-profit Seattle Post-Intelligencer newspaper went out of business in early 2009, its owners launched a skeleton online successor to the paper.²¹² This successor employed very few former staff members and offered limited coverage.²¹³ Other staffers soon began a competing venture, *seattlepostglobe.org*, a charity formed as a nonprofit corporation.²¹⁴ This venture teamed with a local tax-exempt public television station as a fiscal sponsor, and seeks financing through a combination of advertising and donations.²¹⁵

For-profits pursuing social enterprise also fundamentally challenge the idea that commercial and charitable activities must be kept separate. These entities manufacture products and offer services with self-consciously dual goals of making profits for their owners and making the world a better place. Perhaps they use

²⁰⁷ See Dennis R. Young, *Alternative Perspectives on Social Enterprise*, in NONPROFITS & BUSINESS, *supra* note ___ at 42-44; Joseph J. Cordes & Burton A. Weisbrod, *Differential Taxation of Nonprofits and the Commercialization of Nonprofit Revenues*, in TO PROFIT OR NOT TO PROFIT, *supra* note ___ at 83, 103-04.

²⁰⁸ See Colombo, 44 WM. & MARY L. REV. at 514, 523-24.

²⁰⁹ See Joseph J. Cordes & C. Eugene Steurle, *The Changing Economy and the Scope of Nonprofit-Like Activities*, in NONPROFITS & BUSINESS, *supra* note ___ at 54-64; Cordes & Steurle, *The Undivided Self*, *supra* note ___ at 9-18 (suggesting this trend may be explained largely by the migration of the U.S. economy toward service-provision and the use of information and highly-specialized personal skills).

²¹⁰ See Editorial, *Let Ford Save Ford*, WALL ST. J. at A16 (Dec. 9, 2008).

²¹¹ See Charles Lewis & Bruce Sievers, *All the News That's Fit to Finance*, CHRON. OF PHILANTHROPY, at 72 (Mar. 12, 2009) (detailing proposals advocating foundation and other donative funding for struggling newspapers); Tim Arango, *Mother Jones Tests Nonprofit Model in Race to Survive the Recession*, N.Y. TIMES, at C1 (Mar. 7, 2009) (reporting that Mother Jones, a longtime nonprofit magazine, received numerous inquiries as interest in nonprofit or endowed journalism grows).

²¹² See Johnny Diaz, *Online Upstarts Deliver News Without the Paper*, BOS. GLOBE, at 5 (May 14, 2009) (detailing the Seattle venture and several other similar ones); *Former P-I Staffers Launch Online Newspaper*, Associated Press Financial Wire, Apr.15, 2009, 3:31 AM GMT.

²¹³ See *Former P-I Staffers*, *supra* note ___.

²¹⁴ See *Former P-I Staffers*, *supra* note ___.

²¹⁵ See *Former P-I Staffers*, *supra* note ___.

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socially conscious sourcing in order to procure needed inputs from poor suppliers or in ways that foster local and indigenous production.²¹⁶ They may employ individuals with limited other employment prospects due to disability, socioeconomic situation, or particular life experiences.²¹⁷ They may select their offerings based not only on consumer demand but on views of what products or services should be placed into the economy and the stream of commerce, with concerns about labor practices, environmental impact or public health.²¹⁸ These developments sharply question charity law's devotion to the idea that charity and commerce should be truly distinct.

Another important challenge can be seen in the move by individuals and firms to harness the profit-making potential of the poor as consumers. Perhaps the most dramatic example of this is found in the microfinance movement, most prominently associated with Mohammed Yunus and Grameen Bank.²¹⁹ The Grameen model, begun in Bangladesh, is to offer very small loans to very poor borrowers. These loans come with relatively high rates of interest, but make financing available to borrowers who otherwise have no access to capital.²²⁰ The loans are used to fund micro-scale business enterprises and borrowers are linked into a social network to foster social norms regarding repayment.²²¹ Grameen has shown profits using this model, and the model has been replicated in other under-banked communities as well.²²² Lending money in order to make a profit on interest payments is certainly a commercial activity and a Grameen-type entity would not qualify as a charity under U.S. charity law for this and other reasons. Yet, Grameen does not view itself as merely another profit-making enterprise but rather one marrying commercial activity and the desire to achieve social good.²²³

This has been suggested as a more generalized model by Bill Gates in his quest for "creative capitalism."²²⁴ He and others have suggested that if companies see the

²¹⁶ See Dees & Anderson, *supra* note __, at 3-5.

²¹⁷ See Dees & Anderson, *supra* note __, at 3-5.

²¹⁸ See Dees & Anderson, *supra* note __, at 3-5.

²¹⁹ See Grameen Bank, About Us at http://www.grameen-info.org/index.php?option=com_content&task=blogsection&id=5&Itemid=164; see also MUHAMMAD YUNUS, *BANKER TO THE POOR* (1998) (describing his creation of Grameen Bank and its growth over the years).

²²⁰ See Philip Nichols, *Legal Theory Of Emerging Economies*, 39 VA. J. INT'L L. 229, 299-300 (1999).

²²¹ See Grameen Bank, *Grameen Bank at a Glance*, at http://www.grameen-info.org/index.php?option=com_content&task=view&id=26&Itemid=164.

²²² See Grameen Bank, *Grameen Bank at a Glance*, *supra* note __.

²²³ See Grameen Bank, *Is Grameen Different?*, at http://www.grameen-info.org/index.php?option=com_content&task=view&id=27&Itemid=176 (describing Grameen's as a "composite objective, coming out of social and economic visions").

²²⁴ See Bill Gates, Speech at 2008 Davos World Economic Forum Speech, *available at* <http://www.microsoft.com/Presspass/exec/billg/speeches/2008/01-24WEFDavos.msp>; see also CREATIVE CAPITALISM: A CONVERSATION WITH BILL GATES, WARREN BUFFETT, AND OTHER ECONOMIC LEADERS (Michael Kinsley ed. 2008) (collecting essays on the creative capitalism idea);

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world's poor as an untapped source of consumers (and perhaps suppliers or employees), capitalism can be used to bring them not only goods and services they need but also an improved quality of life.²²⁵ He argues that the motive to produce and expand both profits and recognition can propel companies to serve the needs of the world's poor.²²⁶ He calls on business leaders to take up this challenge in order to benefit the world – and their shareholders or owners.

The pressure on charity law's anti-commerciality rules is real, building, and coming from all sides. Charity law should yield to this pressure, by explicitly repealing federal tax exemption limitations on charities' commercial activity and any state property tax law that bars property tax exemption for charities engaging in commercial activity. UBIT and state property tax law rules that levy tax on charities' property used for commercial purposes should be maintained, in order to preserve the public fisc as needed. To the extent, however, that enforcing these regimes injects government into the internal decisions charities make about how best to achieve their missions, an attitude of general skepticism is warranted.

Of course, charities' tax-favored status makes this form attractive to individuals who wish not to engage in charity, but simply to avoid taxes. This raises two serious fears²²⁷ about my proposals, to which I propose two different solutions. The first concern is that some entities that are deemed by the law to be charities instead will be “for-profits in disguise,” used as vehicles to transfer tax-free payments to insiders and others. Indeed, if a supposed charity abandons charitable programming and expenditures, and merely runs a commercial business in order to cover its costs – including employee salaries – there is real cause for concern.

Janet E. Kerr, *The Creative Capitalism Spectrum: Evaluating Corporate Social Responsibility Through a Legal Lens*, 81 TEMPLE L. REV. 831 (2008) (offering a model for evaluating CSR).

²²⁵ See Bill Gates, *Speech at Davos*, supra note __; see also PHILANTHROCAPITALISM: HOW THE RICH CAN SAVE THE WORLD (2008) (arguing that capitalism can be harnessed to pursue social good).

²²⁶ See Bill Gates, *Speech at Davos*, supra note __.

²²⁷ Another frequently raised concern is that charities engaging in commercial activities will create inappropriate and unfair competition with small and other businesses. Yet, as a revenue generation opportunity, it is difficult to see why charities aiming to produce as much revenue as possible to dedicate to their charitable mission would price the products or services they offer at lower rates than the market would bear. See *Colombo*, 44 WM. & MARY L. REV. at 529-31; Evelyn Brody, *Business Activities of Nonprofit Organizations: Legal Boundary Problems*, in NONPROFITS & BUSINESS, supra note __ at 99-100. While unfair competition concerns may be politically attractive arguments for anti-commerciality rules in general, and UBIT in particular, the economic evidence does not tend to support them. See *Colombo*, 44 WM. & MARY L. REV. at 530-31; Michael S. Knoll, *The UBIT: Leveling An Uneven Playing Field Or Tilting A Level One?*, 76 FORDHAM L. REV. 857 (2007) (“Under ordinary circumstances, the exemption from tax does not provide nonprofits with the ability to outbid their for-profit competitors for business assets.”); Ethan G. Stone, *Adhering To The Old Line: Uncovering The History And Political Function Of The Unrelated Business Income Tax*, 54 EMORY L.J. 1475 (2005). Prof. Colombo also considers several other possible rationales for federal tax law's anti-commerciality position, but concludes that none of these possibilities provide a robust defense of the current regime.

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Current charity law tries to separate true from disguised charities by examining the scope and particularly the manner in which a charity operates its commercial activities. This real concern can instead be addressed by stepped up enforcement of charity law expressing the other-regarding orientation requirement. If salaries are excessive or other private payments are being made, this is prohibited inurement, excess benefit, or private benefit and likely a breach of fiduciary obligation. If profits are being sought simply to support these kinds of expenditures, the charity breaches the nondistribution constraint and other law and rules designed to implement the other-regarding orientation requirement. On the other hand, however, if commercial activities are undertaken to support a meaningful charitable program, this is a beneficial activity and should not be limited.

Undertaking commercial activities is a tactical decision about how to raise revenue, and sources of revenue for charities are limited and inadequate. A charity itself is best able to make the decision whether commercial activity will provide sufficient income to warrant taking on its attendant financial and opportunity costs and risks of distraction. It should make this decision through dialogue among its leaders and its constituencies. When a charity opts to engage in commercial activity, its need to earn a profit to support its mission-related programs will provide the necessary discipline for its decision. Charities' autonomy is what allows them to play their crucial role in civil society and to fill gaps in the market economy; it should be zealously guarded.²²⁸

Further relaxing the commerciality essential would also free courts and regulators from some of the burden of enforcing the notoriously murky doctrines in this area. They can cease interfering in charities' internal decision-making and wasting legal and enforcement resources to determine whether charities' commercial operations are run in a more or less business-like manner. They can instead focus more explicitly on mission accountability, for which commercial activities are a highly imperfect proxy. If and when revenue generation comes to dominate a charity's program, crowding out charitable activities or simply providing a means to cover the commercial activities' own expenses, only then does the entity cease to be a charity.

A second serious concern about relaxing charity law's anti-commerciality rules questions whether doing so will seriously damage the public fisc. Times are tough and public budgets are always stretched thin. If for-profits in disguise move en masse from the taxable rolls to the exempt charity category, federal income tax revenues will decrease. Localities already perceive charitable exemptions causing shortfalls serious enough that many municipalities have challenged them in court or

²²⁸ See Lloyd Hitoshi Mayer, *The "Independent" Sector: Fee-for-Service Charity and the Limits of Autonomy* (forthcoming draft on file with author).

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negotiated payments-in-lieu-of-taxes with individual well-heeled charities.²²⁹ My proposal takes the measured form it does partly in order to deal with this concern, avoiding significant revenue implications and making it politically feasible. Remember, this proposal would strike only the commerciality limitations blocking access to exemption under federal income and state property tax law. I posit most commerciality challenges to tax exemption currently undertaken by federal and state tax regulators are deemed worthy of their efforts because of a fear that the other-regarding orientation requirement is being breached, rather than merely as a potential route to bring funds into the government coffers. If charity law were reformed along the lines suggested here, time spent on enforcement using the confused and misguided commerciality doctrines would helpfully be limited. Yet, necessary enforcement capacity would be maintained under the inurement, excess benefit, private benefit, fiduciary obligation, nondistribution, and charitable purpose doctrines. Moreover, charities would be freed from concerns that their revenue-generation decisions could cost them their charity status if they breached a notoriously vague limitation on “too much” or “too commercial” commercial activity.

It is also important to note the regimes this proposal would leave in place. It would not repeal UBIT.²³⁰ It also would allow continuation of the longstanding practice of considering state property tax exemption on a per-parcel basis, based on a combination of exempt organization ownership *and* charitable use. Although charities would not be screened out of eligibility for property tax exemption based on commercial activities, individual parcels devoted to non-charitable commercial uses could still be taxed. In each case, the proposal allows taxation of assets (either income or owned property) devoted to unrelated commercial activities,²³¹ but does

²²⁹ See Gallagher, *The Legal Structure of Property-Tax Exemption*, supra note __ at 14-16.

²³⁰ In fact, I have sympathy with calls to repeal UBIT. It can be criticized as unhelpfully influencing charities' internal decision-making along the lines described above. It is a very low revenue-producing tax, the enforcement costs of which may well not be warranted. However, proposing the repeal of any revenue-producing tax at this moment, if not anytime, makes the proponent too easy to disregard. See Colombo, 44 WM. & MARY L. REV. at 547-56.

²³¹ Notably, in the case of UBIT, defining the unrelated category is not solely about distinguishing truly charitable activities that produce income from more business-like activities. I believe the proposal would be improved, therefore, by incorporating the simplifying changes to UBIT proposed by Professor Colombo. These would remove the passive income and other exceptions in favor of applying the UBIT to all commercial activities of exempt organizations. Colombo's proposal that UBIT be expanded to apply to all commercial activities seems, at first glance, to remove the relatedness criterion and therefore remove this level of government influence over charity decision-making as well. However, this proposal really just moves the relatedness question to differentiating “taxable commercial activities and nontaxable but revenue-producing ‘charitable’ activities.” Colombo, 44 WM. & MARY L. REV. at 559. These would still need to be distinguished to avoid taxing universities' tuition payments, for example. I would therefore, happily adopt this sense of unrelated rather than the current UBIT regime's definition.

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not threaten the entity's eligibility for charity status due to its decision to undertake them. Taxation will, of course, still influence a charity's decision whether to engage in unrelated commercial activities in order to earn revenue or to pursue some other means, such as related commercial activities, donations, or grants. A rational charity will pursue unrelated commercial endeavors if and when the anticipated post-tax revenue from them exceeds that from other potential revenue sources. Placing unrelated commercial activities on this footing as compared with other revenue-generating opportunities appropriately re-centers charity law on its roots in enforcing the mission imperative. Charity law should serve to focus charities and their leaders on the need to serve mission, not to micromanage their decisions about how to produce the revenue needed to do so.

D. Political Charity

The greatest challenge to charity law's exhortation that charities avoid politics comes from the actions charities themselves have taken to avoid these restrictions. Boldest among these actions were direct legal assaults on federal restrictions on political activity, grounded on First Amendment and autonomy arguments.²³² On the federal level, where one finds most of the law requiring that charities eschew politics, these challenges have been uniformly unsuccessful. Some state law challenges on these

²³² Charities have challenged the federal law restrictions on their political activities virtually since their inception, on both constitutional and public policy grounds. The ultimate word on the constitutional question came from the United States Supreme Court in *Regan v. Taxation With Representation*, 461 U.S. 540 (1983). Taxation With Representation (TWR) was an organization that applied for exempt status under § 501(c)(3) to promote the "public interest" on taxation issues by publishing a journal, litigating cases, and lobbying. *See id.* at 543. Prior to the suit, TWR had used a dual structure, locating its publishing and litigation activities in a § 501(c)(3) entity and its lobbying in a separate affiliate organized under § 501(c)(4). *See id.* TWR consolidated all of these functions into a single organization and applied for (c)(3) exempt status, precipitating the case. *See id.* The IRS denied exemption to it on grounds that it the organization failed the requirement that no substantial part of its net earnings be used for lobbying. *See id.* at 542. Among other things, TWR argued that the lobbying restriction placed an unconstitutional condition on its free speech as protected by the First Amendment. *See id.* at 545. The Court upheld the statute, with the plurality relying on the identification of the federal tax benefits for charities as a subsidy. The Court explained that although Congress cannot deny a benefit to a person on the basis of his exercise of a constitutional right, Congress need not subsidize protected activity. *See id.* at 545-46. Refusing to subsidize charities' political activity thus simply did not count as an infringement or restriction on 1st Amendment free speech.

Justice Blackmun's concurrence provided the important fifth vote. He wrote separately to point out that he agreed with the majority if and on the assumption that the dual (c)(3)/(c)(4) structure remains available. *See id.* at 552-53. This structure ensures that exempt organizations may engage in lobbying without losing their exemption, but would prevent funding this activity with deductible contributions.

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grounds have prevailed,²³³ but there are so few restrictions on political activity at the state level that this offers charities with political aspirations little comfort.

In response, charities have taken more pragmatic steps to pursue the political activities they see as fundamental to pursuing their missions. Current charity law allows sophisticated charities to engage in insubstantial political activity, and some charities do so. By electing 501(h) status, more lobbying may be permitted, though it must be carefully tracked and reported. Adopting complex legal structures and taking advantage of other organizational affiliations also allows charities to achieve greater political impact than current law's restrictions would seem to allow at first glance. The dual and triad affiliated structures described above sanction significant interrelation and coordination between charitable and political entities, and even permit charities to provide some support for candidates. By blessing these structures, federal law has already allowed the idea that charities must eschew politics to be seriously undermined.

Of course, use of these affiliated structures will only be available to charities of a certain size and sophistication. They clearly impose an administrative burden. Too, perhaps, they impose reputational costs, as charity law expresses the idea that charitable and political endeavor are incompatible. Together, these costs of affiliation will be insurmountable for many small, novel, or unorthodox charities. Yet, many charities clearly see political advocacy and even campaign activity as an important way to pursue their missions. Otherwise, they would not shoulder the cost (which cannot be funded through deductible contributions) to structure themselves in dual or triad forms and would not undergo the administrative pains required to maintain those structures.

Corporate foundations provide another example of how charities use affiliation to stretch the limits placed on them by federal tax law's restrictions on political activity. Due to their single funding source, corporate foundations will be characterized as private foundations within § 501(c)(3). Private foundations operate under especially restrictive limits on political activity. The Internal Revenue Code lists amounts paid for lobbying legislators or government officials directly, expenditures to persuade members of the public to do the same, to influence elections, and even to carry on voter registration drives as "taxable expenditures," and subjects them to penalty taxes.²³⁴ Corporate foundations, however, have a relatively easy way to avoid these

²³³ See, e.g., *New England Legal Found. v. City of Boston*, 670 N.E.2d 152, 158–59 & n.8 (Mass. 1996) (holding that an organization that engaged primarily in test-case litigation was charitable and not political, permitting it to retain property tax exemption); *Mich. United Conservation Clubs v. Twp. of Lansing*, 378 N.W.2d 737, 743 n.6 (Mich. 1985) (finding the organization's lobbying activities would not bar its property tax exemption).

²³⁴ See I.R.C. § 4945.

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significant restrictions. A sympathetic donor for-profit corporation may simply add the foundation's political agenda to its own government relations strategy.²³⁵

Here, as elsewhere, innovators also have begun to use for-profit forms in order to sidestep charity law's restrictions on their political activities. For example, the founders of Google.org explained their use of a for-profit model partly as a way to avoid restrictions charity law would place on political activities. Early explanations of its choice of form highlighted plans "to lobby for policies that support [its] philanthropic goals" as part of its rationale for choosing for-profit charity.²³⁶ Google.org has not yet indicated any plans to participate in political campaigns, though its structure as a division of for-profit Google Inc. would give it ample flexibility to do so. When compared with charities, the political activities of business entities are relatively unrestricted. Of course, campaign finance and good governance rules requiring registration of lobbyists and limiting contributions do apply to business actors, as they do to all speakers.

Court battles and affiliated structures of various kinds have long raised questions about the force and desirability of a strong division between charity and politics. Innovations blending charity and business models have added new pathways for charities who wish to opt out of restrictions on political activities. These efforts combine to create substantial pressure challenging the legal restrictions on charities' political activities. Again, charity law should relent.

Like in the anti-commerciality context, the key issues are mission and autonomy. The United States and the world more broadly are increasingly political places. In order to achieve societal good and certainly to make any sort of meaningful change, some political action is often necessary. It does little good for charity law to define engagement with the political system as outside the proper charitable sphere. Doing so can force charities to be fundamentally less relevant to the civil society they are supposed to embody and less able to achieve the missions they are charged with pursuing.²³⁷ Doing so also encourages charities to create administratively complex organizations in order to engage in the political activities they see as crucial, to skirt the rules, or to opt out of charity status.

²³⁵ I thank Prof. Garry Jenkins for this insight.

²³⁶ Google.org, Our Structure, formerly at <http://www.google.org/about.html>, now on file with author.

²³⁷ See Laura B. Chisolm, *Exempt Organization Advocacy: Matching the Rules to the Rationales*, 63 IND. L.J. 201, 241-44 (1987-88) (noting the arguments that the political restrictions steer nonprofits away from their view of their mission); see also LESLIE R. CRUTCHFIELD & HEATHER MCLEOD GRANT, FORCES FOR GOOD (2007) (arguing that combining service provision and political advocacy is the first of six practices identified with nonprofits that achieve especially great social impact).

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As much as possible, charity law's restrictions on political activity should be removed. Primarily, these will be federal tax law restrictions. To the extent that state organizational law and property tax law also condition charity status on refraining from political activity, these constraints should also be eliminated. Charities themselves are best situated to determine when political action will be useful in pursuing their missions. When political involvement is used as a mere subterfuge for pursuit of private purposes, the inurement, excess benefit, and private benefit doctrines, fiduciary obligation, and the nondistribution and charitable purpose requirements provide sufficient enforcement muscle for regulators. So long as charities remain committed to an other-regarding purpose, and structured to police this purpose through a group model, any other limits on charities' engagement with the political system should be imposed by the lobbying and election law limits seen fit to apply to other actors within it.

Of course, some will be concerned that the tax-deductible status of contributions to charities will lead to abuses beyond the reach of lobbying and election law. The federal tax prohibition on electioneering has been argued to dovetail importantly with broader election regulation, operating together to avoid such abuses.²³⁸ This suggests an important caveat to my proposals here. Charity law does not exist in a vacuum, but as part of the web of law regulating charities and other institutions engaged in charitable and noncharitable activities. Changes in charity law may, therefore, necessitate changes in other areas. If charity law's restrictions on political activity are relaxed in recognition of the fact that political activity in general, and participation in electoral campaigns in particular, can be an appropriate part of a charity's programs, other areas of law might need to change in response. But, regulating the potential for influence-peddling, bribery, or political distortions in these activities is a more appropriate task for lobbying or campaign finance laws than it is for charity law.

Removing charity law's political restrictions entirely will likely not be politically feasible. Doing so could potentially create abuses insurmountable by lobbying and election law alone. In either case, in crafting alternative reforms to relax charity law's restrictions on political activity, limitations on the use of deductible contributions or exempt property should be preferred over access to exempt form. The current federal system opening political activity only to those organizations that can afford to structure themselves using complex dual or triad forms is not a sufficient solution. It disturbingly solves the problem of lack of political access only for those charities affluent enough to use these sophisticated techniques.

²³⁸ See Donald B. Tobin, *Political Campaigning by Churches and Charities: Hazardous for 501(c)(3)s, Dangerous for Democracy*, 95 GEO. L.J. 1313, 1339-42 (arguing that it would be extremely difficult to track deductible contribution if charities were permitted to engage in electioneering).

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III. CONCLUSION

Charity law can best promote fidelity to mission by focusing on two essential requirements: charities must be other-regarding and must be composed of and governed by a group. The requirement that charities be other-regarding, and not self-regarding, stems the possibility that charitable mission will be clouded by self-interest. The requirement that a charity must be controlled by a group, rather than by the vision of a single individual, provides a structure for articulating, evaluating and evolving mission internally over time. Current charity law strongly asserts the other-regarding orientation requirement. However, rather than embracing on the group governance norm, much of current charity law is taken up identifying, restricting and penalizing charities' commercial and political activity. When focused on an other-regarding purpose and governed by a group, charities themselves are better suited to determine when these categories of activity threaten mission, and when they are pivotal to carrying mission forward. Thus, charity law should be reformed to refocus on the other-regarding orientation and group governance requirements, excising restrictions on commercial and political activity where possible. Doing so will not only improve charity law's ability to regulate traditional charities, but will also give it the necessary tools to respond to the spate of recent innovations blurring the boundary between charity and business.