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By

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INSTITUTIONAL DISSONANCE IN THE NONPROFIT SECTOR

EVELYN BRODY*

> *[Nonprofit organizations'] crucially important function in the American polity [derives from] their concrete historical association with a particular institutional culture, a configuration of values, resources, organizational technologies, legal infrastructure, and styles of leadership. This institutional culture originated at the end of the eighteenth century, became dominant . . . in the twentieth, and entered a period of crisis—quite possibly a crisis of success—in our own time.*[1]

I. INTRODUCTION

SOME observers of the nonprofit sector take a dim view of *fin-de-millénium* America. As support diminishes for public solutions to social problems, nonprofits appear unable to shoulder the burden. Activities in all sectors seem commercialized, making it harder to distinguish nonprofit enterprises from proprietary ones. Daily, the press reports on television ministries, cut-throat competition for university students, the explosion in proprietary hospitals, bloated salaries for nonprofit executives and corporate sponsorship of college athletics. Perceived abuses of nonprofit privileges bring calls for legal reform.

To the dismay of others, however, our enlightened age still does not permit collective activity to move freely among various forms of enterprise—public, for-profit and nonprofit—as efficiency and efficacy would appear to dictate. Why shouldn't primary education be available according to the preferences of different families, from the best public, nonprofit and even proprietary schools? Why don't hospitals readily convert from nonprofit to for-profit form, or vice versa, as conditions warrant? Why does the public resent high salaries in the public and nonprofit sectors, when failure to pay the going wage can result in poor service? To these observ-

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1. PETER D. HALL, INVENTING THE NONPROFIT SECTOR 2 (1992).

ers, social institutions other than the law constrain activity, sometimes for the worse. They believe that the wrong laws only increase the "lock in" of various activities into certain sectors.

Our political and economic system traditionally splits into three distinct sectors: public (government), proprietary (business) and nonprofit (charity and mutual benefit). The public currently holds several popular beliefs and expectations: the government provides physical infrastructure, policing and schooling; the business sector satisfies market demands for goods and services while returning profits to shareholders; and charities satisfy the social needs that fall between the cracks.

An examination of historical and current events, however, reveals that a clear tripartition of these three sectors never existed in the United States. The basic terms of the economic and social debate are eternal, while institutions dominant at different times and in different localities resolved the sectoral choices in different ways. Advocates of strong formal laws face disappointment and frustration by trying to assign firms to the "right" sector. Indeed, nonprofit law takes a laissez-faire approach to permissible nonprofit activities. Rather than amend the nonprofit corporate laws, society would do better by targeting subsidies (including tax subsidies) to desired services, provided either in the nonprofit or for-profit sector.

Part II of this Article sets forth the developments giving rise to calls for legal reform.[2] This extensive description of activities, both historical and current, reveals that the apparent erosion of sectoral purity rests on a misunderstanding of the traditional function of nonprofit organizations, as well as a misapprehension of the economic and social pressures they face.[3] In our mixed political economy, the boundaries between the government, business and nonprofit sectors constantly shift, blur and overlap. Nevertheless, many people believe certain nonprofit behaviors to be "inappropriate." Part III explains how such concerns need not necessarily be addressed by formal laws, because a flexible and constantly evolving network of other social institutions governs the behavior of non-

2. For a discussion of the historical context of calls for reform, see *infra* notes 10-144 and accompanying text.

3. *See generally* Evelyn Brody, *Agents Without Principals: The Economic Convergence of the Nonprofit and For-Profit Organizational Forms*, 40 N.Y.L. SCH. L. REV. 457 (1996) [hereinafter, Brody, *Agents Without Principals*] (exploring whether nonprofits are different from for-profits from an economic perspective).

profit organizations and the people who deal with them.[4] Next, Part IV explores past and current proposals to reform nonprofit laws.[5] Part V, the analysis, largely defends the legal status quo.[6] Most of the problems cited today have long been recognized. Existing reform proposals would either fail to fix these problems or create additional difficult problems. In Part VI, I conclude that, for the most part, these issues are better addressed by social institutions other than the law.[7]

A few words on terminology will help focus the discussion to follow. The proprietary sector is usually called "for-profit" to distinguish it from the "nonprofit" sector, although both proprietary and nonprofit entities may earn a surplus from year-to-year.[8] Nonprofit entities fall loosely into one of two categories: charities (including churches, schools, hospitals and social service organizations) and mutual-benefit organizations (including labor unions, trade associations and social clubs). For simplicity, this Article sometimes uses the term "charity" interchangeably with "nonprofit."

An additional legal distinction complicates the analysis. In England, nearly every charity is a charitable *trust*, endowed with perpetual life as an exception to the Rule Against Perpetuities. American nonprofits, however, prefer the corporate solution to human mortality, and therefore this Article concentrates on the law of nonprofit corporations.

Finally, the public often conflates the concept of a *nonprofit* organization and the concept of a *tax-exempt* organization. Basically, state law defines the substantive law of nonprofits, and federal law determines whether a nonprofit may claim exemption from the federal income tax on trusts or corporations.[9] While the public might think that all nonprofits are tax-exempt—and indeed, while some founders might form an activity as a nonprofit in order to

4. For a discussion of these social forces, see *infra* notes 145-83 and accompanying text.

5. For a discussion of these proposals, see *infra* notes 184-276 and accompanying text.

6. For a discussion of the status quo, see *infra* notes 277-341 and accompanying text.

7. For an argument that current problems are best addressed by social institutions other than the law, see *infra* notes 342-43 and accompanying text.

8. Economists, and some state statutes, refer to this latter group as "not-for-profit" to remove any inference that the organization is legally constrained from earning a surplus in any year. *See, e.g.*, N.Y. NOT-FOR-PROFIT CORPORATION LAW § 103 (McKinney 1970) (defining "not-for-profit" as corporation whose purpose is not pecuniary gain).

9. State statutes commonly grant some sort of property tax exemption for charities.

obtain tax exemption—the states have an interest separate from tax exemption in policing the nonprofit sector. This Article concentrates on the substantive law of nonprofits, leaving the issues of tax exemption and other subsidies for future discussion.

II. THE HISTORICAL AND CURRENT CONTEXT OF CALLS FOR REFORM

Many Americans believe that the government takes too much of our money and wastes much of what it collects.[10] They believe that only the diversity of private enterprise, including a nonprofit sector, can satisfy our heterogeneous needs.[11] Since de Tocqueville's famous commemoration of the American propensity to form voluntary associations,[12] we have primarily viewed ourselves as self-reliant in "community," somehow defined independently of government.[13] But, as my father likes to say, "Things ain't what they

10. The rigorous explanation for governmental red tape points to the government's accountability:

> It must treat equals equally and it must show that it is doing so. . . . I use the term [red tape] to indicate the rigidly rule-bound requirements and restraints that administrators are almost forced to impose, since they may be called upon to defend their actions publicly in any specific case.

James Douglas, *Political Theories of Nonprofit Organization*, *in* THE NONPROFIT SECTOR: A RESEARCH HANDBOOK 43, 49-50 (Walter W. Powell ed., 1987) [hereinafter THE NONPROFIT SECTOR]; *see also* DEREGULATING THE PUBLIC SERVICE (John J. DiIulio, Jr. ed., 1994) (providing scholarly analyses of "waste, fraud, and abuse" arguments).

11. Douglas, *supra* note 10, at 47 ("The classic pluralist argument is that a voluntary nonprofit sector permits a greater diversity of social provisions than the state itself can achieve.").

12. 2 ALEXIS DE TOCQUEVILLE, DEMOCRACY IN AMERICA 106 (P. Bradley ed., 1966). According to de Tocqueville,

> Americans of all ages, all conditions, and all dispositions constantly form associations. They have not only commercial and manufacturing companies, in which all take part, but associations of a thousand other kinds, religious, moral, serious, futile, general or restricted, enormous or diminutive. . . . Wherever at the head of some new undertaking you see the government in France, or a man of rank in England, in the United States you will be sure to find an association.

Id. *See also* Mary Bosworth Treudley, *The "Benevolent Fair": A Study of Charitable Organization Among American Women in the First Third of the Nineteenth Century*, 14 SOC. SERV. REV. 509 (1940), *reprinted in* COMPASSION AND RESPONSIBILITY: READINGS IN THE HISTORY OF SOCIAL WELFARE POLICY IN THE UNITED STATES 132 (Frank R. Breul & Steven J. Diner eds., 1980) [hereinafter COMPASSION] ("The victorious conclusion of the Revolutionary War released an extraordinary amount of social energy among Americans. Along the eastern seaboard that energy was transformed into associations of all sorts, especially of an educational or humanitarian character.").

13. *See, e.g.*, Dana Milbank, *GOP Proposal Would Let Charity Begin at Home with Taxpayers Choosing Their Favorite Causes*, WALL ST. J., June 20, 1996, at A20. Republican presidential candidate Bob Dole declared that his proposal for a tax credit of up to $500 for donations to charities that direct their services to the poor "would

used to be; in fact, they never was." The classic three-sector model never really reflected three distinct spheres of ownership or activity.

A. *Public or Private?*

Early in American history, the law and social institutions did not distinguish between public and private entities, or even between nonprofit and proprietary ones.[14] Once corporations (including nonprofit ones) won legal autonomy, the private sectors (including the nonprofit sector) performed important economic functions within society. Evidently, the less the elites were able to control the public sector, the more they needed a nonprofit sector to bolster their control of the proprietary sector. Today, institutional investors such as pension trusts, foundations and charitable endowments invest trillions of dollars worth of risk capital.[15]

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present Americans with a stark choice . . . . Give your money to the Department of Housing and Urban Development, or give it to Habitat for Humanity . . . to big government, or to Big Brothers and Big Sisters." *Id.* *But see* Carolyn D. Wright & Fred Stokeld, *Charities Far From Sold on Dole's Proposed Charitable Tax Credit*, 72 TAX NOTES 951, 951 (Aug. 19, 1996) (describing how Dole severely scaled back his proposal). Senator Dole's initial plan would have cost up to $120 billion in foregone taxes for the six-year budget period; the revised plan cost only $5.2 billion. *Id.* It would permit taxpayers to claim a credit for only one-half the amount they donate, but not more than $50 in 1997 and $100 in 1998, and would sunset thereafter. *Id.*

14. *See* Gerald E. Frug, *The City as a Legal Concept*, 93 HARV. L. REV. 1059, 1101-02 (1980). According to Frug,

> Corporations, whether cities or mercantile entities, were chartered only to further public purposes, and many of their functions overlapped. . . . Many mercantile corporations wielded the same powers as cities, such as eminent domain, while many cities received their income from the same sources as mercantile corporations, primarily commerce and trade. . . . Many cities and mercantile corporations were controlled by an elite, and consequently both were subject to popular attack.

Id. (footnotes omitted); *see also id.* at 1097 ("Even colonial religious bodies often considered themselves corporations, their corporate nature seen as affirming and strengthening their associational ties.").

15. At the end of 1990, public and private pension funds owned assets worth approximately $3.5 trillion. U.S. TREASURY DEP'T, INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS: TAXING BUSINESS INCOME ONCE 68 tbl.6.1 (1992). The aggregate pension portfolio contained roughly 37% of all U.S. corporate stock and 46% of all U.S. corporate bonds. *Id.* at 67. In 1989, tax-exempt organizations (other than private foundations) reported aggregate investments in securities of $203 billion. Celia Hilgert & Paul Arnsberger, *Charities and Other Tax-Exempt Organizations, Highlights of 1989 Data*, *reprinted in* INTERNAL REVENUE SERVICE, STATISTICS OF INCOME, 2 COMPENDIUM OF STUDIES OF TAX-EXEMPT ORGANIZATIONS, 1986-1992, at 69 tbl.1 (1993) (noting that smaller tax-exempts that filed simplified Form 990EZ reported additional $501 million in "cash, savings, and investments"). In 1992, private foundations reported $144 billion in investments in securities, allocated 66% to corporate stock, 21% to government bonds and 13% to corporate debt. Paul Arnsberger & Susan Estep, *Private Foundations and Charitable Trusts, 1992*, *in* 15 SOI BULL. 152 (Winter 1995-96).

1. *Political Economies*

Following the American Revolution, debates raged in the states over the availability, and desirability, of political control over corporations.[16] *Trustees of Dartmouth College v. Woodward*[17] established that the charter of a corporation, even a nonprofit corporation, cannot be amended unilaterally by the state.[18] Historian Louis Hartz viewed the triumph of corporate independence as inevitable because economic growth needs political stability.[19]

A private nonprofit sector performs important economic and political functions. A study by historian Peter Dobkin Hall found that the elitist nineteenth-century Boston Brahmins feared the political power of the general populace. In response, they endowed universities, hospitals and other charities in order to build up the learned professions (such as law, medicine, science and business) for their sons.[20] To close the loop, the professionals, through in-

16. *See* LOUIS HARTZ, ECONOMIC POLICY AND DEMOCRATIC THOUGHT: PENNSYLVANIA, 1776-1860, at 250-51 (1948) (detailing debate between Locke, Paine and Ingersoll over desirability of political control of corporations); *see generally* HARRY N. SCHEIBER, OHIO CANAL ERA: A CASE STUDY OF GOVERNMENT AND THE ECONOMY, 1820-1861 (1969) (studying American state government and its role in public enterprise); Gregory A. Mark, Note, *The Personification of the Business Corporation in American Law*, 54 U. CHI. L. REV. 1441 (1987) (tracing legal evolution of American corporations).

17. 17 U.S. (4 Wheat.) 518 (1819).

18. *Id.* at 636. State corporation laws now often contain such a reservation clause. *See* James J. Fishman, *The Development of Nonprofit Corporation Law and an Agenda for Reform*, 34 EMORY L.J. 617, 644 (1985) (cautioning that decision for Dartmouth College could have come out differently had Dartmouth actually operated as public institution, "a forerunner of modern state action arguments"). Justice Story's concurrence in *Dartmouth College* suggests that a legislature could amend a charter if it had reserved that right in the original grant. *Dartmouth College*, 17 U.S. at 675, 708, 712.

19. HARTZ, *supra* note 16, at 252. Hartz observed:

> The Dartmouth College ideology, with its emphasis upon previously acquired property rights and its grave respect for the organic growth of law, betrayed an ideal political world of measured change, limited shifts. On the other hand, the democratic dogma that was mobilized against it, with its changing popular sovereign, its rotating offices, and its worship of the immediate mass will, reflected a version of political life as a fluid contingent affair[:] "Each generation should act for itself. . . . Each generation is more competent to regulate its internal policy, than a preceding generation."
>
> . . .
>
> [But the] developing exploitation of the corporate device was itself a sure indication that business enterprise was moving into a new era of long-range planning which called for an increasingly stable legal and political environment.

Id. (citations omitted) (quoting speeches of Thomas Earle).

20. Defending Harvard's property-tax exemption before the state legislature in 1874, Harvard President Charles Eliot asked:

terlocking trusteeships, then managed these endowments by investing in local industrial and commercial enterprises.[21] The pattern of bank failures during the depression of 1837-1842 dramatically illustrates the impact of such arrangements. Out of the twenty-four commercial banks in Boston that survived the depression, twenty-one enjoyed ties to endowed charitable organizations through directors and trustees, while nine of the ten banks that failed had no such connections.[22]

The Midwestern model of philanthropy saw closer ties among the three sectors. While states created land-grant colleges and universities, Midwestern business put a populist twist on Boston's efforts to link the proprietary and nonprofit sectors. For example, Cleveland's business community conducted coordinated appeals (called "federated campaigns") that permitted donor designation of a charitable beneficiary.[23] In 1913, Cleveland pioneered the community foundation, which similarly allowed small donations to be pooled and managed for local charitable purposes in perpetuity.[24] The Cleveland Foundation was essentially a quasi-public body, with elected officials and judges dominating the board.[25]

The almost unimaginable private wealth amassed through technological revolutions after the Civil War gave rise to the grant-

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> Who have built up the manufactures and trade of this bleak and sterile Massachusetts? A few men of singular sagacity, integrity, courage, backed by hundreds of thousands of men and women of common intelligence, courage, and honesty. . . . Massachusetts today owes its mental and moral characteristics, and its wealth, to eight generations of people who have loved and cherished Church, School, and College.

HALL, *supra* note 1, at 182.

21. *Id.* at 174. *See generally*, Evelyn Brody, Charitable Endowments and the Democratization of Dynasty (Aug. 22, 1996) [hereinafter Brody, Charitable Endowments] (unpublished manuscript, on file with *Villanova Law Review*) (exploring role of charitable endowments in political economy).

22. HALL, *supra* note 1, at 176.

23. *Id.* at 163. The United Way began in Denver in 1887, and the Cleveland Chamber of Commerce created the first Community Chest at the turn of the century. JOHN S. GLASER, THE UNITED WAY SCANDAL 36, 37 (1994).

24. A dissenting voice wrote of the pressure of communitarianism:

> "Cleveland would cooperate even if it had to be genteelly clubbed into doing so. Cleveland would be neighborly, Cleveland would give til it hurt. . . . In 1924, it may be recalled, the voters of Cleveland rejected the stainless Calvin in favor of the hell-roaring La Follette. . . . Did it bespeak a proletarian dissatisfaction with the art galleries, libraries, parks, schools, little theaters and scientific charity? Was it a revolt against the whole theory of municipal grandmothering?"

HALL, *supra* note 1, at 169 (quoting R.L. Duffus writing in *The New Republic* at end of 1920s).

25. *Id.* at 164.

making foundation, often family controlled and located primarily in New York. By the 1920s, foundations begun by such families as Rockefeller, Ford, Mellon, Field, du Pont, Carnegie and Lilly "helped tie together the system of government bureaus, private social-service agencies, universities, trade associations, and professional societies that composed the backbone of [President] Hoover's associationist vision."[26]

Down to our own age, governments cannot resist using tax abatements and other incentives to encourage certain activities. Early state governments made no sectoral distinctions in bestowing or withholding tax subsidies. New England canal, turnpike, bridge and manufacturing companies enjoyed the same tax exemption extended to eleemosynary entities such as Yale College.[27] In the first wave of tax reform under President Ronald Reagan, certain sectors of the business community enjoyed *negative* income tax rates through the combination of accelerated depreciation and investment tax credits on new equipment.[28] In the same era, the U.S. Treasury Department bailed out the Chrysler Corporation by guaranteeing $1.2 billion of loans to the corporation in return for stock warrants. Happily, the federal government turned a $184 million profit by exercising the warrants (against the corporation's wishes!).[29]

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26. *Id.* at 187. *See generally* WALDEMAR A. NIELSEN, THE BIG FOUNDATIONS (1972) (explaining nature and role of foundations in American life).

27. HALL, *supra* note 1, at 21. By 1900, New Jersey ranked second in the rate of property taxation, but near the bottom in the ratio of tax collected to total property value; exemptions, mostly for railroad property, covered more than one-fourth of the state. Harold W. Stoke, *Economic Influences upon the Corporation Laws of New Jersey*, 38 J. POL. ECON. 551, 568 (1930).

28. *See* STAFF OF THE JOINT COMM. ON TAXATION, GENERAL EXPLANATION OF THE REV. PROVISIONS OF THE TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982, H.R. REP. NO. 97-4961, at 35 (1982). According to this report:

> Cost recovery deductions for most personal property allowed under [the Accelerated Cost Recovery System], in combination with the regular investment tax credit, generated tax benefits which had a present value that was more generous than the tax benefits that would be available if the full cost of the investment could be deducted in the year when the investment was made.

Id.

29. *See, e.g.*, ROBERT B. REICH & JOHN D. DONAHUE, NEW DEALS: THE CHRYSLER REVIVAL AND THE AMERICAN SYSTEM (1985) (examining complicated maneuvering involved in Chrysler deal); Nathaniel C. Nash, *Pro & Con: Federal Bailouts in a Free Market*, N.Y. TIMES, Sept. 28, 1986, § 4, at 5 (questioning two Senators on their views of Chrysler bailout); David E. Sanger, *U.S. to Sell Its Chrysler Warrants*, N.Y. TIMES, Aug. 12, 1983, at D1 (reporting that United States will sell Chrysler warrants at profit against wishes of Chrysler). In the late 1980s, concern over the money-center banks' financial safety and soundness led some to speculate that the federal government would routinely pump in revenue to banks viewed as

Government laws and regulations increasingly blur the private/public distinction in matters such as zoning, building codes, workplace safety, labor relations, antitrust issues, securities offerings, income tax subsidies and environmental impact.[30] We also have a new form of entity, the government-sponsored enterprise, such as Fannie Mae, whose stock is in private hands, but whose obligations are backed by the federal government.[31]

2. *Privatizing Government Social Services*

a. Public Welfare Versus Private Charity

The poor have always been among us, as has the debate over the proper role of government in alleviating their distress and in ameliorating conditions that may lead to poverty.[32] In 1854, President Franklin Pierce vetoed a bill, requested by Dorothea Dix, for the federal government to finance institutions for the mentally ill.[33] The door slammed shut on a federal social welfare role and remained closed until the New Deal era.[34]

During colonial times, states adopted the Elizabethan Poor Laws, and responsibility for the poor rested with local governments.[35] "[T]he essentially 'American way' of aiding the poor was

"too big to fail." In 1991, Congress scaled back the "too big to fail doctrine" by limiting insurance to $100,000 per depositer in all but the rarest cases, where bank failure presents a systemic risk to the U.S. financial system. *See* Federal Deposit Insurance Corporation Improvement Act of 1991 § 123(b), Pub. L. No. 102-242, 105 Stat. 2236 (1991) (amending 12 U.S.C. § 1823).

30. *See also* BARRY BOZEMAN, ALL ORGANIZATIONS ARE PUBLIC: BRIDGING PUBLIC AND PRIVATE ORGANIZATIONAL THEORIES 94-95 (1987) (arraying organizations on "publicness grid," whose x-axis is political authority and whose y-axis is economic authority).

31. REPORT OF THE SECRETARY OF THE TREASURY ON GOVERNMENT-SPONSORED ENTERPRISES (May 1990) *and* REPORT OF THE SECRETARY OF THE TREASURY ON GOVERNMENT-SPONSORED ENTERPRISES (Apr. 1991); *see also* Carrie S. Lavargna, *Government-Sponsored Enterprises Are "Too Big to Fail": Balancing Public and Private Interests*, 44 HAST. L.J. 991, 1011-14 (1993).

32. *Cf.* Fishman, *supra* note 18, at 621-22 n.20 (citing DANIEL J. BOORSTIN, THE AMERICANS: THE COLONIAL EXPERIENCE 71-95 (1958)) (describing how State of Georgia was first established as charitable corporation for English poor, but plan failed and charter of corporation was returned to crown in 1752).

33. *See, e.g.*, Seaton W. Manning, *The Tragedy of the Ten-Million-Acre Bill*, 36 SOC. SERV. REV. 44 (1962), *reprinted in* COMPASSION, *supra* note 12, at 169, 172 (tracing history of veto).

34. *Id.* at 175. The author notes that "the traditional patterns of exclusive local and state responsibility for social matters continued unchanged until the ravages of the great depression, producing bankrupt local governments and overburdened voluntary agencies, forced significant modifications of the old traditions." *Id.*

35. Eleanor Parkhurst, *Poor Relief in a Massachusetts Village in the Eighteenth Century*, 11 SOC. SERV. REV. 446 (1937), *reprinted in* COMPASSION, *supra* note 12, at 95.

through legislative enactments and taxation rather than through reliance upon voluntary efforts, for the great growth of organized philanthropy did not take place until the nineteenth century."[36] We continue today to see strong echoes of the Puritan view of charity: the notion that attributes poverty to the sufferer's sins of intemperance, indolence and extravagance.[37] Thus, Americans sought to limit relief, granting it only to the "worthy" or "deserving" poor, such as widows and orphans, whose misfortune could not have been foreseen.[38] Pre-Civil War debates raged over the supposed deleterious effects of the poor laws, which, by "'removing the dread of want . . . destroyed the main incitement to industry.'"[39] This view advocated reliance on voluntary philanthropy, which, born out of religious spirit, improved both benefactor and recipient, and did not "carry with it the stamp of right."[40]

Democracies feel ambivalent about private philanthropy: "We expect rich men to be generous with their wealth and criticize them when they are not; but when they make benefaction, we question their motives, deplore the methods by which they obtained their abundance, and wonder whether their gifts will not do more harm than good."[41] The argument against private philanthropy points to the "'injudicious multiplication of charitable societies,'"[42] whose in-

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Communities adopted the English practice of "warning out" undesirable immigrants; Massachusetts abolished this practice in the Massachusetts Settlement Act of 1794. *Id.*

36. Elizabeth Wisner, *The Puritan Background of the New England Poor Laws*, 19 SOC. SERV. REV. 381 (1945), *reprinted in* COMPASSION, *supra* note 12, at 54.

37. *Id.* Some colonies distinguished, in theory if not physically, between the poorhouse for the impotent poor, the workhouse for the "worthy" unemployed, and the house of correction (or bridewell) for the "unworthy" unemployed ("sturdy beggars"). David M. Schneider, *The Patchwork of Relief in Provincial New York, 1664-1775*, 12 SOC. SERV. REV. 464 (1938), *reprinted in* COMPASSION, *supra* note 12, at 64, 74; *see also* Benjamin J. Klebaner, *Poverty and Its Relief in American Thought, 1815-1861*, 38 SOC. SERV. REV. 382 (1964), *reprinted in* COMPASSION, *supra* note 12, at 114 (tracing historical treatment of poor).

38. Klebaner, *supra* note 37, at 116. Thus, we see private charities "advocat[ing] temperance, prevention of vice, and character improvement through religion and education." *Id.* at 121.

39. *Id.* at 122-23 (quoting claim that the poor laws breed "generation after generation of hereditary paupers").

40. *Id.* at 125.

41. Robert H. Bremner, *Private Philanthropy and Public Needs: Historical Perspective*, *in* 1 COMMISSION ON PRIVATE PHILANTHROPY AND PUBLIC NEEDS, RES. PAPERS 89-90 (U.S. Treas. Dep't 1977) [hereinafter FILER COMM'N RES. PAPERS] (the commission, discussed *infra*, notes 246-48 and accompanying text, was chaired by John H. Filer, and so is popularly called the Filer Commission).

42. Klebaner, *supra* note 37, at 125 (quoting CHARLES BURROUGHS, A DISCOURSE DELIVERED IN THE CHAPEL OF THE NEW ALMS-HOUSE 73 (Portsmouth 1835)).

efficiencies would result in "aggressive mendicants [receiving] more than was their due, while the modest would be unprovided for."[43] The twentieth century professionalized its social workers, some of whom became politically active in order to attack the causes of poverty, rather than just help clients adapt to their bleak circumstances.[44] By the Great Depression, when the federal government finally instituted mass relief efforts, "[s]ocial work was forced to recognize that retail methods no longer sufficed to meet the desperate needs of millions of citizens."[45] Today, we often hear that only the government can fairly distribute benefits, free of the paternalism of private charity.[46]

The twentieth-century rage to quantify goals and results changed the very question that charity asks. Andrew Carnegie applied his innovative business tactics to his charitable endeavors. The effectiveness of a charitable dollar depends, in part, on the degree to which a particular beneficiary could be helped. Thus, Carnegie's "scientific philanthropy involved a shift from attending to the subjectively defined *needs* of individuals to the *eligibility* of individuals for assistance: Were they potentially good investment vehicles?"[47]

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43. *Id.* at 127. *See also* Robert H. Bremner, *"Scientific Philanthropy," 1873-93*, 30 SOC. SERV. REV. 168 (1956), *reprinted in* COMPASSION, *supra* note 12, at 197. The motto of the scientific philanthropy movement of the 1870s was "Not alms but a friend." *Id.* at 199. Its adherents believed that only voluntary agencies, and not government, should provide (coordinated) relief, and, moreover, that private benevolence should be restrained: "Almsgiving was counterfeit philanthropy; true charity required something much more demanding—'personal interest in persons.'" *Id.* (quoting WILLIAM RHINELANDER STEWART, THE PHILANTHROPIC WORK OF JOSEPHINE SHAW LOWELL 82 (1911)).

44. One social reformer in 1937 "lashed out at all those who continued 'to pick up the pieces without ever attempting to stop the breakage.' She thought caseworkers were particularly guilty of adjusting the client to 'deprivation' without seeking to correct injustice." Clarke A. Chambers, *Social Service and Social Reform: A Historical Essay*, 37 SOC. SERV. REV. 67 (1963) (quoting Grace L. Coyle, *Social Workers and Social Action*, 73 SURV. 138 (1937)), *reprinted in* COMPASSION, *supra* note 12, at 17.

45. *Id.* at 20.

46. *See, e.g.*, STEVEN R. SMITH & MICHAEL LIPSKY, NONPROFITS FOR HIRE: THE WELFARE STATE IN THE AGE OF CONTRACTING 18 (1993) ("Robert Reich believes that the reliance of the United States on the 'ideology of charity' has produced inadequate, fragmented social programs because citizens in need of relief are not regarded as entitled to social benefits."). It is important to note that the largest "entitlements" in the federal budget—social security retirement benefits and Medicare coverage for the elderly—are not viewed as charity by their recipients, despite the fact that payments to the current elderly far outweigh contributions they have made to these social "insurance" programs.

47. HALL, *supra* note 1, at 118. "Just as in his business he had pioneered cost accounting, so in looking to the larger problems of society he sought to relate calculable inputs to calculable outputs." *Id.*

Scientific philanthropy made strides in coordinating and rationalizing the delivery of charitable services.[48] Its emphasis, however, on eliminating the root causes of poverty had a cruel side.[49] Because "religion stood in the way of putting the unfit out of their misery," the scientific movement sought instead to prevent poverty by outlawing marriage by those suffering from insanity, syphilis, gonorrhea and epilepsy, and by sterilizing criminals.[50] Historian Peter Dobkin Hall concludes: "Although the rise of fascism made this kind of thinking unfashionable, . . . through the 1930s, this kind of social Darwinist brutalism remained perfectly respectable and continued to dominate the thinking of many grant makers and the charities that benefited from their largess."[51]

Compare the era of the Great Society to the current era's debate over welfare reform: "Democrats insist that decency and equity require Federal standards for aid and a guarantee of help to all who qualify. Republicans say Federal standards and guarantees caused the welfare mess by easing the pain and stigma of illegitimacy and divorce."[52] Once again, the terms of the debate remain constant, while sectoral choices are likely temporary.

Moreover, the lines between private charities and the public sector are blurring. Many state income tax forms provide for $1 (or more) "check-offs" for designated charitable purposes, such as helping the homeless, preventing child abuse, environmental conservation, and education and research.[53] For example, in 1994, taxpayers in Illinois contributed $675,000 to a variety of state agencies.[54] Illinois agencies have also created sister nonprofit orga-

48. *See also* Paul J. DiMaggio, *Constructing an Organizational Field as a Professional Project: U.S. Art Museums, 1920-1940, in* THE NEW INSTITUTIONALISM IN ORGANIZATIONAL ANALYSIS 267, 288 (Walter W. Powell & Paul J. DiMaggio eds., 1991) [hereinafter THE NEW INSTITUTIONALISM] ("Whereas interorganizational contacts among for-profit firms evoke suspicions of collusion, interaction among nonprofit firms and their employees is hailed as 'coordination'").

49. HALL, *supra* note 1, at 131.

50. *Id.* at 122. Law students remember Justice Holmes's proclamation that "[t]hree generations of imbeciles are enough." Buck v. Bell, 274 U.S. 200, 207 (1927) (upholding Virginia's statute requiring sterilization of institutionalized inmates afflicted with hereditary insanity or imbecility).

51. HALL, *supra* note 1, at 122.

52. Michael Wines, *"Not My Job." "Not Our Job." So Whose Job Is It?*, N.Y. TIMES, Apr. 9, 1995, § 4, at 1.

53. Cathlene Williams & Joseph J. Cordes, *Eliciting Voluntary Contributions for the Public Good Through State Income Tax Check-Offs and Credits, in* 1995 IND. SECTOR WORKING PAP. 549.

54. Sue Ellen Christian, *Donors Give DCFS a Boost; Firms, Individuals Try to Help Agency's Kids*, CHI. TRIB., July 10, 1995, at A1.

nizations to attract donations from those who perceive that they can thereby better control the use of funds.[55]

b. The Contract Charity

Most social services today are supplied by "public/private partnerships," with tax-funded governments at various levels paying for the private sector to deliver social services.[56] Government contracts have become the single largest source of income for nonprofit social service agencies.[57] Unfortunately, with the nature of the funding invisible, the public expresses surprise and confusion when popular tax cuts jeopardize equally popular social services.[58] While the federal budget devotes $200 billion a year for poverty relief, private charities spend only $20 to $30 billion on the poor.[59] Yet before charities can hope to make up proposed reductions in federal direct transfers, they would first have to make up their own losses from cutbacks in government contracts.[60]

An illustration of the drive to privatize government benefits through the nonprofit sector appeared in the 1996 presidential campaign of Republican candidate Lamar Alexander. Alexander

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55. *Id.*

56. Lester M. Salamon, *The Marketization of Welfare: Changing Nonprofit and For-Profit Roles in the American Welfare State*, 67 SOC. SERV. REV. 16, 19 (1993) ("As of 1980 . . . over 40 percent of the funds spent by federal, state, and local governments in the United States for a broad range of human service activities supported service delivery by nonprofit organizations. Almost 20 percent went to support for-profit providers."). *See generally* SMITH & LIPSKY, *supra* note 46 (documenting trend of public sector's contracting with nonprofits for traditionally public sector programs).

John O'Looney sorts the possibilities for privatizing social service delivery into eight archetypal models, ranging from vouchers to managed competition to an integrated bureaucracy. John O'Looney, *Beyond Privatization and Service Integration: Organizational Models for Service Delivery*, 67 SOC. SERV. REV. 501 (1993). These models variously arrange the features of public and private structure, "loose" and "tight" coupling (ties between providers), monopoly or competition, economies of scale, service reliability, innovation, transaction costs (including information costs), risks to the client, the provider and the government, and power distribution (including opportunities for "exit" or "voice") among the parties. *Id.* at 515-16.

57. SMITH & LIPSKY, *supra* note 46, at 4.

58. Indeed, the charitable sector continued to grow during the 1980s primarily due to increased reliance on service fees and product sales. Salamon, *supra* note 56, at 24 (stating that between 1977 and 1989, private giving accounted for 15% of overall growth of nonprofit sector, commercial income accounted for 55% of growth, and government support accounted for 30% of growth). "What is more, [commercial income] was the principal source of growth of every major type of organization except for arts organizations . . . ." *Id.* at 26.

59. Dana Milbank, *U.S. Charities Fear They Will Be Overwhelmed, Not Empowered, by Republican Welfare Cutbacks*, WALL ST. J., Nov. 7, 1995, at A24. "To offset [these cutbacks], the charities would need giving to increase 247% by the year 2002." *Id.*

60. *Id.*

proposed to eliminate entirely two federal welfare programs, food stamps and Aid to Families with Dependent Children, and transfer their funding to community charities. He also supported a proposed federal income tax credit for contributions up to $500 made to charities that fight poverty. Republican nominee Bob Dole picked up this latter proposal, albeit much scaled back in dollar terms.[61]

c. Privatopia: The Shrinking Community

Recent taxpayer revolts, and the resulting financial pressures on local government, have forced a re-evaluation of the meaning of "community." In the residential sphere, the explosion in the number and size of condominiums, housing cooperatives and planned-unit developments effectively transforms homeowner associations into private governments.[62]

The commercial sphere has seen the growth of business improvement districts ("BIDs"), which are small geographic areas whose landowners fund common services such as security and street improvements.[63] Landowners are willing to fund these benefits because they can see the results. Moreover, BIDs avoid the "baggage of municipal politics and the inherent inefficiencies of the city's bureaucracy."[64] Critics, though, express concern about the BIDs' growing size and lack of general accountability.[65]

61. Kevin Sack, *Alexander Builds His Hopes on Some Radical Departures*, N.Y. TIMES, Feb. 18, 1996, at A18. Senator Dan Coats (Republican, Indiana) sponsored a $500 credit in October 1995. Sean O'Brien, *Coats Touts $500 Credit for Charitable Giving*, 69 TAX NOTES 424 (Oct. 23, 1995). For a description of candidate Dole's proposal, see *supra* note 13 and accompanying text.

62. *See generally* EVAN MCKENZIE, PRIVATOPIA: HOMEOWNER ASSOCIATIONS AND THE RISE OF RESIDENTIAL PRIVATE GOVERNMENT (1994) (discussing trend of residential communities amounting to private governmental units); *see also* Pam Belluck, *In Era of Shrinking Budgets, Community Groups Blossom*, N.Y. TIMES, Feb. 25, 1996, at A1 ("Across New York City and the country, neighborhood groups are growing in number and strength, in some cases taking on responsibilities once the sole province of government, and in other cases turning themselves into effective lobbying groups for their communities.").

63. *Let the Landlords Do It*, ECONOMIST, Apr. 15, 1992, at 23 ("[Business Improvement Districts ("BIDs")] raise mandatory taxes on the businesses within their boundaries and use the proceeds to provide security, rubbish collection, tourist guides, street improvements and even rudimentary social services.").

64. *Id.* at 24 (observing, however, that director of several New York City BIDs earns twice as much as mayor).

65. *Id.* (noting that New York City and state politicians "want to curb BIDs by curtailing the amount of debt they can take on and limiting their life to ten years"). Furthermore, "[t]he districts, they say, are becoming cities within cities, doing public work without elected control; they are diverting resources from needier parts for the benefit of business, and creating two-tier government in an already fractured and tense city." *Id.*

B. *Proprietary Businesses Enter "Traditionally" Nonprofit or Public Areas*

1. *The Rise of the Investor-Owned Hospital*

Responsible for the sick poor, colonial local governments established hospitals as an efficient alternative to contracting with physicians for customary house calls.[66] Early hospitals often served merely as "a refuge for friendless and infirm poor," as the term hospital suggests.[67] Hospitals also engaged in curing illness, medical research and training, all of which benefited donors and the community.[68]

Modern nonprofit hospitals depend little on contributions. Third-party reimbursements such as Medicare, Medicaid and private insurance can make hospital operations self-sustaining, if not profitable.[69] As a result, seventeen percent of hospitals are now proprietary.[70] Similar economic forces drive nonprofit hospitals and for-profit hospitals to resemble each other. Hospitals face increasing costs and competitive pressures.[71] Occasionally, a nonprofit hospital's need to achieve efficient operations clashes with traditional goals. For example, the Archdiocese of Chicago recently stripped St. Elizabeth's Hospital of its identity as a Roman Catholic institution. The church determined that by affiliating with a University of Chicago Hospital managed-care plan, St. Elizabeth's

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66. Schneider, *supra* note 37, at 90.

67. *Id.* at 89-90.

68. Ralph E. Pumphrey, *Compassion and Protection: Dual Motivations in Social Welfare*, 33 SOC. SERV. REV. 21 (1959), *reprinted in* COMPASSION, *supra* note 12, at 5, 12 (quoting Benjamin Franklin as saying Pennsylvania Hospital "was to be open to paying patients only if there were beds available after all public cases were taken care of").

69. The federal payment structure under Medicare has changed in recent years, but in the first twenty years of the program, the payment methods "were a major factor behind the creation and growth of investor-owned hospitals." BRADFORD H. GRAY, THE PROFIT MOTIVE AND PATIENT CARE 6 (1991); *see also id.* at 31-60 (describing evolution of investor-owned hospital companies).

70. As of 1989, for-profits made up 17% of hospitals, up from 13% in 1980; for-profits accounted for 80% of the new day-centers, 45% of new residential care facilities, and 39% of the job training and vocational rehabilitation facilities (for-profits represented 36% of all such social service firms in 1977). Salamon, *supra* note 56, at 29, 32. Conversely, for-profits made up 77% of nursing homes, down from 82% in 1977. *Id.* at 33-34. As the federal and state governments sought to restrain Medicaid costs, "it was the nonprofit firms that moved to meet the demand in the constrained climate of the 1980s." *Id.* at 34.

71. *See, e.g.*, Elisabeth Rosenthal, *Columbia-Presbyterian Seeks a Merger*, N.Y. TIMES, July 8, 1995, at A16 (reporting that insurers, particularly HMOs, have little interest in cross-subsidizing sophisticated technology and training).

engaged in "undue competition" with a neighboring Catholic hospital.[72]

Most unsettling to the public, and to state and federal charity regulators, is the recent wave of nonprofit hospital "conversions." These transformations from nonprofit to for-profit enterprise often take the form of a joint operating agreement between a nonprofit hospital and a proprietary company, or the outright sale of nonprofit hospital assets to an investor-owned chain. In October 1996, George Washington University signed an $80 million preliminary agreement granting an 80% interest in the George Washington University Hospital to OrNda HealthCorp, the third-largest hospital company in the country.[73] In the new atmosphere, Columbia University has filed a trademark and unfair competition lawsuit against Columbia/HCA Healthcare Corp., accusing it, in the words of *The Wall Street Journal*, of "poaching on its venerable Ivy League name."[74]

Even the public sector is feeling the financial pressure. In the country's first private effort to rescue a public hospital, the Boston City Council recently approved an arrangement converting the Boston City Hospital into a joint venture with Boston University's medical center.[75]

2. *For-Profit Schools*[76]

In May 1992, Yale University President Benno Schmidt stunned his board by resigning to head a venture to develop proprietary schools. He told the press:

> At first, frankly, I thought the notion that I would leave the presidency of a 300-year-old institution for something so new and risky was outlandish, like leaping into the abyss. But if this venture succeeds, . . . there's nothing

72. Paul Galloway, *Catholic Hospital Loses Ties*, CHI. TRIB., Feb. 20, 1996, § 2, at 1.

73. Amy Goldstein, *Tenn. Firm to Take Over GWU Hospital*, WASH. POST, Oct. 26, 1996, at A1 (quoting George Washington's Vice President of Medical Affairs as saying, "The world has changed against us").

74. Lucette Lagnado, *What's In a Name? Columbia University Says a Whole Lot*, WALL ST. J., Sept. 16, 1996, at B4 (reporting statement by university official: "There is a fundamental distinction here between the medicine that we represent—not-for-profit research academic centers—and a for-profit hospital chain.").

75. Philip J. Hilts, *City and University Hospitals in Boston to Merge*, N.Y. TIMES, June 30, 1996, at A14.

76. The very concept of what constitutes a school is undergoing change. *See, e.g.*, Ann Podd, *Business Bulletin*, WALL ST. J., June 8, 1995, at A1 (reporting that companies are examining college accreditation for their own degrees).

> that could be done, aside from changing human nature, that would be more constructive for our society.[77]

No doubt Schmidt's $800,000 salary with his new employer encouraged his leap of faith.[78]

Schmidt joined the Edison Project, a brain child of Christopher Whittle. Whiz-kid Whittle already had rocked public-school culture with his Channel One satellite network. Channel One offers a "Faustian bargain": In return for free equipment, public schools must show all students a daily-twelve minute news program with two minutes of ads.[79] In describing the Edison Project, Whittle, ever the self-proclaimed visionary, eerily echoed early nineteenth-century Protestant stewards of industry by declaring: "This would be better than public life: A mission and free enterprise. A blend of capitalism and mission. This goes to the heart of the debate: Should capitalism be in the public sector? I felt this as a real calling."[80]

Three years later, in August 1994, the corporate parents of a collapsing Whittle Communications stripped Whittle of his interests in everything but the Edison Project.[81] Even this lone base appeared uncertain. *The New Yorker* predicted that "[o]nce the public-school administrators of America have absorbed the magnitude of Whittle's failure with his other ventures they are hardly likely to trust him with their tax dollars, let alone their children."[82] In March 1995, Benno Schmidt found new outside investment to keep

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77. Associated Press, *Yale President Resigns: Schmidt to Develop Chain of Private Schools*, WASH. POST, May 26, 1992, at A5 (reporting that Whittle Communications intended to spend $60 million developing network of one thousand profit-making private schools, called Edison Project).

78. James B. Stewart, *Grand Illusion*, NEW YORKER, Oct. 31, 1994, at 64, 74.

79. Patrick M. Reilly, *A KKR Vehicle Finds Profit and Education a Rich But Uneasy Mix*, WALL ST. J., Oct. 12, 1994, at A1. Profitable Channel One reaches 40% of secondary schools. *Id.* Whittle Communications sold it for $250 million to a subsidiary of Kolhberg Kravis Roberts & Co. (controller of tobacco giant RJR Nabisco). *Id.* Advertisements are finding other ways into schools: One El Paso County school district hopes to raise $300,000 annually from dozens of ads displayed on school hallways and stadium walls, on school buses, and in newsletters and reports. *School Sells Ads to Plug Budget Gap*, AP, CHI. TRIB., Nov. 13, 1994, § 1, at 12. Another company, owned by Hughes Electronics (a subsidiary of General Motors), hopes to be able to bring educational shows into classrooms without also carrying advertisements, but this requires charging schools a subscription fee of thousands of dollars. Sarah Lubman, *TV or Not TV? Schools Test Hughes Idea*, WALL ST. J., Mar. 20, 1995, at B1.

80. Stewart, *supra* note 78, at 72.

81. *Id.* at 64.

82. *Id.* at 80.

the Edison Project going, while squeezing Whittle's role.[83] Happily, the four schools operated by Edison during the 1995-96 school year produced promising results. Predicts *The New York Times*: "Districts around the country are increasingly giving Edison a long look, and investors who once shunned the company are now showing so much interest that Edison seems destined to become a publicly traded company within a few years."[84]

A suburban Pittsburgh school district recently granted another proprietary venture, Alternative Public Schools of Nashville, the authority to replace existing teachers. In the opinion of the teachers union, this was "'union busting, plain and simple.'"[85] The union won a preliminary injunction. The Pennsylvania Supreme Court, however, in a 4-to-2 decision vacated and remanded, directing an evidentiary hearing. The court described the deplorable situation in the affected school and emphasized that "the best interest of the child is the polestar."[86]

While companies experience difficulties obtaining contracts to run school districts, proprietary businesses take in $30 billion of the $340 billion spent annually on education below the college level. Businesses fill niches in classroom teaching, tutoring and remedial education, provide computers and software, and design curricula.

83. Barbara Carton, *Edison Project Is Given New Financing in Move Reducing Role of Its Founder*, WALL ST. J., Mar. 17, 1995, at B7. Meanwhile, a competitor, publicly traded Education Alternatives, Inc., won and then lost contracts to run public schools in Dade County, Florida, Baltimore, Maryland, and Hartford, Connecticut. In 1995, Dade County decided not to renew its expiring contract. Steve Strecklow, *Florida Pact to End for Education Alternatives, Inc*, WALL ST. J., May 2, 1995, at B10. County officials found that while attendance and test scores improved, test scores improved at a similar rate at a comparable, publicly-run school. In November 1995, Baltimore terminated its contract. Hartford followed shortly thereafter, pulling out in January 1996. *See, e.g.*, Rick Green, *Officials Considering Paying Part of EAI Bill, Retaining Firm*, HARTFORD COURANT, Feb. 14, 1996, at A3. Education Alternatives, Inc. (EAI) clings to a single ray of hope: a $100,000 consulting contract that it won in February 1996 on a 5-4 vote from a small school district near Poughkeepsie, New York. George Judson, *School Consultant's Job Is Company's 2d Chance*, N.Y. TIMES, Feb. 14, 1996, at B12. EAI's stock had plunged from $48.75 in 1993 to $4.50 in mid-February 1996, a value that it has maintained as of mid-October 1996.

84. Peter Applebome, *Grading For-Profit Schools: So Far, So Good*, N.Y. TIMES, June 26, 1996, at A1; *see also* Ross Kerber, *Edison Project Completes Funding for $30.5 Million*, WALL ST. J., Nov. 20, 1996, at A10. For a scholarly analysis of the proprietary school experiences and the economic and political constraints under which they have been operating, see Douglas J. Lamdin, The Economics of Provision by For-Profit Contractors (Oct. 1996) (unpublished manuscript, on file with *Villanova Law Review*).

85. Peter Applebome, *Private Company Given Power to Pick Teachers*, N.Y. TIMES, Apr. 9, 1995, at A26 (quoting Barbara Bell, affected elementary school teacher and union negotiator).

86. Wilkinsburg Educ. Ass'n v. School Dist. of Wilkinsburg, 667 A.2d 5, 13 (Pa. 1995).

Many schools also contract for support services, including food, transportation, maintenance and security.[87]

3. *Welfare Capitalism*

Corporate employers have long offered health care benefits, pensions, profit-sharing plans, educational benefits, and, recently, on-site child care facilities for their employees as examples of "welfare capitalism." Samuel Gompers, the first president of the American Federation of Labor, opposed government social programs because they competed with the allure of fringe benefits in enticing workers to join unions.[88] Unions, of course, are another specie of nonprofit organization.

On a broader scale, spurred by recent welfare reform, proprietary companies have already started seeking some of the billions of dollars in potentially available government contracts. For example, a subsidiary of Lockheed Martin is bidding against Electronic Data Systems and Andersen Consulting to manage Texas's welfare operations. To state and local officials, facing lump-sum grants in lieu of a guarantee of federal aid to the poor, "a fixed-price contract with a corporation has strong appeal."[89]

C. *Nonprofits Exhibiting "Traditionally" Proprietary Behavior*

1. *The Merger of God and Mammon*

Leave it to cyberspace to bring us word of the merger between the largest nonprofit organization and the most visible business corporation. A spoof disguised as an Associated Press wire story, titled "Microsoft Bids to Acquire Catholic Church," flashed through the Internet in early December 1994.[90] The hoax press release described how Microsoft would gain exclusive electronic rights to the Bible; Pope John Paul II would become a senior vice president; and two Microsoft vice presidents would be invested in the College of Cardinals.[91] Microsoft President Bill Gates was quoted as saying "[t]he combined resources of Microsoft and the Catholic Church will allow us to make religion easier and more fun for a broader

87. Peter Applebome, *Lure of the Education Market Remains Strong for Business*, N.Y. TIMES, Jan. 31, 1996, at A1.

88. BRUCE S. JANSSON, THE RELUCTANT WELFARE STATE 232 (1988).

89. Nina Bernstein, *Giant Companies Entering Race to Run State Welfare Programs*, N.Y. TIMES, Sept. 15, 1996, at A1.

90. *See, e.g.*, *Bigger Than Jesus?*, WASH. TIMES, Dec. 18, 1994, at A14.

91. Paul Andrews, *A Message for Microsoft: Lighten Up; It Was Just a Joke*, SEATTLE TIMES, Dec. 17, 1994, at A1. A copy of this Internet-carried "release" is available from the author.

range of people."[92] Talk-show host Rush Limbaugh read the release aloud on his nationally syndicated television program.[93] Distressed listeners protested to Microsoft, which issued a disclaimer and apology "to anyone who was offended by the document."[94]

"Offended?" responded John A. McCoy, a spokesman for the Roman Catholic Church in western Washington. "We thought our prayers had finally been answered." Indeed, McCoy put out a fax of his own, headlined: "Church Hopes Dashed as Microsoft Denies Acquisition Bid."[95] Yet life has begun to imitate art. The Vatican celebrated Christmas 1995 by debuting its home page on the World Wide Web.[96] The site registered more than a million hits in its first two weeks; most visitors accessed the Pope's Christmas message in a choice of six languages. Some addressed e-mail questions directly to the Pope. He, however, rarely uses his computer.

A series in *The New York Times* on "megachurches" covered topics ranging from the "mall culture" of big-time religion to lessons that megachurches have learned from the business sector.[97] Originally, technology transfer probably went in the other direction. Post-revolutionary New England clergymen taught the rationales and methods of voluntary religious associations to the newly devel-

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92. *Id.*

93. *See, e.g.*, *Microsoft Forced to Deny Wild Rumor on Internet*, REUTER BUS. REP., Dec. 16, 1994.

94. Peter H. Lewis, *And the Spoof Begat a News Release, and Another*, N.Y. TIMES, Dec. 31, 1994, § 1, at 53.

95. *Id.* Mr. McCoy's release described several reasons why the deal might be mutually beneficial, including: "We've had 2,000 years of working with icons. Microsoft has only done it for three. We could have helped." *Id.*

96. *See* Celestine Bohlen, *Pope John Paul @ Vatican: How Many Angels Can Dance. . . ?*, N.Y. TIMES, Jan. 7, 1996, § 1, at 6 (visited Nov. 11, 1996) <http://www.vatican.va/>; *see also Ex-Bishop Opens On-Line Diocese*, AP, CHI. TRIB., Jan. 15, 1996, § 1, at 8 (quoting fired French bishop on French television: "Being able to communicate in borderless space is something new. Young people are all interested in this new form of communication"); Adam Gopnik, *The Virtual Bishop*, NEW YORKER, Mar. 18, 1996, at 59 (reporting on this bishop's virtual diocese, which exists only on Web); *cf.* Edmund S. Tijerina, *Wired to God*, MILWAUKEE SENTINEL J., Nov. 30, 1996, at B2 (setting forth Website addresses for various churches and religious organizations).

97. Gustav Niebuhr, *Where Religion Gets a Big Dose of Shopping-Mall Culture*, N.Y. TIMES, Apr. 16, 1995, at A1; Gustav Niebuhr, *The Minister as Marketer: Learning From Business*, N.Y. TIMES, Apr. 18, 1995, at A1; Paul Goldberger, *The Gospel of Church Architecture, Revised*, N.Y. TIMES, Apr. 20, 1995, at C1; Gustav Niebuhr, *Protestantism Shifts Toward a New Model of How "Church" Is Done*, N.Y. TIMES, Apr. 29, 1995, at A12. *See also, e.g.*, Fara Warner, *Churches Turn to Marketing Plans to Spread Their Spiritual Message*, WALL ST. J., Apr. 17, 1995, at B4.

oping business corporations.[98] Their theology of "moral agency" viewed material wealth, as well as human endowments, as property held in trust for the service of God. As Professor Hall writes, according to Leonard Bacon of New Haven "men should strive for achievement—and should actively seek material gain—because judicious use of wealth and talent was a measure of one's worthiness to be the steward of greater and more enduring forms of spiritual wealth."[99]

2. *Is It Art or Is It Commerce?*

One can find a branch of the Metropolitan Museum of Art gift shop in Macy's department store.[100] Likewise, one could pick up that essential Art Institute of Chicago reproduction scarf in a chic mall on Michigan Avenue.[101] This is really nothing new. *The New York Times* recently quizzed its readers: "Where did the first Cubist art show in America take place?" The answer: Gimbels.[102] Early museums were mere places of "amusement." Department stores cultivated customer taste, and encouraged acquisitive natures in the new bourgeoisie, by displaying fine art. Observed the *Times*: "Today it is demeaning to say about a museum like the Met that it resembles a department store. But one of the dirty secrets of American cultural history is that these two great offspring of the

98. PETER DOBKIN HALL, RELIGION AND THE ORGANIZATIONAL REVOLUTION IN THE UNITED STATES 11-12 (Yale Univ. Program on Non-Profit Organizations, Working Paper No. 208, Sept. 1994).

99. *Id.*; *cf.* Eugene F. Fama & Michael C. Jensen, *Agency Problems and Residuals Claims*, 26 J.L. & ECON. 327, 343 (1983). The authors state:

> Some argue that the sale of some products and services (for example, religion) is not acceptable and that this explains the nonprofit form in these activities. . . . When giving outputs away generates more resources through donations than sale, survival dictates the nonprofit form. . . . Churches usually do not insist on payment of admission charges or member taxes because they attract more total resources through voluntary contributions.

Id.

100. *See, e.g.*, Joshua Levine, *Art Chic*, FORBES, Aug. 21, 1989, at 94 (reporting Metropolitan Museum of Art's expansion of its museum stores into nontraditional locations). The Met has satellite stores in the New York City Public Library and Macy's department store at Herald Square. *Id.* The museum also has shops in malls in Short Hills, New Jersey, in Stamford and West Hartford, Connecticut, and even in Columbus, Ohio. *Id.* The Met's museum shop sales totaled $65 million in 1988. *Id.*

101. Alan G. Artner, *Artistic License*, CHI. TRIB., July 20, 1995, § 5, at 1, 2.

102. Michael Kimmelman, *Art in Aisle 3, by Lingerie, and Feel Free to Browse*, N.Y. TIMES, Mar. 19, 1995, § 2, at 43.

late 19th century have been linked together from the beginning, dancing a kind of high-culture-low-culture pas de deux."[103]

When I first visited the Temple of Dendur at the Met, I thought the space dwarfing the temple was wastefully *empty*. My mistake was seeing it during museum hours. For the real-estate-squeezed elite of New York City, the museum is "Club Met," the place to hold weddings, birthday parties and corporate entertainments.[104] As of 1989, for a "donation" of $30,000 (in addition to actual costs), anyone can "party at the palace."[105] Having recently added six new wings at a cost of $200 million, the Met's voracious appetite for funds happily coincided with the conspicuous consumption of the 1980s newly rich. Punch Sulzberger, chairman of the Met's board (and then publisher of *The New York Times*), asked: "If it's going to be dark, and someone's going to pay thousands of dollars to open it up, why not open it up?"[106]

3. *Executive Compensation: The United Way Scandal*

Contending for the top nonprofit story of the "sober" 1990s is the exposure and disgrace of William Aramony, the former longtime president of United Way of America.[107] The disclosure of his high salary and lavish perks provoked public outrage.[108] The scandal triggered a rebellion in the ranks of the local, independent United Ways. Initially, about 750 of the local organizations with-

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103. *Id.* Also, consider Chicago's Marshall Field's department store and the Field Museum of Natural History.

104. John Taylor, *Party Palace: The High Life at the Gilded Metropolitan Museum*, NEW YORK, Jan. 9, 1989, at 20, 22 (quoting social columnist Billy Norwich).

105. The museum has several functions a night on the three nights a week it permits parties. *Id.* To Hilton Kramer, the Temple of Dendur has no function but to serve as a party hall. *Id.* at 28.

106. *Id.* at 23.

107. Only the Foundation for New Era Philanthropy can claim a greater degree of hubris and greed. *See, e.g.*, Steve Stecklow, *False Profit's: How New Era's Boss Led Rich and Gullible Into a Web of Deceit*, WALL ST. J., May 19, 1995, at A1 (reporting Foundation's offer to double contributions from charities with money from anonymous donor revealed as Ponzi scheme; charities and donors file claims for lost millions); Steve Stecklow, *New Era's Head Charged with Fraud*, WALL ST. J., Sept. 30, 1996, at A3 (describing 82-count federal criminal indictment for fraud, money laundering and tax evasion).

108. Aramony received total compensation of $463,000 a year, flew the Concorde, and used chauffeured cars on his frequent trips to New York, where he stayed in a $430,000 condominium purchased primarily for his use by a subsidiary corporation. Charles E. Shepard, *Perks, Privileges and Power in a Nonprofit World*, WASH. POST, Feb. 16, 1992, at A1 [hereinafter Shepard, *Perks*].

held their voluntary payments to the national.[109] Meanwhile, the locals braced for a drop-off in contributions from the public.[110]

Aramony insisted that his compensation fairly reflected his achievements and the $29 million budget he supervised. The local United Ways, too, were satisfied that they got their money's worth from the national organization through training and promotion.[111] A *Washington Post* editorial observed: "The salaries of executives in big-time philanthropy are always a matter of controversy, and one side of the argument points out that these executives are running organizations that are among other things big businesses."[112]

A second *Washington Post* editorial, however, turned the focus from the chief executive to the board of directors: "Where was [the United Way of America's] board while its staff was flying the Concorde to Europe? The board has traditionally been composed largely of leading figures from the corporate world—people who brought prestige to it, but put little time into it."[113] In fact, the United Way resembles corporate America because it was created by corporate America, receiving most of its funding from workplace payroll deductions.[114] This "corporate" mentality limited the daringness of the charities that the United Way was willing to fund,

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109. Charles E. Shepard, *United Way of America Adopts New Ethics Rules, Safeguards*, WASH. POST, June 26, 1992, at A2 [hereinafter Shepard, *Safeguards*]; *see* Wendy Melillo, *Community-Wide Giving Launched 105 Years Ago*, WASH. POST, Feb. 16, 1992, at A39.

110. Shepard, *Perks*, *supra* note 108, at A38.

111. Charles R. Babcock, *3 Large Locals Ask National United Way About President's Spending*, WASH. POST, Feb. 20, 1992, at A6. One long-time United Way executive said, "When Aramony took over, we were a very weak movement and we did not have a common name in the field." Melillo, *supra* note 109, at A39.

112. Opinion Editorial, *A Charitable Salary*, WASH. POST, Feb. 24, 1992, at A24. Elsewhere, the *Post* also noted that some "contend that the public expects frugality beyond reason." Shepard, *Perks*, *supra* note 108, at A38. Meanwhile, the press extensively covered the dispute between the National Association for the Advancement of Colored People (NAACP) and its executive director Benjamin Chavis. The NAACP fired Chavis (who enjoyed a $200,000 salary plus expenses and a housing allowance) for agreeing to pay up to $332,400 of NAACP money to settle a sexual harassment suit by a former assistant. *NAACP Sues Ousted Leader for Repayment*, CHI. TRIB., Sept. 23, 1994, § 1, at 18; *see NAACP, Chavis Settle Lawsuit Out of Court*, CHI. TRIB., Oct. 22, 1994, § 1, at 6.

113. Opinion Editorial, *United Way's Breach of Trust*, WASH. POST, Apr. 7, 1992, at A24. The organization adopted a code of ethics requiring more local representation on the board and created new committees on ethics, budget and finance, compensation and personnel, services and membership. Shepard, *Safeguards*, *supra* note 109, at A2.

114. The locals raised $3.1 billion in contributions in 1990, of which $2.2 billion came from automatic payroll deductions. Melillo, *supra* note 109, at A39. Recall the discussion of Midwestern federationism, *supra* notes 23-25 and accompanying text.

particularly before the donor-choice rebellion. It also explains why the board failed to anticipate the public revulsion to high salaries.[115] Indeed, Aramony once quipped, "A cardinal rule . . . is that you never put anyone on your Board who makes less than you do."[116]

Initially, observers saw no violations of law.[117] Then came the bombshell: A multi-count indictment charged Aramony with fraudulently diverting hundreds of thousands of dollars to personal use and filing false tax returns.[118] Aramony argued that the board was fully aware of his activities. After an entire week of deliberation, a jury convicted Aramony on twenty-five counts.[119] He received a seven-year prison term which he appealed.[120] While the Fourth Circuit Court of Appeals affirmed most of his convictions, it vacated one and thus remanded for resentencing.[121]

D. *Higher Education*

The world of higher education serves as a microcosm of all the issues discussed above: blurred boundaries between public and private sectors, expansion into commercial activities, and "inappropriate" behavior resulting from pressures to survive.

1. *Harvard: The First U.S. Nonprofit Organization*

As originally established, Harvard University counted most of its revenues from legislative grants, tuition and fees. The state legislature debated its curriculum. Not until 1865 did state senators cease to sit as overseers, by which time state influence had atrophied.[122]

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115. GLASER, *supra* note 23, at 36, 37.

116. *Id.* at 114.

117. Bruce R. Hopkins, *Afterword* to GLASER, *supra* note 23, at 259. "Readers may find this statement hard to believe, but . . . Bill Aramony did not break a single federal law." *Id.*

118. *Former United Way Head Indicted*, CHI. TRIB., Sept. 14, 1994, § 1, at 8 (reporting that charitable funds of $1.5 million were used for personal trips).

119. Karen W. Arenson, *Former United Way Chief Guilty in Theft of More Than $600,000*, N.Y. TIMES, Apr. 4, 1995, at A1.

120. *High Life Sends Ex-United Way Boss to Prison*, CHI. TRIB., June 23, 1995, at A3; *Prosecution of Ex-Charity Head is Faulted*, N.Y. TIMES, Mar. 8, 1996, at A21 (describing oral argument on appeal).

121. United States v. Aramony, 88 F.3d 1369 (4th Cir. 1996).

122. HALL, *supra* note 1, at 17.

2. *University Finances and Governance*

Just before Thanksgiving break in November 1994, Harvard University President Neil L. Rudenstine failed to make scheduled fundraising meetings; he was found asleep at home. His doctors immediately placed him on medical leave to recover from severe fatigue and exhaustion.[123] Rudenstine was six months into a five-year capital campaign to raise $2.1 billion—which works out to over a million dollars a day—even though, at $6 billion, Harvard's endowment was already the largest university endowment in the country.

With varying degrees of regret, modern university presidents predominantly see themselves as administrators rather than scholars.[124] Former Vice Chairman of Xerox Corp. and now President of Babson College, William Glavin, said: "I do not believe that academic institutions have got to be run by academics. They need to be run like a business, more cost-effective and efficient."[125] George Washington University President Stephen Trachtenberg claims he tells people "I run a conglomerate in Washington, D.C., which has residential accommodations, dining facilities, athletic clubs, bookstores, health facilities . . . [,] that last year our budget exceeded $500 million, and that, on the side, we do some education."[126]

Recently, the academic world watched in horror as Yale University handed back a $20 million gift from Lee Bass.[127] Bass had designated the gift to be used for teaching Western Civilization, derided by campus proponents of multiculturalism as the "dead

123. Karen W. Arenson, *A Harvard Leave Highlights the Pressures of University Life*, N.Y. TIMES, Dec. 4, 1994, § 1, at 34.

124. Mary Jordan, *Wanted: Presidents for U.S. Universities—Higher Stress, Lower Prestige and New Focus on Fund-Raising Contribute to Swift Turnover*, WASH. POST, June 14, 1992, at A4.

125. Maryann Haggerty & Joel G. Brenner, *The Campus as Corporation*, WASH. POST, Mar. 11, 1991, at F3.

126. *Id.* Indeed, a few proprietary institutions of higher education have grown so successful that they have become publicly traded. The Apollo Group's University of Phoenix has 35,000 enrolled adult students at 70 U.S. campuses, and thousands more are engaged in distance learning offered by Apollo through online programs. *A Haven from Prejudice: With Academia Elsewhere Closed to Teaching for Profit, the Company's Boss Turned to Arizona*, FIN. TIMES, May 21, 1996, at 5. Explaining why its campuses have no clubs, dormitories, bars or sports facilities, founder John Sperling explains: "This is a corporation, not a social entity. . . . The most precious thing our students possess is their time. Coming here is not a rite of passage. We are not trying to develop their value systems or go in for that 'expand the mind' bull****." *Id.*

127. *See, e.g.*, Andrew Delbanco, *Contract with Academia*, NEW YORKER, Mar. 27, 1995, at 7 (reporting on "largest rescinded donation, apparently, in the history of American education").

white male" curriculum.[128] The University dawdled for years before admitting its inability to implement such a program.[129] The Bass episode recalls a *Doonesbury* cartoon from the 1970s in which the university president, King, leans across his desk to an elderly alumnus and asks hopefully: "Thank you for your generous offer, but we already have a very fine gymnasium; how would you like to endow our African-American Studies Center?"

In contrast to Yale's lethargy over the Bass grant, some universities have become willing to sue donors who fail to satisfy large pledges, which often fund capital building projects.[130] Charities rarely sue living donors. The cases typically arise after a donor dies, having failed to provide for the gift in his or her will. The charity claims to be following through on the donor's wishes, although to the detriment of the heirs.

In the high stakes world of college athletics, universities turn increasingly to corporate sponsorship contracts. We have all witnessed the boundary-blurring commercialization of college football bowl games. More recently, Rutgers University signed a 10-year, $10 million deal with Coca-Cola, providing that only Coke products may be served in university dining halls, available in vending machines and campus stores, and even poured over the heads of victorious athletes.[131] Nike closed a $5.7 million multi-year deal with the University of Michigan, a state school.[132] Michigan's athletic director commented: "The question is whether the commercialism controls the program and does bad things to it, and I don't think this does. . . . If we're going to be into it, we might as well get as much

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128. *See, e.g.*, *Yale to Return Millions with Strings Attached*, CHI. TRIB., Mar. 15, 1995, § 1 at 20 (describing how university lost gift).

129. *See* Barbara Carton, *Yale, Unwilling to Cede Faculty Control, Decides to Return $20 Million Bass Gift*, WALL ST. J., Mar. 15, 1995, at B2 (recounting statements by John L. Lee, a Yale trustee and chair of Yale's $1.5 billion, five-year fund-raising campaign, who explained that long-running negotiations with Lee Bass occurred through "three administrations in three years, three presidents, and three provosts," resulting in "the very poor handoff of the ball"); *see also Yale Explains Bass Gift; Original Version*, WALL ST. J., Mar. 23, 1995, at A14 (reporting on controversy surrounding Bass gift).

130. Richard B. Schmitt, *If Donors Fail to Give, More Nonprofit Groups Take Them to Court*, WALL ST. J., July 27, 1995, at A1.

131. *See, e.g.*, Maria Mallory, *The Cola Wars Go to College*, BUS. WK., Sept. 19, 1994, at 42 (reporting on colleges' acceptance of contracts with soft drink makers).

132. Andrew Gottesman, *Taking License: Corporate Logos Intermingle with School Colors*, CHI. TRIB., Dec. 4, 1994, § 3, at 1. It appears that Michigan closed this deal without first bringing it to the attention of its governing board. *Id.* at 15.

as we can." At the same time, one analyst termed the Michigan contract a coup for Nike.[133]

3. *Competition Among Universities*[134]

a. Lying to Rating Services

In a front-page story subtitled "Cheat Sheets," *The Wall Street Journal* reported the widespread practice among colleges of shading the statistics that they provide to editors of college handbooks. Schools want to appear more selective, and so they drop off the standard aptitude test scores of some of their special admissions students. Many schools also fudge information about applications, admittances, enrollments and graduation rates. The *Journal* reported that, in contrast, the same schools provide much less favorable numbers to Moody's and Standard & Poor's, the agencies that rate the tax-exempt debt the schools issue. The *Journal* noted that lying to ratings agencies violates federal securities laws.[135]

b. Tuition Price Wars

Economic and demographic factors have unsettled the notion of fixed tuition. Colleges now use financial aid not just to assist needy students ("need-based financial aid"), but also to attract quality students ("merit-based financial aid"), and sometimes simply to maintain class size.[136] One business school dean told *The New York Times*, "I think we're going to see increasingly more aggressive and creative and sometimes desperate pricing schemes." Another educator commented: "[T]he whole price structure of higher education, particularly in the private sector, is collapsing, and there will be a lot of . . . novel experiments. . . . The market is trying to . . . clear, and find out the real price the public is willing to pay for higher education."[137]

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133. *Id.* Corporate sponsors view these types of contracts as substitutes for advertising, leading observers to predict that "only the most successful schools with huge national followings are likely to win such contracts." *Id.* at 1.

134. *See also* William Celis III, *Newest Sport on Campus: Steal That Research Lab*, N.Y. TIMES, Dec. 4, 1994, § 1, at 1.

135. Steve Stecklow, *Colleges Inflate SATs and Graduation Rates in Popular Guidebooks*, WALL ST. J., April 5, 1995, at A1.

136. Peter Applebome, *Colleges Luring Students with Discounts in Tuition*, N.Y. TIMES, Dec. 25, 1994, at A1.

137. *Id.*; *see also* Steve Stecklow, *Colleges Manipulate Financial-Aid Offers, Short-changing Many*, WALL ST. J., Apr. 1, 1996, at A1 (reporting on financial aid for college students); Steve Stecklow, *Some Small Colleges Hire Recruiters to Get Bigger Freshman Class*, WALL ST. J., Sept. 5, 1995, at A1 (reporting on aggressive approach to increasing student enrollment).

c. Ivy League Antitrust Violations

In May 1991, the Justice Department entered into a consent decree in which Brown, Columbia, Cornell, Dartmouth, Harvard, Princeton, Yale and Pennsylvania—members of the "Overlap Group"—agreed to avoid future collusion on tuition, salaries and financial aid.[138] The Massachusetts Institute of Technology (MIT), also a participant, refused to settle. MIT defended on the legal ground that financial aid, as a charitable activity, is not subject to the Sherman Antitrust Act.[139] MIT lost at trial, but a split three-judge panel of the Third Circuit reversed and remanded, ordering the trial judge to reconsider MIT's social welfare argument.[140] Before a new trial began, MIT and the Justice Department settled, with MIT agreeing to be bound by the consent decree already entered into by the other members of the Overlap Group.[141]

d. Education as Contract

With the new view of higher education as a business, it was bound to happen. Two students in an adult computer science course sued Pace University for a tuition refund plus punitive damages, because the course demanded more math competency than the school had led the students to expect. The students won. Small claims court judge Thomas Dickerson found that "[s]tudents are consumers of educational services. There is nothing holy or sacred about educational institutions."[142]

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138. Gary Putka, *Ivy League Discussions on Finances Extended to Tuition and Salaries*, WALL ST. J., May 8, 1992, at A1. According to Putka, enforcing the cartel proved difficult but attainable except in rare cases. For example, Dartmouth complained that Harvard unilaterally reduced the net tuition cost to a student whom the two schools had accepted. "I'm very unhappy with [Harvard's] actions on this squeeze play," wrote the Dartmouth assistant financial aid officer to his boss. "This kid is supposedly the [illegible] soccer player in the country! Either we have an agreement we all stick to or we do not have an agreement. I'm tired of being taken advantage of." *Id.* at A5 (alterations in original).

139. Debbie Goldberg, *U.S. Price-Fixing Case Against MIT is Opened*, WASH. POST, June 26, 1992, at A3.

140. United States v. Brown University, 5 F.3d 658, 661 (3d Cir. 1993).

141. *MIT Settles Antitrust Suit on Fixing of Student Aid*, Reuters, CHI. TRIB., Dec. 23, 1993, § 1, at 14.

142. Andre v. Pace University, 618 N.Y.S.2d 975, 979 (N.Y. Ct. Cl. 1994). Competitive pressures, however, continue to induce schools to make increasingly costly promises. *See, e.g.*, Rogers Worthington, *Guarantees Are Big Lure on Campuses*, CHI. TRIB., Oct. 24, 1996, § 1, at 1 ("Across the country, . . . colleges are luring freshmen with promises of jobs and internships upon graduation, free tuition for additional education and even monthly cash payment to grads who can't find appropriate work in their chosen fields.").

Students have tried contract arguments before, nearly always unsuccessfully, in order to wiggle out of repaying student loans. Indeed, one of those students was Judge Dickerson himself. *The Wall Street Journal* reports that his alma mater, Cornell, twenty years ago sued him for $1,500 in unpaid student loans.[143] He then argued that his Cornell education "had little or no value." He now claims to be embarrassed by that case (which he lost), and denies that it influenced his opinion in the Pace suit.[144]

III. SOCIAL INSTITUTIONS AS A REGULATORY FORCE

As economic forces obliterate the differences between nonprofit organizations and proprietary organizations,[145] an invisible glue holds together existing arrangements, preventing the economist's beloved atomistic rational actors from redeploying resources. This glue is the broad network of social institutions existing between electorate and representatives, donors and charities and beneficiaries, shareholders and corporations. Institutions may include laws, but they extend far more pervasively.[146] Institutions are rituals, common value patterns and culture. To the less normative sociologist, they are social patterns and the common sense routines that are taken for granted.[147] As Douglass North observes, "[i]nstitutions are not necessarily or even usually created to be socially efficient; rather they, or at least the formal rules, are created to serve the interests of those with the bargaining power to devise new rules."[148]

Modern society is a complex organism, and multiple social institutions present overlapping and often competing institutional imperatives. The same people can, and do, perform several roles that take place in different sectors. For example, a woman might

143. Edward Felsenthal, *Avogadro's Number, You Say, Professor? I Don't Think So*, WALL ST. J., May 9, 1995, at A1.

144. *Id.*

145. For a discussion of this "organizational isomorphism," see Brody, *Agents Without Principals*, *supra* note 3.

146. "Cultural controls can substitute for structural controls. When beliefs are widely shared and categories and procedures taken for granted, it is less essential that they be formally encoded into the organizational structure." W. Richard Scott, *Unpacking Institutional Arguments*, *in* THE NEW INSTITUTIONALISM, *supra* note 48, at 164, 181. Certain illegal activities amount to institutions as well—gang behavior is highly institutionalized.

147. *See* Walter W. Powell & Paul J. DiMaggio, *Introduction* to THE NEW INSTITUTIONALISM, *supra* note 48, at 1 (discussing differences between "old institutionalisms" and "new institutionalisms").

148. DOUGLASS C. NORTH, INSTITUTIONS, INSTITUTIONAL CHANGE AND ECONOMIC PERFORMANCE 16 (1990).

work for a business corporation, serve on the board of the local arts museum, live in a community with high local taxes and high levels of public social services, send her child to a private primary school, donate money to her Ivy League alma mater, and join a for-profit health maintenance organization. She might suggest that the museum board adopt an advertising campaign like her proprietary employer uses. She should not be surprised, however, to discover resistance, because a "pure" model of nonprofits spurns self-promotion.[149] Institutionalized social beliefs govern nonprofits more than formal laws ever could.

A. *Core Sectoral Constructs in a Complex Society*

Society has become populated by a myriad of entities that seem literally to have lives of their own. Along with the reification of organizations comes an expectation of how firms in different spheres should behave. For example, business corporations should pay their fair share of tax. Governmental agencies need to be restrained from trying to take our money and regulating our lives. At the other extreme, we similarly view charities as somehow outside of ourselves, but as entities "above" the mundane desires to compete and prosper.

The various constructs of corporation, government agency and charity, however, are only legal fictions.[150] As a practical matter, the boundaries of an organization cannot be precisely determinable. That is, organizations cannot be separated from the human beings who deal with them in their various capacities as sharehold-

149. *Cf.* JoAnne Cleaver, *Museum's Dark Days*, CRAIN'S CHI. BUS., Apr. 10, 1995, at 1, 69 (quoting Barbara Meyerson, president of the Association of Youth Museums, who described museums' "fundamental shift from being inwardly focused to being market-driven" as "'getting out the front door and meeting your neighbors'").

150. Justice Marshall provided the earliest American legal description of the corporation:

> A corporation is an artificial being, invisible, intangible, and existing only in contemplation of law. Being a mere creature of law, it possesses only those properties which the charter of its creation confers upon it, either expressly, or as incidental to its very existence. . . . Among the most important are immortality, and, if the expression may be allowed, individuality; properties, by which a perpetual succession of many personals are considered the same, and may act as a single individual. . . . It is chiefly for the purpose of clothing bodies of men, in succession, with these qualities and capacities, that corporations were invented, and are in use.

Trustees of Dartmouth College v. Woodward, 17 U.S. 518, 636 (1819). Marion Fremont-Smith traces the English roots of ecclesiastical foundations back to 550, with the revision of the Roman Law and the enactment of the Statutes of Justinian. MARION R. FREMONT-SMITH, FOUNDATIONS AND GOVERNMENT 15 (1965).

ers, voters or donors; as directors, elected and appointed officials, trustees or staff; and as customers, citizens or beneficiaries.[151] All of these entities are *associations*, collective activities of human beings.

As illustrated above, Americans' propensity to form associations requires a great variety of transacting and formal organization.[152] Each of the traditional three sectors undeniably stakes out discrete cores.[153] The public sector enjoys the power of compulsion in order to ensure the health, safety and well-being of the public: The citizens consent to adhere to the laws, including tax laws, enacted by chosen representatives. The proprietary sector retains near-total autonomy over the private property it owns; in turn, corporations act in the interests of their shareholders. The nonprofit sector has both the public purpose of the governmental sector and the autonomy of the proprietary sector, but nonprofit entities have no owners.[154]

There is no ideal sector for any particular collective activity. As illustrated in Part II, history suggests that we delude ourselves in trying to classify activities by sector. Many activities have, in various times and in various places, been provided within various spheres of conduct: the family, the church, the government, the proprietary

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151. As an example of unclear boundaries, economists debate about who bears the burden of the corporate income tax. Unagreed proportions are assigned to shareholders (through lower dividends), employees (through lower wages), suppliers (through lower prices paid), customers (through higher prices charged), or even to all holders of capital. *See* U.S. TREAS. DEP'T, INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS, *supra* note 15.

152. *See* Ronald L. Jepperson & John W. Meyer, *The Public Order and the Construction of Formal Organizations, in* THE NEW INSTITUTIONALISM, *supra* note 48, at 204, 220. They observe:

> First, in a system in which individuals are handed the loaded gun of legitimated actorhood and legitimated interests, each individual must recognize that others are similarly empowered. The first interest (and collective obligation) of all in the Tocquevillean society is to attain control over everyone else . . . . An enormous amount of . . . organization is constructed: religious organizations, courts and the criminal systems, local government, parties, massive educational efforts, moral improvement and self-control associations . . . .

Id.

153. *See* W. Richard Scott & John W. Meyer, *The Organization of Societal Sectors: Propositions and Early Evidence, in* THE NEW INSTITUTIONALISM, *supra* note 48, at 108.

154. "Ownership" is a complicated economic question. *See* Brody, *Agents Without Principals, supra* note 3, at 466 (noting that "economic theory fragments ownership into three characteristics: the right to profits, the right to control and utilize assets, and the right to alienate"). Here, I use the term "ownership" to mean the right to receive profits and the right to transfer the interest.

sector and private community organizations.[155] Often the same types of activities are produced simultaneously in more than one sphere. For example, marriage counseling might be provided within the family, neighbor-to-neighbor, by a pastor, by a private therapist, by a governmental social service agency or by a nonprofit entity. In choosing among sectors for service delivery, policy makers constantly argue over the relative importance of fairness and efficiency, equality and diversity, and compulsory participation and choice.[156]

Here is a schematic summary of the core features of the three sectors, as the public conceives them today:

	Government	**Proprietary**	**Nonprofit**
Owners:	None	Shareholders	None
Purpose:	Public (broad)	Commercial	Public (narrow)
Coverage:	Entitlement	Market	Discretionary
Governance:	Representative	Agents for hire	Voluntary trustee
Funding:	Taxes (compulsory)	Profits/equity investment	Donations
Reputation:	Ineffectually egalitarian	Opportunistic	Trustworthy
Oversight:	Electorate	Shareholders	Members/State
Subsidies:	Tax exemption; deduction for state income taxes	None	Tax exemption; charitable contribution deduction

At any given time, however, the sectors could have starkly different or overlapping characteristics. To complicate the inquiry, distinctions are not always so clear as they initially appear. For example—

1. When voting privileges were limited to free male landowners, the electorate closely matched those who owned the (then agricultural) means of production.

155. *See generally* ALBERT O. HIRSCHMAN, SHIFTING INVOLVEMENTS: PRIVATE INTEREST AND PUBLIC ACTION 8 (1982) (setting forth a theory to explain "the swings from private concerns to public action and back").

156. Governments typically have broader, majoritarian, or last-resort goals, whereas private enterprise, whether for-profit or nonprofit, can choose narrower goals. *See, e.g.*, Daniel C. Levy, *A Comparison of Private and Public Educational Organizations*, *in* THE NONPROFIT SECTOR, *supra* note 10, at 258, 270 ("[T]he private sector may have an option, the public sector a responsibility. The public sector more often tackles the difficult tasks, even the dirty work. In short, private-sector effectiveness often depends on public-sector coverage.").

2. Either de jure or de facto, the board of directors of both a for-profit corporation and of a nonprofit corporation are often self-perpetuating.
3. Taxes are not always so compulsory, nor contributions so voluntary. Compare property taxes in a new planned community with a religion that mandates tithing, or a workplace solicitation for United Way, or even the *noblesse oblige* of the moneyed classes.[157]
4. Nonprofits often conduct business activities (the profits from which are taxable if substantially unrelated to the organization's exempt purpose). Are the activities of a nonprofit hospital any less commercial than those of a for-profit?
5. Real estate owned by governmental entities as well as by nonprofit charities is exempt from local property tax. Certain proprietary industries have, at times, enjoyed effective property-tax or income-tax exemption.

In all of these cases, is the presence or absence of an obligation or privilege based on legal form really so important?

B. *Institutional Imperatives*

The emerging democracies in the former Soviet Union and Eastern Europe have been struggling to enact a legal structure hospitable to charitable activity, yet one which polices abuses. Laws, however, are empty words unless implemented in a context of broader societal institutions. These formerly socialist countries first need to develop notions of private property, personal responsibility, cultures of trusteeship and the rule of law.[158]

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157. *See, e.g.*, Burton A. Weisbrod, *Toward a Theory of the Voluntary Nonprofit Sector in a Three-Sector Economy*, *in* THE ECONOMICS OF NONPROFIT INSTITUTIONS 21, 35 (Susan Rose-Ackerman ed., 1986) [hereinafter THE ECONOMICS OF NONPROFIT INSTITUTIONS] (noting "voluntary organizations do employ 'coercive and compulsive powers,' just as do governments, although the penalties are social rather than governmentally sanctioned fines or imprisonment"). Weisbrod also states that "[w]hile pressures to 'donate' to the United Fund, Red Cross, Cancer Society, or private colleges, are (sometimes) more subtle than the pressure to pay one's taxes, the difference is one of degree, not of kind." *Id.*; *see also* THERESA ODENDAHL, CHARITY BEGINS AT HOME 144 (1990) (discussing "card calling" pressure by Jewish fundraising groups); Karen W. Arenson, *Donations to a Jewish Philanthropy Ebb*, N.Y. TIMES, Dec. 27, 1995, at A1 (noting that in past "many Jews considered their contributions a kind of tax, referring to [the United Jewish Appeal-Federation] as the Jewish I.R.S.").

158. They face similar problems developing a proprietary sector. Observed economist Ronald Coase: "These ex-communist countries are advised to move to a market economy, and their leaders wish to do so, but without the appropriate insti-

In contrast, the United States has highly developed institutions for nonprofit activity, but the American nonprofit sector today seems infested with conflict, if not decay. Our nonprofit organizations find themselves caught between reduced government funding and donor burn-out, yet face high demand for their services. Defending against charges of unfairly competing with the proprietary sector, nonprofits increasingly compete even against each other. The greed and hubris of some nonprofit executives expose charities to disgrace in the press, while even management attempts to act in a more "business-like" manner attract criticism. It can often be difficult to explain how a particular nonprofit organization, or even industry, behaves differently from proprietary enterprises or governmental agencies.

No one, however, can gainsay the economic strength of the American nonprofit sector and the high level of American altruism. Every year that brings America closer to the millennium brings thousands of new charities,[159] and donations rise each year.[160] Moral, religious, political, economic and other forces drive people to form nonprofits, to volunteer money or time to them, to work for them, to seek assistance from them, to purchase their goods and services, and to look to them for social or spiritual leadership.

A broad range of institutional forces dictate what nonprofits are. While often constraining, institutions can also be liberating.[161] To Douglass North, the "major role of institutions in a society is to reduce uncertainty by establishing a stable (but not necessarily efficient) structure to human interaction."[162] Stability, of course, is not permanence. Institutions should, and do, change.

Institutional beliefs can be good, bad or indifferent. A particular institution might or might not have normative content. Regardless, though, of whether it serves as a "highly rationalized myth" or

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tutions no market economy of any significance is possible." R.H. Coase, ESSAYS ON ECONOMICS AND ECONOMISTS, 6 (1994) (Nobel Prize Lecture, delivered Dec. 9, 1991).

159. The number of nonprofits, a state law designation, cannot be determined with precision. A total of 1.4 million nonprofit organizations was estimated as of 1992, based on IRS and other data, and the number of tax-exempt charities has grown 5% a year for the last eight years. VIRGINIA A. HODGKINSON ET AL., NONPROFIT ALMANAC: 1996-97: DIMENSIONS OF THE INDEPENDENT SECTOR 37 tbl.1.1, 219 (1996). Nearly three-fourths of all charities were founded since 1970. *Id.* at 15. This figure, however, is partially a quirk of the data; not until the Tax Reform Act of 1969 were charities required to obtain IRS recognition of their tax-exemption.

160. *Id.* at 5-6, 55-125.

161. Ronald L. Jepperson, *Institutions, Institutional Effects, and Institutionalism, in* THE NEW INSTITUTIONALISM, *supra* note 48, at 143, 146.

162. NORTH, *supra*, note 148, at 6.

merely reflects social habit, a particular set of social arrangements tends to persist.[163] Consider such common modern institutional demands that nonprofits:

1. should not charge more than cost for a service or good, or run a surplus from year-to-year (that is, should not make a profit);
2. should not be run in a "business-like" way;
3. should not pay a market wage to employees;
4. should not compete;
5. should not take "tainted" money; and
6. can ignore laws that interfere with the charitable mission.

This last belief can be the most dangerous. Nonprofits, *because they are nonprofit*, sometimes assume that they need not be aware of legal obligations. Some of them believe that the halo of nonprofit status protects them, and perhaps mandates, that they rise above legal impediments.[164]

C. *Institutional Dissonance*

As illustrated at length in Part II, despite public expectations, most nonprofits must and do compete: for funds, for labor, for legitimacy and for survival.[165] A nonprofit must accommodate the institutional expectations of its industry, its donors, its volunteers, its members, its beneficiaries, its clientele, its corporate sponsors, its government granting agencies and the taxpaying public. Inevitably, expectations conflict.[166] Nonprofit scholar Lester Salamon

163. Walter W. Powell, *Expanding the Scope of Institutional Analysis*, *in* THE NEW INSTITUTIONALISM, *supra* note 48, at 183, 194 ("Efforts at change are often resisted because they threaten individuals' sense of security, increase the cost of information processing, and disrupt routines.").

164. At the seemingly mundane level, a common problem is tax filings. *See, e.g.*, HALL, *supra* note 1, at 91. As a more substantive example, some church groups believe that important religious tenets trump legal demands. *See, e.g.*, Bob Jones Univ. v. United States, 461 U.S. 574 (1983) (upholding denial of federal tax exemption to religious school engaging in racial discrimination, at odds with long-standing federal policy). *See also* Christian Echoes Nat'l Ministry v. United States, 470 F.2d 849 (10th Cir. 1972), *cert. denied*, 414 U.S. 864 (1973) (upholding constitutionality of legislative ban on political activities by charities).

165. For examples of competition between nonprofits, see Part II, *supra* notes 10-144 and accompanying text.

166. Roger Friedland & Robert R. Alford, *Bringing Society Back In: Symbols, Practices, and Institutional Contradictions*, *in* THE NEW INSTITUTIONALISM, *supra* note 48, at 232, 255 ("Thus the ancient Greek dramatists first represented individual choice through role conflict, as in the case of Sophocles' Antigone who is torn

notes "a growing mismatch between the actual operation of the voluntary sector and popular conceptions of what this sector is supposed to be like," opening up the sector to "cheap shots and exposés" and political attacks.[167]

As a result, nonprofits and their constituents often find themselves gripped by "institutional dissonance." Like cognitive dissonance—the stress of simultaneously holding two opposing views[168]—institutional dissonance requires the various players to rationalize what they do. These dilemmas are what make nonprofit stories headline news.

For example, the Philip Morris company has for decades generously funded the arts, particularly in New York City where it is headquartered.[169] Suddenly, in the Fall of 1994, "writhing in dismay over strong anti-smoking legislation pending before the New York City Council, Philip Morris executives telephoned arts institutions that had benefited from their largess and asked them to put in a good word."[170] "This has put all my clients into a tailspin," moaned one arts consultant.[171] "They have been so shocked that they don't know how to react."[172] So powerful is the company that no nonprofit would speak for attribution.[173]

Why the angst? Philip Morris has the legal right to lobby and to make or withhold contributions.[174] It has the right to ask the supported arts groups for their help, but the charities have the right to say no.[175] The city has the right to agree or disagree with

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between familial duty to bury her brother and a political obligation not to bury a traitor.").

167. Karen W. Arenson, *Woeful '95 Leads U.S. Charities to Introspection*, N.Y. TIMES, Dec. 10, 1995, § 1, at 38.

168. *See generally* LIONEL FESTINGER, A THEORY OF COGNITIVE DISSONANCE (1957) (setting forth theory of cognitive dissonance).

169. Paul Goldberger, *Philip Morris Calls in I.O.U.'s in the Arts*, N.Y. TIMES, Oct. 5, 1994, at A1.

170. *Id.* Said a spokesman: "We will continue to give willingly and with great enthusiasm to the arts: the question is not whether, but where. Right now, leaving New York is not under active consideration, but the only permanent fixtures in New York City are Grand Central Terminal and the Empire State Building." *Id.* at C14.

171. *Id.*

172. *Id.*

173. *Id.* Moreover, such is the status of the company's arts program that "Philip Morris money represents a kind of stamp of approval that can bring other grants in its wake." *Id.*

174. *See* Nancy J. Knauer, *The Paradox of Corporate Giving: Tax Expenditures, the Nature of the Corporation, and the Social Construction of Charity*, 44 DEPAUL L. REV. 1, 19 (1995) (discussing proprietary sector's support of nonprofits).

175. A charity jeopardizes its tax exemption if it engages more than insubstantially in lobbying. Under the Internal Revenue Code and the Treasury Depart-

the views expressed by the lobbyists, and potential donors and arts patrons have the right to grant or withhold their patronage. What will and "should" the arts group do? For example:

1. Would donors welcome corporate financial support as sufficient to finance the needs of the charity, and thus reduce their own donations?[176] This "crowding out" effect has nothing to do with the morality or immorality of the corporate sponsor's business.
2. Would donors and constituents such as ticket-buyers lose respect for the arts groups because, in lobbying the city government, they are furthering the commercial interests of a corporate sponsor (again, independent of the moral issue)?[177]
3. Does the fact that this large corporate sponsor sells cigarettes make things worse?[178] Anna Quindlen calls this: "When Good People Take Bad Money."[179]

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ment regulations, these contacts would likely be considered negligible. I.R.C. §§ 501(c)(3) & (h) (1996); Treas. Reg. §§ 1.501(h)-1 through -3 (1996).

176. *See* Burton A. Abrams & Mark D. Schmitz, *The Crowding-Out Effect of Government Transfers on Private Charitable Contributions*, *in* THE ECONOMICS OF NONPROFIT INSTITUTIONS, *supra* note 157, at 303, 304-05 (describing how government grants have both substitution effect, where donors feel less need to give if someone else does, and income effect, where the government's grantmaking increases taxes and so reduces donors' ability to contribute); *see also* Susan Rose-Ackerman, *Do Government Grants to Charity Reduce Private Donations?*, *in* THE ECONOMICS OF NONPROFIT INSTITUTIONS, *supra* note 157, at 313 (discussing effect of government support on level of donations).

177. *See, e.g.*, Douglas McLennan, *Arts: When Art Cozies up to Business, Peril Lurks*, NEWS TRIB., Oct. 6, 1994, at F2 (commenting that one Philip Morris-sponsored show seemed like "a corporate infomercial with art as the bait").

178. Said a spokeswoman for a New York dance company dependent on Philip Morris sponsorship: "I say thank God for sinners: they're the only people to support the arts." In this way, though, Philip Morris "reaches audiences unlikely to pause before a Marlboro ad." Goldberger, *supra* note 169, at A1.

179. Anna Quindlen, *The Tobacco Lobby: Good Causes, Bad Money*, CHI. TRIB., Nov. 17, 1992, § 1, at 19 ("Organizations that work tirelessly to make life better, freer and more fruitful pay for their works with profits on a product that kills almost 440,000 Americans every year."). Ninety years ago, George Bernard Shaw ridiculed the notion that we can separate clean money from tainted in the preface to his play *Major Barbara*:

> Some of [my critics] thought that the [Salvation] Army would not have taken money from a distiller and a cannon founder: others thought it should not have taken it: all assumed more or less definitely that it reduced itself to absurdity or hypocrisy by taking it. . . .
>
> [The Army] must take the money because it cannot exist without money, and there is no other money to be had. Practically all the spare money in the country consists of a mass of rent, interest, and profit, every penny of which is bound up with crime, drink, prostitution, disease, and all the evil fruits of poverty, as inextricably as with enterprise, wealth, commercial probity, and national prosperity. The notion that you can

4. Would donors and other constituents recognize the exigencies facing the arts groups and forgive their having to kowtow to an essential corporate sponsor?[180]
5. Or do arts patrons enjoy slumming with artists expected to live Bohemian, dissolute lives, so that alliance with Philip Morris actually lends cachet to these arts groups?[181]

The New York City arts groups cannot simultaneously hold to opposing institutional constructs. In the end, they "should" reject Philip Morris's demand if others reject it, perceiving public condemnation, and they "should" capitulate if others capitulate, perceiving public sympathy. It's no wonder the nonprofits are in a tailspin. Each arts group wants someone else to act first. Ultimately, outcomes will depend on which institutional imperative currently has the upper hand.

We must recognize that similar conflicts operate in the public and proprietary sectors.[182] Politicians must balance various voter expectations. When a corporation makes a grant to a controversial cause, customers can vote with their dollar.[183] No sector can escape institutional forces and society's constant revision of them.

> earmark certain coins as tainted is an unpractical individualist superstition.

Bernard Shaw, *Preface* to MAJOR BARBARA 157 (Brentano's 1911).

180. *Cf.* Linda Winer, *The Arts' Addiction to Philip Morris*, NEWSDAY, Oct. 7, 1994, at B3 ("Philip Morris has been celebrated for its support of the avant-garde and dance—fields that have increasingly been the most controversial and difficult to fund. . . . [T]hese are the neediest groups, the most grateful groups, often the most idealistic groups.").

181. According to Paul Goldberger, Philip Morris

> often pays for lavish opening-night parties at which the Philip Morris cigarettes at every table are the only obvious signs of corporate sponsorship. (There was so much smoking at the opening of the Impressionism show that the Temple of Dendur was enveloped in a cloud of smoke, something that will be prohibited if the legislation pending before the City Council is passed.)

Goldberger, *supra* note 169, at L14.

182. *See* Steven Lee Myers, *City Hall's Going Retail in Wholesale Fashion*, N.Y. TIMES, July 9, 1995, § 4, at 2 (stating municipalities sell advertising on police cars, garbage trucks, and at playgrounds, and cities open official stores to sell such local mementos as parking meters, street signs and manhole covers).

183. *See, e.g.*, *PC Pizza in the White House*, WASHINGTONIAN MAG., Apr. 1993 (describing Clinton administration's change in pizza delivery companies). Late-night meetings at the Reagan and Bush White Houses were fueled by pizza from Domino's. Clinton staffers switched companies because Domino's owner Tom Monaghan was active in the anti-abortion movement. *Id.*

IV. PROPOSALS FOR LEGAL REFORM

What is the proper role for law in this picture? This Part examines proposals, some old and some recent, to reform various laws affecting the nonprofit sector or subsectors. We begin with broad proposals to shrink the nonprofit sector by limiting the size, lifespan or permitted purposes of charities. Next, we consider calls for uniformity in nonprofit law and for creating a central government agency to supervise charities, essentially federalizing the sector. Finally, we focus on narrower proposals, such as those dealing with mandated disclosure and expanded standing rights.[184]

A. *Broad Proposals for Reform*

1. *Restricting the Size of the Nonprofit Sector*

Charities now form at a rate faster than proprietary businesses.[185] As suggested in Part II, there are segments of the nonprofit sector whose size and power one could only have dreamed of in the early days of American philanthropy.[186] Some people undoubtedly seek nonprofit status for their activities out of, perhaps, a mythic yearning to fit within the traditional notions of that sector. For others, something more mundane is at stake, such as tax minimization. In many cases, nonprofit formation occurs without conscious choice, merely based on the type of activities undertaken. In any case, once assets reach the charitable subsector, particularly, individuals have little ability to reclaim them.[187] Should states thus make it harder to shift assets into a private nonprofit sector?

a. English Development of Charitable Trust Law

A tension between private ownership and public control has existed since the beginning of private property. By the time of

184. I save for another time proposals that go to the question of tax and other subsidies for the nonprofit sector.

185. HODGKINSON ET AL., *supra* note 159, at 25 (reporting rate of growth of other nonprofits was slower than rate of business formation); *see also* Dan Skelly, *Sources of IRS Data on Nonprofits and Charitable Giving* (May 22, 1992), *reprinted in* 5 EXEMPT ORG. TAX REV. 973 (June 1992). IRS data show that gross domestic product, adjusted for inflation, increased by 50% from 1974 to 1990. *Id.* During the same period, inflation-adjusted revenue of private foundations grew by 124%. *Id.* Total revenue of publicly supported charities increased by 52% in real terms. *Id.* Since 1992, growth in the charitable sector has declined. HODGKINSON ET AL., *supra* note 159, at 3.

186. For a discussion of the growth of the nonprofit sector, see Part II, *supra* notes 10-144 and accompanying text.

187. Mutual nonprofits, by contrast, can generally distribute their assets to their members on dissolution.

Henry VIII, church ownership of land reached an estimated one-third to one-half of private landholdings. This situation evolved despite a provision in the Magna Carta, added by Henry III in 1225, that forbade "freemen to alienate 'so much of his land as will render the residue insufficient to secure the service due to his Lord.'"[188] William Shakespeare found the dispute between the crown and church so dramatic that he opened his play *Henry V* with a scheme cooked up by the Archbishop of Canterbury.[189] The clergy goaded young Henry V into invading France, as a distraction from considering a bill to strip the Church of "all the temporal lands which men devout/By testament have given to the Church."[190] "'Twould drink the cup and all," Canterbury declares.[191] Henry VIII secularized charity by dissolving the monasteries and "prohibiting the creation of trusts for religious uses of more than twenty years."[192]

Tudor England struggled to develop a coherent law privileging private ownership of property at a time when most property consisted of land.[193] The law of primogeniture mandated that title in land must pass to the oldest son; only personal property could pass otherwise by testamentary disposition.[194] Attempts to circumvent this restriction led property owners to grant "uses" in the land.[195] By the time of Henry V, most of the land in England was held in use.[196] This proliferation prompted Parliament to adopt two laws: the Statute of Uses in 1535, under Henry VIII, and the Statute of Charitable Uses in 1601, under Elizabeth I.[197]

The Statute of Uses gave us the Rule Against Perpetuities, which essentially requires that outright ownership of property must

188. FREMONT-SMITH, *supra* note 150, at 17 (quoting Magna Carta). In this quote, "Lord" obviously refers to the earthly sovereign.

189. WILLIAM SHAKESPEARE, THE LIFE OF KING HENRY THE FIFTH act 1, scene 1 (Yale Univ. Press 1955).

190. *Id.*

191. *Id.*

192. FREMONT-SMITH, *supra* note 150, at 23. Compare this term with the early American business corporation. State charters in the early nineteenth century often contained duration limits, commonly 20 years. *See, e.g.*, HARTZ, *supra* note 16, at 238-40 (ascribing this trend, and other legislative reservation clauses, to Supreme Court's decision in *Dartmouth College v. Woodward*, 17 U.S. 518 (1819)).

193. *See* FREMONT-SMITH, *supra* note 150, at 26; Brody, Charitable Endowments, *supra* note 21, at 28-39.

194. FREMONT-SMITH, *supra* note 150, at 26.

195. *Id.*

196. *See id.* at 20.

197. *Id.*

vest at least every hundred years,[198] thus preventing a testator from dictating beneficial enjoyment long after his death. Under these Dead Hand rules, a devise of property into a trust fails if the trust has no ascertainable beneficiaries.[199] The *sine qua non* of a charity, however, is that its beneficiaries be of a broad enough class that they are unknowable.[200] Accordingly, the Statute of Charitable Uses created an exception from the Dead Hand rules for bequests to charitable trusts.[201]

The list of purposes contained in the preamble to the Statute of Charitable Uses included such activities as the founding of hospitals and prisons, and relief for the poor. Over the years, trusts were upheld for a range of charitable purposes, some silly. As Lewis Simes put it: "By this device, the vanity of the dead capitalist may shape the use of property forever."[202] No donor can be so far-sighted as to see what society will need hundreds of years into the future. Accordingly, under the *cy pres* doctrine, the state retains the power to reform the purposes of a charitable trust whose intended purposes can no longer be carried out.[203] The state's power to disregard or reform the directions of the donor, however, is usually applied as minimally as possible.[204]

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198. Rob Atkinson, *Reforming Cy Pres Reform*, 44 HAST. L.J. 1111, 1114 & n.8 (1993).

199. *Id.*

200. FREMONT-SMITH, *supra* note 150, at 20.

201. Specifically, the Elizabethan law permitted trusts to be formed for the following purposes:

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

Statute of Charitable Uses, 39 Eliz. I, ch. 5 (1597) (Eng.), *as reprinted in* Fishman, *supra* note 18, at 630 n.65. The subsequent Statute of Charitable Uses, 43 Eliz. I, ch. 4 (1601) (Eng.), "provided machinery for the enforcement of charitable trusts." Fishman, *supra* note 18, at 621 & n.19 ("The new procedure was little employed after a period of time and, the importance of the law of charitable trusts lies in the preamble of the statute, which contains an enumeration of charitable purposes."); *see also* FREMONT-SMITH, *supra* note 150, at 23-27.

202. LEWIS M. SIMES, PUBLIC POLICY AND THE DEAD HAND 111 (1955).

203. The charitable exception also abrogates the general policy against inalienability. In modern times, this rarely presents a problem, because most assets held in charitable trusts are liquid. Difficulties might arise for real property held by a trust (for example, a school, hospital or museum) dedicated to the specified use in perpetuity.

204. G.G. BOGERT & G.T. BOGERT, THE LAW OF TRUSTS & TRUSTEES § 433, at 95 (2d ed. 1991) (noting that term *cy pres* derives from *cy pres comme possible*, the French for "as near as possible"); Atkinson, *supra* note 198, at 118.

b. The American Experience

As in England, charity law developed in the United States largely through suits instigated by disappointed heirs seeking to defeat charitable bequests.[205] State trust law—including the *cy pres* doctrine—governs transfers into charitable trusts.[206] American charitable trust law also gives broad deference to the settlor's wishes and generally accepts long periods of dormancy and accumulation of income for a charitable purpose.[207] Courts upheld the accumulation provisions in Benjamin Franklin's bequest to a trust for loans to "young married artificers." Over the next 150 years, however, its earnest trustees repeatedly sought judicial *cy pres* reform of the trust, as the dollar caps proved inadequate, the eligibility restric-

205. *See, e.g.*, Ould v. Washington Hosp. for Foundlings, 95 U.S. 303 (1877) (considering challenge by heirs that bequest was not charitable). For a discussion of the development of charity law in England, see GEORGE DUKE, CHARITABLE USES (1637). *See also* Fishman, *supra* note 18, at 626 ("[In the] ongoing anti-charity-anti-clerical atmosphere of the period[, even] as wise a jurist as Justice Joseph Story supported mortmain statutes to check clerical power and believed that charities, religious or otherwise, trampled individual rights by depriving future heirs of property to which they were entitled.").

206. After the American Revolution, some states repealed English statutes, including the Statute of Charitable Uses; the Supreme Court declared invalid charitable trusts in those states that failed to adopt replacement statutes. Trustees of Philadelphia Baptist Ass'n v. Hart's Ex'rs, 17 U.S. 1, 38-39 (1819). *But see* Vidal v. Mayor, Alderman and Citizens of Philadelphia, 43 U.S. 127 (1844) (effectively repealing *Hart*, after discovery of evidence that charitable trusts existed at common law, i.e., without regard to English statutes). *See also* Fishman, *supra* note 18, at 627 n.49 ("Stephen Girard should be considered the patron saint of American lawyers, for his will has generated so much litigation that he possibly has helped more attorneys than orphans.").

The spectacular failure of Samuel J. Tilden's multi-million dollar bequest to fund a free public library in New York City shocked the public. *See* Tilden v. Green, 28 N.E. 880 (N.Y. 1891) (holding charitable testamentary trust invalid due to lack of certainty of beneficiary). New York quickly adopted the Tilden Act, 1893 N.Y. Laws 701, which provided that gifts for charitable uses could not be "deemed invalid by reason of the indefiniteness or uncertainty of" their beneficiaries. FREMONT-SMITH, *supra* note 150, at 39; Fishman, *supra* note 18, at 628 n.57.

207. *See* EDITH FISCH ET AL., CHARITIES AND CHARITABLE FOUNDATIONS § 119 (1974) (stating charitable trust may not accumulate all income in perpetuity). Whether or not states have legislated limits on accumulations, courts exercise equity powers to require that accumulations be reasonable in light of the charitable purpose and public policy. For example, the will in *In re James' Estate*, 199 A.2d 275 (Pa. 1964), established a trust for Masonic homes, with much of the income to be accumulated until termination and vesting in the Masons after 400 years. *Id.* at 275-76. The court stated: "We are reluctant to ascribe to testator the paramount desire merely to turn an approximately $50,000 trust fund into a final gift of almost $15,000,000 at the expense of immediate social needs." *Id.* at 279. In making the income available to the beneficiary currently, the court observed: "Shifting and advanced social concepts, programs and concerns emphasize the hazards of seeking to correct or alleviate social problems so distantly removed from testator's generation." *Id.* at 280.

tions too limiting and, finally, the benefited trade fell to advancing technology.[208]

In general, however, American charity law has come to look quite different from English charity law because most American charities take the corporate form.[209] A bequest to a charitable corporation does not invoke the Rule Against Perpetuities, because ownership of the property vests outright in the corporation. Nor, under the modern view, does the state's *cy pres* power reach nonprofit corporations, although charities are bound by restrictions imposed on donations.[210] Nonprofit corporation law cedes a great deal of autonomy to founders and directors of charitable corporations, a level of discretion that trustees can match only if granted by the founder in the settlement instrument.[211]

Proposals to restrict the size of the charitable sector surface occasionally, especially during times of social uncertainty. Reformers have generally concentrated on a subset of charities, known as foundations, that are viewed as uniquely susceptible to control by a single family. In the 1912 presidential race, Theodore Roosevelt opposed federal charters for foundations because "no amount of charity in spending such fortunes [as John D. Rockefeller's] can compensate in any way for the misconduct in acquiring them."[212]

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208. SIMES, *supra* note 202, at 141-53.

209. Marion Fremont-Smith attributes the dominance of the nonprofit corporation form in the United States to the continued skittishness of donors with the trust form after *Hart*, as well as to the rise of the business corporation. FREMONT-SMITH, *supra* note 150, at 40. It might also be that American philanthropists chose the corporate form because of eighteenth-century married women's property acts! Treudley, *supra* note 12, at 135. Truedley notes that: "Most societies of any importance were incorporated so that they might hold property. They had the same elected officers and tended to choose the treasurer from among the unmarried women to avoid any legal complications arising from a husband's right to control money placed in his wife's hands." *Id.*

210. New York is one state that imposes "quasi-cy pres principles" to a charitable corporation that wants to modify the purposes clause of its articles of incorporation. Alco Gravure, Inc. v. Knapp Found., 479 N.E.2d 752, 757 & n.7 (N.Y. 1985); *cf.* REV. MODEL NONPROFIT CORP. ACT §§ 10.02 & 10.30 (1987) (granting directors in nonmembership corporation authority to amend articles of incorporation unless articles require approval of another specified person or persons).

211. *See generally* EVELYN BRODY, THE LIMITS OF CHARITY FIDUCIARY LAW (Yale Univ. Program on Non-Profit Organizations, Working Paper, forthcoming 1997) (draft June 3, 1996).

212. HALL, *supra* note 1, at 48. In 1906, John D. Rockefeller unsuccessfully sought a federal charter for his proposed $100 million foundation. *Id.* at 189-90. Rockefeller wanted public accountability for the foundation through an *ex officio* board comprising the President of the United States, the Chief Justice of the Supreme Court, the President of the Senate, the Speaker of the House of Representatives, and the presidents of several elite universities. *Id.* Defeated, Rockefeller then easily obtained a state charter from New York, but he abandoned the public features of the charter because the "parochialism [of New York officials]

That same year, Congress created a Commission on Industrial Relations, whose 1916 final report "charged that the concentration of wealth in the large foundations, such as the Carnegie and the Rockefeller, was being used by industrial magnates to gain control of the universities and, thereby, the social and educational side of American life."[213] The Commission recommended "requiring federal charters for the incorporation of all nonprofit organizations with more than one function and funds of more than $1 million, limitation on the size, income, and life of the foundations, as well as the creation of rigid supervisory procedures."[214]

Subsequent congressional investigations focused on tax laws, the main area of federal jurisdiction over nonprofits. When Henry Ford died in 1947, he left the voting stock in Ford Motor Company to his family and the nonvoting stock to the Ford Foundation.[215] Politicians and journalists worried that a tax-sensitive public would hardly accept as charitable the use of a foundation to avoid taxes and concentrate wealth while promoting a liberal policy agenda.[216] In 1952, as the nation was caught up in the Red Scare, a congressional committee probed foundations and other nonprofits "especially to determine which such foundations and organizations are using their resources for un-American and subversive activities or for purposes not in the interest or tradition of the United States."[217] The foundations, however, responded so persuasively that the committee's final report urged that even greater contributions be made to these worthwhile entities.[218] Despite this, a disappointed congressman, B. Carroll Reece, pressed on. Although he failed to prove organized philanthropy guilty of supporting communism, he again exposed the way vast private wealth could be preserved in

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would be unsuited to an organization that proposed to operate 'for the benefit of mankind' on a national and international basis." *Id.*

213. FREMONT-SMITH, *supra* note 150, at 51 (citing COMMISSION ON INDUSTRIAL RELATIONS, INDUSTRIAL RELATIONS: FINAL REPORT AND TESTIMONY, S. DOC. NO. 64-415 (1916)).

214. COMMISSION ON INDUSTRIAL RELATIONS, INDUSTRIAL RELATIONS: FINAL REPORT AND TESTIMONY, S. DOC. NO. 64-415, at 85.

215. HALL, *supra* note 1, at 64 (stating foundation promptly sold stock at immense profit).

216. *Id.* Professor Hall identifies Howard Hughes as an example of a leading right-winger who made adroit use of a nonprofit (and tax-exempt) foundation. *Id.* at 290 n.183. *See generally* DONALD L. BARTLETT AND JAMES B. STEELE, EMPIRE: THE LIFE, LEGEND, AND MADNESS OF HOWARD HUGHES (1979) (chronicling life of recluse industrialist Howard Hughes).

217. HALL, supra note 1, at 67-68, 291 n.191 (quoting H. RES. 561, *in Hearings Before the Select Comm. to Investigate Tax-Exempt Foundations and Comparable Orgs.*, 82d Cong. 1 (1952)).

218. *Id.* at 68.

charities, while being administered by donors and professional managers (the "philanthropoids") to influence research, education and the media.[219]

During the 1960s Representative Wright Patman called for widespread reform. His plan included suspending the creation of tax-exempt foundations; limiting the life of foundations to twenty-five years; imposing a 20% tax on foundation income; prohibiting foundations from borrowing or lending money; and requiring that all contributions and capital gains be spent currently.[220] The U.S. Treasury Department issued a report in 1965, far more mild but still radical, that recommended such major legislative changes as prohibiting business dealings between donors and foundations; limiting foundation ownership of voting control of businesses; restricting the deductibility of donor-controlled gifts; and regulating the number of years donors and their families could serve on governing boards.[221] Many of the Treasury's proposals found their way into the Tax Reform Act of 1969, along with restrictions on political activities.[222] Except for the limits on political activities, however, these limitations apply only to "private foundations," and not to universities, hospitals or "publicly-supported charities."

2. *Limiting Permitted Purposes*

Many state nonprofit laws (as well as the Internal Revenue Code) separate nonprofits into two general categories, the mutual nonprofit and the charity.[223] Typically, the mutual nonprofit is a

219. *Id.* at 69.

220. *Id.* at 71.

221. *Id.*; *see also* TREASURY DEPARTMENT REPORT ON PRIVATE FOUNDATIONS, PRINTED FOR USE OF THE HOUSE COMMITTEE ON WAYS AND MEANS, 89TH CONG., 1ST SESS. (Comm. Print 1965)).

222. *See* Pub. L. No. 91-172, 83 Stat. 488 (1969) (adding Chapter 42A to Internal Revenue Code). The Tax Reform Act of 1969 dealt particularly strong blows to the family-controlled private foundation. *See* I.R.C. §§ 4943, 4946 (1996) (imposing taxes on excess business holdings by private foundations).

223. An example is the Revised Model Nonprofit Corporation Act of 1987, with its separate regimes for "public purpose" corporations, "mutual benefit" corporations and religious corporations. This triumvirate was modeled on California's law, although the model act treats the three classes together except where necessary. *See* Michael C. Hone, *Aristotle and Lyndon Baines Johnson: Thirteen Ways of Looking at Blackbirds and Nonprofit Corporations—The American Bar Association's Revised Model Nonprofit Corporation Act*, 39 CASE W. RES. L. REV. 751, 762 (1989). Professor Hone was the reporter for both the California act and the Revised Model Act.

The Revised Model Act has been adopted, in whole or in part, in Arkansas, Indiana, Mississippi, Montana, North Carolina, South Carolina, Tennessee, Washington and Wyoming. *See* ARK. CODE ANN. § 4-28-210 (Michie 1995); IND. CODE ANN. § 23-17-1-1 (Michie 1996); MISS. CODE ANN. § 79-11-101 (1995); MONT. CODE

group of people or organizations banded together to serve the members' common interests. For workers, think of labor unions; for businesses, think of trade associations and boards of trade; in a social setting, think of social clubs with their private dining facilities and golf courses. By contrast, charities are outward-looking, community-based or community-oriented organizations. Churches, universities and nonprofit hospitals are classic examples of charities.

A nonprofit corporation need not necessarily distinguish itself from a for-profit corporation by the statement of purposes set forth in its articles of incorporation. Modern nonprofit laws typically permit nonprofits to be formed for any lawful purpose.[224] As a separate matter, however, a charity qualifies for federal income tax exemption only if it has a specified public purpose, rather than a private purpose.[225] Most charities adopt limited purpose language in their articles of incorporation in order to obtain tax exemption.

While some might believe that "there oughta be a law" governing many areas of nonprofit behavior, no law requires charities to serve only the poor,[226] prohibits nonprofits from engaging in business activities[227] or bars nonprofits from paying high salaries.[228]

ANN. § 35-2-113 (1995); N.C. GEN. STAT. § 55A-1-01 (1995); S.C. CODE ANN. § 33-31-101 (Law. Co-op. 1995); TENN. CODE ANN. § 48-51-101 (1996); WASH. REV. CODE § 24.03.005 (1995); WYO. STAT. ANN § 17-19-101 (Michie 1996). Georgia and Ohio recently revised their nonprofit corporation laws, but explicitly rejected the Revised Model Act. New York has four categories of nonprofits. N.Y. NOT-FOR-PROFIT CORP. LAW ch. 35, § 201(b) (McKinney 1996).

224. *See* Henry B. Hansmann, *Reforming Nonprofit Corporation Law*, 129 U. PA. L. REV. 497, 509-38 (1981) [hereinafter Hansmann, *Reforming Law*] (discussing "the varying approaches taken in the state statutes toward the purposes for which nonprofit corporations may be formed").

225. I.R.C. § 501(c)(3) (1996); *see also* Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii) (1996) (mandating that charity must serve public interest rather than private interests of "designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests"). Charity status offers donors tax deductibility for charitable contributions. I.R.C. § 170 (1996).

226. *Cf.* Mark Pauly & Michael Redisch, *The Not-for-Profit Hospital as a Physicians' Cooperative*, 63 AM. ECON. REV. 87, 98 n.16 (1973). The authors state:

> It is sometimes alleged that these firms have attained a nonprofit status so that they may better provide services to the poor. However, the recent experience in this country is for the poor to receive health services from government operated hospitals, to receive education in government operated institutions, and not to partake at all of the output of symphony orchestras, theatre groups, or private universities.

Id.

227. But if the business is "unrelated" to the exempt purpose of the nonprofit, it might be subject to income tax. I.R.C. §§ 501(b) & 511 through 515 (1996).

228. The public also carries expectations of appropriate salaries in noncharitable pursuits. *See, e.g.*, Roger Angell, *Hardball*, NEW YORKER, Oct. 17, 1994, at 65,

In fact, only a small percentage of nonprofits devote themselves to relief of the poor.[229] Donations make up less than thirty percent of the sector's total receipts.[230] Volunteers represent only thirty-six percent of total charity labor.[231]

Although nonprofits may legally conduct commercial activities, these transactions have raised questions about their tax exemption, in whole or in part. In the mid-1980s, small businesses lobbied Congress to reign in the "unfair competition" resulting from nonprofits' expansion into commercial enterprises, free of the income taxes imposed on the proprietary sector. In the face of hard lobbying from the charitable sector, however, proposals for reform could not even make their way out of a subcommittee of the House Ways and Means Committee.[232] In 1991, the Ways and Means Committee held hearings on whether nonprofit hospitals should be required, as a condition of their tax-exempt status, to provide specified levels of care to indigents.[233] Again, the proposals died.[234] While no one has proposed to deny opera companies tax-exempt status, several Republicans have proposed tax credits for

68 ("'Because it's baseball, the players shouldn't be getting so much,' I heard it declared not long ago; this came from a fortyish lawyer at a social gathering, but it had an oracular tone to it—a mysterious message echoing out of a cave.").

229. For an example of a study reflecting this conclusion, see Kirsten A. Gronbjerg, *Poverty and Nonprofit Organization Behavior*, 64 SOC. SERV. REV. 208, 217, 228-29 (1990). Moreover, this study focuses on human service nonprofits *other than* hospitals, and excludes other broader-based—if not elitist—arts, cultural, educational and research organizations. *Id.* at 239 n.1.

230. According to tax filings (which are not required of churches or small charities), contributions as a percentage of charitable revenues fell from 31.6% in 1975 to 19.9% in 1990 and fell further to 17.7% in 1991. Including churches and small charities would obviously increase these percentages. *See Tax-Exempt Organizations: Additional Information on Activities and IRS Oversight, GAO's Testimony at House Government Reform and Oversight Panel Hearing on Nonprofit Advocacy Before the Subcomm. on Nat'l Econ. Growth, Natural Resources, and Reg. Affairs, Comm. on Gov't Reform and Oversight*, 102d Cong. 1 (1995) (statement of Natwar M. Ghandi, Assoc. Dir. for Tax Policy and Admin. Issues, Gen. Gov't Div., Gen. Acc'g Office), *available in* LEXIS, Fedtax Library, TNT File, 95 TNT 129-70.

231. HODGKINSON ET AL., *supra* note 159, at 13, 28-30, 134-35.

232. *See* Letter from Kenneth W. Gideon, Ass't Sec. Treas. (Tax Policy), to Dan Rostenkowski, Chair H. Ways & Means Comm., and to J.J. Pickle, Chair Oversight Subcomm. H. Ways & Means Comm. (May 23, 1991), *available in* LEXIS, Fedtax Library, TNT File, 91 TNT 152-1 ("That review and those consultations developed no set of proposals which would significantly improve tax administration with respect to [the unrelated business income tax] and command a broad base of support. Accordingly, we make no specific proposals to the Committee.").

233. JOINT COMMITTEE ON TAXATION, 102D CONG., 1ST SESS., PROPOSALS AND ISSUES RELATING TO THE TAX EXEMPT STATUS OF NOT-FOR-PROFIT HOSPITALS INCLUDING DESCRIPTIONS OF H.R. 1374 AND H.R. 790, at 13-22 (Comm. Print 1991).

234. *Id.* Activity at the state level, however, has been more successful; a few jurisdictions repealed the property tax exemption of nonprofit hospitals failing to provide sufficient charity care.

donations only to anti-poverty charities.[235] Moreover, precedents exist for removing subsidies to a nonprofit category. In 1951, Congress repealed the tax exemption of mutual savings and loan associations.[236] In 1986, Congress repealed the tax exemption of Blue Cross and Blue Shield.[237]

B. *A New Federalism?*

1. *Uniform Law of Charity*

Before the states adopted standardized corporation laws, each incorporation was a matter of negotiation between the state legislature and the corporation.[238] This case-by-case approval mechanism sounds quaint to our ears, a harkening back to an era of quill pens and sealing wax. Nonprofit corporations can now form under the state nonprofit corporation act just as easily as for-profit corporations do under the state business corporation act.[239]

Nonprofit corporation laws, like business corporation laws, provide rules of internal governance and state regulation.[240] A

235. For a discussion of the tax credit proposal by 1996 Republican presidential nominee Bob Dole and others, see *supra* notes 13 and 61 and accompanying text. A large volume of literature on altruism exists. *See, e.g.*, Kenneth Arrow, *Gifts and Exchanges*, *in* ALTRUISM, MORALITY AND ECONOMIC THEORY 13 (Edmund S. Phelps ed., 1975); Rob Atkinson, *Altruism in Nonprofit Organizations*, 31 B.C. L. REV. 501 (1990). Peter Dobkin Hall deplores the assumption that "tax avoidance has been a major incentive for individual and corporate philanthropy." HALL, *supra* note 1, at 107-08; *cf.* William C. Randolph, *Dynamic Income, Progressive Taxes, and the Timing of Charitable Contributions*, 103 J. POL. ECON. 709 (1995).

236. Revenue Act of 1951, Pub. L. No. 82-183, § 313, 65 Stat. 452 (1951), *repealing* Int. Rev. Code of 1939, *as amended* §§ 101(2) (exemption from tax of mutual savings banks) & 101(4) (exemption from tax of building and loan associations and cooperative banks); *see* CONF. COMM. REP., REVENUE ACT OF 1951, H.R. REP. NO. 82-1213 (1951), *reprinted in* 1951-2 Cum. Bull. 622, 627.

237. *See* I.R.C. § 501(m) (1996) (certain organizations providing commercial-type insurance not exempt from tax); Tax Reform Act of 1986, Pub. L. No. 99-514, § 1012(c)(3), 100 Stat. 2085 (1986) (providing special rules for existing Blue Cross or Blue Shield organizations).

238. ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 129-30 (1932). The corporate "charter provided with extreme care the exact property which the corporation could own and the maximum amount thereof; . . . the precise methods by which its business transactions could be carried on; and a very careful (if somewhat loosely drawn) indication of the line of its future development." *Id.* at 130 n.4. Charters also specified rules about the board of directors; for example, in Pennsylvania, in order to prevent a concentration of corporate power, often charters required bank directors to rotate and barred public officials from bank directorships. HARTZ, *supra* note 16, at 254-55.

239. Amazingly, though, some individualized negotiation occurs today for many of the thousands of new nonprofit organizations seeking recognition each year from the IRS as section 501(c)(3) charities.

240. *See* Ira Mark Ellman, *Another Theory of Nonprofit Corporations*, 80 MICH. L. REV. 999, 1001-02 (1982) (noting that "corporation code deals primarily with rules

charity must also comply with the various laws of every state (and sometimes subdivisions) in which it conducts activities or solicits funds. Finally, most charities seek recognition of federal income tax exemption, so, in practice, the requirements of the Internal Revenue Code provide a lowest common denominator of constraints and obligations.[241]

Obviously a single law would be easier to follow and enforce. Commentators often lament the absence of a uniform body of charity law. A close approximation of uniformity can be achieved through state adoption of uniform laws or multistate cooperation, but such an effort takes time and political persuasion.

2. *State (or Federal) Charity Board*

Oversight of nonprofits generally lodges with the state attorney general.[242] Once a nonprofit corporation comes into being, its obligations to the state often consist of no more than an annual filing attesting to its continued existence, and setting forth its address and the names and addresses of its directors.[243] The registration and reporting system plays a minor role in identifying or initiating attorney general action. Instead, the overwhelming majority of state actions start with complaints from dissenting or disappointed board members, employees and beneficiaries.[244]

In 1960, Kenneth Karst lamented the pervasively poor attorney general enforcement and called for a new agency at the state level

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of internal governance"); Lizabeth A. Moody, *The Who, What, and How of the Revised Model Nonprofit Corporation Act*, 16 N. KY. L. REV. 251, 263-65 (1988) (discussing drafting of Revised Model Nonprofit Corporation Act).

241. Many states' nonprofit corporation rules and the Revised Model Nonprofit Corporation Act refer to the Internal Revenue Code for such rules as the definition of prohibited transactions or the test for a proper distribution of assets on dissolution. *See, e.g.*, Howard L. Oleck, *Mixtures of Profit and Nonprofit Corporation Purposes and Operations*, 16 N. KY. L. REV. 225, 239 (1988) (noting that "[m]any state corporation law statutes now contain at least one specific section that refers to the [IRS] Code's rules as the definition of 'prohibited transactions' for nonprofit organizations").

242. *See* Kenneth L. Karst, *The Efficiency of the Charitable Dollar: An Unfulfilled State Responsibility*, 73 HARV. L. REV. 433, 449-60 (1960) (discussing enforcement by attorney general). *See generally* FREMONT-SMITH, *supra* note 150, ch. VI (Agencies for State Supervision), at 194-232, & ch. VII (The Role of Attorney General), at 233-71; Office of the Ohio Attorney General, *The Status of State Regulation of Charitable Trusts, Foundation, and Solicitations*, *in* 5 FILER COMM'N RES. PAPERS, *supra* note 41, at 2705.

243. Usually charities must also notify the attorney general when they desire to sell substantially all of their assets, merge or liquidate.

244. HARRIET BOGRAD, THE ROLE OF STATE ATTORNEYS GENERAL IN RELATION TO TROUBLED NONPROFITS (Yale Univ. Program on Non-Profit Organizations, Working Paper No. 206, Aug. 1994).

to regulate and advise charities, as well as to prevent duplication among charitable functions and between charitable and governmental functions.[245] In 1977, the Treasury Department, under the direction of John H. Filer, published the first comprehensive, multidisciplinary survey of the nonprofit sector in the form of a five-volume set of research papers. Among numerous other recommendations, which largely supported expansion of the charitable sector, the Filer Commission advocated a permanent national supervisory agency.[246] Proponents envisioned a body that would educate the charitable sector as much as regulate it.[247] The Carter administration, however, was not interested.[248]

Since that time, enforcement by the attorneys general has generally not improved. In the 1980s, Professor Henry Hansmann observed: "Although the prohibition on distribution of profits is more or less clearly embodied in the nonprofit corporation law of nearly all the states, most states in fact make little or no effort to enforce this prohibition."[249] Perceiving weak state enforcement, some call for increased IRS action against tax-exempt organizations, and tighter rules to reach greater numbers and a wider variety of cases of insider benefit.

3. *Conforming Fiduciary Standards*

Both charitable trustees and directors of nonprofit corporations owe their entity the twin fiduciary duties of loyalty and care. The fiduciary law, however, for these two legal forms has developed along different tracks. Charitable trust law tends to resemble the law of private trusts, while nonprofit corporation law tends to resemble the law of business corporations.[250]

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245. Karst, *supra* note 242, at 476-83 (highlighting advantages of consolidating state functions and avoiding political role of attorney general).

246. Commission on Private Philanthropy and Public Needs, *Commentary on Commission Recommendation*, *in* 1 FILER COMM'N RES. PAPERS, *supra* note 41, at 38.

247. *See, e.g.*, David Ginsburg et al., *Federal Oversight of Private Philanthropy*, *in* 5 FILER COMM'N RES. PAPERS, *supra* note 41, at 2575, 2640-44; Donald R. Spuehler, *The System for Regulation and Assistance of Charity in England and Wales, with Recommendations on the Establishment of a National Commission on Philanthropy in the United States*, *in* 5 FILER COMM'N RES. PAPERS, *supra* note 41, at 3045; Adam Yarmolinsky & Marion R. Fremont-Smith, *Preserving the Private Voluntary Sector: A Proposal for a Public Advisory Commission on Philanthropy*, *in* 5 FILER COMM'N RES. PAPERS, *supra* note 41, at 2857.

248. HALL, *supra* note 1, at 78.

249. Henry B. Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835, 873 (1980) [hereinafter Hansmann, *Role of Nonprofit Enterprise*].

250. For a discussion of fiduciary law, see Brody, *Fiduciary Law*, *supra* note 211, at 6-8.

The state's supervisory impotence probably explains an important blunt provision of trust law. Strict duty of loyalty rules prevent a trustee from engaging in self-dealing transactions, even when fair (except for reasonable compensation).[251] For example, a trustee may not purchase stock owned by the trust, regardless of whether the trustee pays fair market value—or even more. Effectively, because the government cannot adequately police the fairness of these transactions, they may not take place at all. Congress imposes similar "prohibited-transactions" restrictions on private foundations, whether in trust or corporate form.[252]

By contrast, state laws governing nonprofit corporations (and tax laws governing publicly-supported charities) only bar the insiders from receiving distributions of the organization's profits. Modern nonprofit statutes apply the liberal business corporation rules to directors.[253] Breaches of the duty of loyalty occur when, for example, directors engage in self-dealing transactions that have not been ratified by disinterested directors or that are unfair to the corporation. Henry Hansmann would conform the trust and corporate standards for charity fiduciaries by subjecting charitable corporation directors to the charitable trustee self-dealing prohibitions.[254]

At the federal level, Congress recently enacted private-foundation-like excise taxes for disqualified persons (generally, insiders) who engage in "excess benefit transactions" with their publicly-sup-

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251. RESTATEMENT (SECOND) LAW OF TRUSTS § 170 (1957) (discussing duty of loyalty). The trust settlor may waive these restrictions and commonly does.

252. I.R.C. § 4941 (1996) (taxes on self-dealing).

253. The Revised Model Nonprofit Corporation Act applies a slightly stricter set of rules to self-dealing and conflicts of interest of public-benefit corporation directors. *Introduction* to REV. MODEL NONPROFIT CORP. ACT xxxvi-xxxvii (1987); *see* Deborah A. DeMott, *Self-Dealing Transactions in Nonprofit Corporations*, 59 BROOK. L. REV. 131, 137-39 (1993) (stating Revised Model Nonprofit Corporation Act applies arm's-length standard even to insider self-dealing). Professor Oleck faulted the ABA for referring the revision of the model act to its Section on Corporation, Banking, and Business Law, "because that section is the wrong one for planning law for altruistic, voluntaristic, *pro bono* organizations—organizations whose purposes are supposed to be selfless, spiritual, and in the public service." Oleck, *supra* note 241, at 243-44.

254. *See* Hansmann, *Reforming Law*, *supra* note 224, at 569-73 (arguing that duty of loyalty standard that applies to charitable trustees be extended to charitable corporation directors). *But see* Ellman, *supra* note 240, at 1014-15 (observing that trust fiduciary rules would bar transactions between charity and its trustees even if fair under corporate standard, while donors might prefer such transactions).

ported charity.[255] Because of the severity of revoking a charity's tax exemption due to prohibited private inurement, especially its impact on innocent beneficiaries, the IRS rarely is willing to revoke the tax-exempt status of charities. This new "intermediate sanctions" scheme allows the IRS to impose sanctions short of revoking the organization's tax-exemption.[256] The tax would be measured only by the "excess benefit" (rather than by the full amount involved, as for private foundation prohibited transactions), and falls only on wrongdoing insiders and participating charity managers.[257]

C. *Expanded Standing to Sue and Increased Disclosure*

Nonprofit law is designed so that private action against the nonprofit rarely occurs. A co-trustee or director can usually bring a derivative suit against wrong-doing trustees or directors.[258] Members with the power to vote for directors[259] usually also have standing to bring derivative suits.[260] Trustees, however, rarely sue each other, and few nonprofits (other than mutual nonprofits) have voting members. As a practical matter, only state attorneys general are likely to bring charities into court.[261]

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255. I.R.C. § 4958 (1996). Section 4958, Taxes on Excess Benefit Transactions, was enacted by subtit. B, tit. XIII, Taxpayer Bill of Rights II, Pub. L. No. 104-168, 110 Stat. 1452, on July 30, 1996.

256. I.R.C. § 4958.

257. *Id.*

258. *See* Mary Grace Blasko et al., *Standing to Sue in the Charitable Sector*, 28 U.S.F. L. REV. 37, 53-59 (1993) (discussing suits brought by charitable directors or trustees). *See, e.g.*, Mary v. Lupin Found., 609 So. 2d 184, 191 (La. 1992) (allowing director to bring derivative suit against co-directors for breach of fiduciary duty).

259. The statutory definition of "member" can differ from the colloquial term. A nonprofit might offer "memberships" to donors without granting voting rights; or a nonprofit might offer several membership classes but only one with voting rights.

260. *See id.* at 606-15 (discussing standing by donors, members, patrons and beneficiaries of nonprofit corporations). Consider the case of *Fowler v. Bailey*, 844 P.2d 141 (Ok. 1992). Members of a church brought suit against the pastor, deacons and trustees in order to examine church records, because they suspected the pastor of misusing church funds. *Id.* at 143. In response, the church expelled the plaintiffs. *Id.* The court held that excommunication is non-justiciable, and accordingly dismissed the complaint for lack of standing—only "members" can sue a church under state law, and the plaintiffs were no longer members. *Id.* at 144. States often defer more to religious nonprofits than to ordinary nonprofits. *See, e.g.*, REV. MODEL NONPROFIT CORP. ACT § 114 cmt. (1987).

261. Similarly, taxpayers have no standing to challenge a nonprofit's tax-exempt status. Simon v. Eastern Ky. Welfare Rights Org., 426 U.S. 26 (1976) (requiring plaintiffs to show that revoking tax-exempt status will redress direct personal injury); *In re* United States Catholic Conference, 885 F.2d 1020 (2d Cir. 1989) (holding third parties cannot challenge tax-exempt status of Catholic Church on grounds of impermissible political activity), *cert. denied sub nom.* Abortion Rights Mobilization, Inc. v. United States Catholic Conference, 495 U.S. 918 (1990).

Both courts and legislators have been loath to permit either donors or the beneficiary class to direct the expenditure of charitable resources. A donor, even one who imposed conditions on the gift, makes a completed transfer. For the beneficiaries, ironically, ordinary trust law grants the greatest rights to the most identifiable beneficiaries. Thus, the more an entity looks like a real charity, having an unidentifiable and broad class of beneficiaries, the less likely that its beneficiaries can sue for relief. Apparently, this is true even for derivative suits, although it is not always easy to distinguish between personal and derivative relief in this context.[262]

Perhaps because a donor's power is strongest before making a contribution, state oversight concentrates on the aspect of charities that deals with the public as donors. Most states impose some charitable solicitation registration and reporting requirements.[263] In the 1960s and 1970s, model statutes swept the states, until twenty-eight states and countless municipalities adopted ceilings on the percentage of annual charity revenues that could be spent on fund-raising expenses.[264] States also increased fund-raising disclosure requirements.[265] In the 1980s, however, a series of Supreme Court decisions blocked reform, on First Amendment free-speech grounds.[266] Percentage limits on fund-raising disproportionately impact new charities, which typically have low name recognition and no established donor base, as well as charities soliciting for unpopular causes, which require a greater expenditure to raise a dollar.[267]

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262. *But see* Stern v. Lucy Webb Hayes Nat'l Training Sch. for Deaconesses and Missionaries, 367 F. Supp. 536, 540 (D.D.C. 1973) (certifying ten thousand patients of hospital as class to sue derivatively for injunction against director mismanagement and self-dealing, but denying certification for direct suit for treble damages under antitrust laws).

263. *See, e.g.*, MICH. COMP. LAWS § 400.273 (1996) (licensing charities for solicitation).

264. BRUCE HOPKINS, CHARITY UNDER SIEGE: GOVERNMENT REGULATION OF FUND-RAISING 96-97 (1980). *See generally* Leslie G. Espinoza, *Straining the Quality of Mercy: Abandoning the Quest for Informed Charitable Giving*, 64 S. CAL. L. REV. 605 (1991) (discussing history and effect of regulating charitable fund-raising).

265. Espinoza, *supra* note 264, at 621-31.

266. Riley v. National Fed'n of the Blind of N.C., Inc., 487 U.S. 781 (1988) (holding North Carolina statute requiring professional fund-raisers to obtain licenses violated First Amendment); Maryland v. Joseph H. Munsun Co., 467 U.S. 947 (1984) (holding Maryland statute prohibiting charitable organizations from paying fund-raising expenses in excess of 25% violated First Amendment); Village of Schaumburg v. Citizens for a Better Env't, 444 U.S. 620 (1980) (holding First Amendment violated where ordinance prohibited charitable organizations from fund-raising where less than 75% of fund-raising proceeds went for charitable purposes).

267. To some extent nonprofit rating agencies like the National Charities Information Bureau (NCIB) encourage the public to focus on overhead percentages. For example, the NCIB imposes minimum standards that require an independent

States may punish fraudulent fund-raising speech after-the-fact, but "[s]chemes which attempt to equate fraud with dollar efficiency have been consistently held to be invalid."[268]

Much of the role of forcing charities to disgorge information has fallen to the IRS. When pressure builds for uniform reporting, the public looks to Congress, who in turn looks to the IRS.[269] It was not until 1942, however, that Congress first required tax-exempt organizations to file information returns.[270] Congress has moved slowly in obligating exempt organizations to provide information to the public. Until legislation was enacted in 1996, a tax-exempt organization needed only to make its exemption application and annual information returns available for inspection at its office.[271] The new legislation finally requires exempt organizations to promptly mail a copy of returns on request and to provide them on the spot to in-person requesters.[272]

Economists Avner Ben-Ner and Theresa Van Hoomissen have made the most extreme proposal to enhance public access and standing. They urge that states amend nonprofit law to establish a

board, a clear statement of purpose, detailed budgets and good cost control. Moreover, the NCIB requires that established charities adhere to a 40% limit on fund-raising and other administrative costs. *See* Alison Leigh Cowan, *The Gadfly Who Audits Philanthropy*, N.Y. TIMES, Oct. 7, 1990, § 3, at 9 (reporting on private auditing of nonprofit entities). The author points out that the NCIB determined that Mothers Against Drunk Driving (MADD) should have allocated 77% of receipts to fund-raising. MADD had allocated 35%, on the ground that it had included information on drunk driving in its fund-raising solicitation. In the NCIB's view, MADD misclassified these mailing costs as program expenses, rather than as fund-raising expenses. *Id.*

268. Errol Copilevitz, *There is a Place for the Non-Profit Community in the Regulatory Process*, FUND RAISING MGMT., Oct. 1991, at 64. Copilevitz was lead counsel in *Riley v. National Fed'n of the Blind of N.C.*, 487 U.S. 781 (1988).

269. Some states that also require a filing accept the IRS return instead. Still, there are often variations in what the states demand, resulting in multiple filings. Charities and the public would benefit if these filing requirements were streamlined. *See, e.g.*, 10 EXEMPT ORG. TAX REV. 807, 807 (Oct. 1994) (reporting comments by attorney Victoria Bjorkland of New York, that "state regulators have informally been talking among themselves to see if they could create a single cover sheet acceptable in every state that would go over the [IRS] Form 990").

270. Howard M. Schoenfeld, *Outline*, 10 EXEMPT ORG. TAX REV. 821, 821 (Oct. 1994) (outlining talk given to Exempt Org. Comm. of Tax Section of ABA, Annual Meeting, Aug. 5, 1994).

271. In 1950, the IRS made available for public inspection the returns of certain charitable organizations and in 1958 made public the applications for recognition of tax exemption. *Id.* It was not until 1969 that the public was permitted to see all other annual information returns. *Id.* In 1987, Congress required exempt organizations to make their exemption application and annual information returns available for inspection at their places of business. *See* I.R.C. § 6104 (1996).

272. I.R.C. § 6104(e) (1996), *as amended by* Taxpayer Bill of Rights II, Pub. L. No. 104-168, § 1313(a), 110 Stat. 1452 (1996). The new law takes effect only upon the issuance of regulations.

new status called "stakeholder."[273] Stakeholders would elect the board of directors, be entitled to financial and programmatic information from the organization, and could sue the board "for making undisclosed programmatic changes."[274] Stakeholders would generally acquire their interests in proportion to contributions, which Professors Ben-Ner and Van Hoomissen defined as monetary donations, purchases and volunteer time.[275] In cases of extremely low stakeholder participation, they would have a government entity elect the board.[276]

V. DEFENSE OF THE LEGAL STATUS QUO

Nonprofit law constitutes only a small portion of the powerful institutional forces that legitimate, and in many cases dictate and sanction (in both senses of the word), the behavior of nonprofit organizations and the people that deal with them. How do we interpret this phenomenon? Perhaps the law goes only as far as it has to, and until misbehavior occurs, the law does not need tightening. Alternatively, the situation might indicate institutional lag: that the law, in its foresighted wisdom, beckons nonprofits to operate most effectively, while the public needs time to overcome its conditioned biases against a well-run nonprofit sector.

I propose a third view. The first two views share a Panglossian assumption of progress, that society evolves in continuous forward improvement. Clearly, we cannot deny the development of new institutional forces, the most important being the (at least apparent) secularization of society.[277] The history reviewed in Part II, however, reveals that many of the basic terms of the social debate are eternal and that institutions dominant at different times and different places resolved the debate in different ways.[278] Many of today's

273. Avner Ben-Ner & Theresa Van Hoomissen, *The Governance of Nonprofit Organizations: Law and Public Policy*, 4 NONPROFIT MGMT. & LEADERSHIP 393, 408-10 (1994).

274. *Id.* at 410. The Revised Model Nonprofit Corporation Act allows only members to obtain even the most formal corporate records. REV. MODEL NONPROFIT CORP. ACT § 16.02 (1987); *see id.* § 16.05 cmt. (member-list access rule).

275. Ben-Ner & Van Hoomissen, *supra* note 273, at 410.

276. *Id.*

277. *See* PETER DOBKIN HALL, RELIGION AND THE ORIGIN OF VOLUNTARY ASSOCIATIONS IN THE UNITED STATES (Yale Univ. Program on Non-Profit Organizations, Working Paper No. 213, Nov. 1994) (discussing role of religion in American culture).

278. For a discussion of this eternal debate, see Part II *supra* notes 10-144 and accompanying text.

"hot issues" also concerned Americans living one, two and three centuries ago:

1. Who bears responsibility for the poor? Are welfare benefits public entitlements or dependent on discretionary charity? And what about the non-poor who are still needy? Do we place the burden on the family, or do we recognize a role for private charity here as well, or even publicly assure each individual health care, an education and a pension?
2. Which sector best provides health care? Schooling?
3. Who should invest in, and profit from, such infrastructure improvements as bridges, canals, railroads, tollroads, telephone service and utilities?[279]
4. Where should wealth, and the control of wealth, reside? Should families be permitted dynastic control of their property through foundations? Should states treat nonprofits as "private," with assets beyond the reach of the political wishes of current generations?[280]

Each society must make these decisions anew. In our time, we see how government privatization of social services raises numerous political, economic and legal questions.[281]

My progress-agnostic view also recognizes the limits of the law. Some scholars complain that, given the absence of shareholders in the nonprofit sector, the law permits nonprofit assets to escape the

279. Early monastic foundations built bridges, as suggested by the title "pontiff." Douglas, *supra* note 10, at 43 n.2; *see also* Ronald L. Coase, *The Lighthouse in Economics*, 17 J.L. & ECON. 357, 362-72 (1974) (discussing generally evolution of British lighthouse system).

280. *See* Brody, Charitable Endowments, *supra* note 21.

281. *See generally* BOZEMAN, *supra* note 30 (discussing economic effects of regulation on organizations); Danielle Butschi & Sandro Cattacin, *The Third Sector in Switzerland: The Transformation of the Subsidiarity Principle*, 16 W. EUR. POL. 362 (1993) (discussing role of nonprofit organizations in construction of modern Swiss welfare system); Estelle James, *Why Do Different Countries Choose a Different Public/Private Mix of Educational Services?*, 28 J. HUMAN RESOURCES 571 (1993) (discussing how government policies influence educational opportunities in public and private sectors); Cotton M. Lindsay, *A Theory of Government Enterprise*, 84 J. POL. ECON. 1061 (1976) (comparing management productivity of government enterprises with productivity of proprietary organizations); B. Peter Pashigian, *Consequences and Causes of Public Ownership of Urban Transit Facilities*, 84 J. POL. ECON. 1239 (1976) (discussing modern shift in transit services from private to public); Lester M. Salamon, *The Marketization of Welfare: Changing Nonprofit and For-Profit Roles in the American Welfare State*, 37 SOC. SERV. REV. 16 (1993) (discussing impact on charities of government cutbacks in social welfare spending); Harold J. Sullivan, *Privatization of Public Services: A Growing Threat to Constitutional Rights*, 47 PUB. ADMIN. REV. 461 (Nov./Dec. 1987) (discussing impact of privatization on constitutional rights).

rigors of the market.[282] Legal forces, however, cannot make nonprofits run in a particular way any more than the law can override the business judgment of proprietary firms.[283] Indeed, nonprofits actually run better, while proprietary enterprises run less efficiently, than conventionally assumed.[284] This intersectoral blurring results because all organizations are subject to many of the same economic forces of resource dependency, organizational isomorphism and operational slack.

The public often reacts negatively to the operational ways in which nonprofits have come to resemble for-profits. Such "inappropriate" behavior as high salaries, fierce competition and bottom-line oriented management brings calls for legal reform. Most of these proposals fail to address the real concerns. Proposals to alter the *cy pres* doctrine, which perpetuates the long-dead donor's designated purpose for a charitable trust, would not in many states reach nonprofit corporations, which are the dominant form of charity in this country. Endowing the public with standing rights to bring nonprofit derivative suits does not disturb the charity manager's strongest defense, the business judgment rule. States worried about misleading fundraising by charities can require greater financial disclosure, but then charities must still educate the public about their expenditure needs.

Finally, the wrong kind of laws can make things worse. Subsidies induce investment in particular activities and overregulation discourages investment. Proposals limiting the scope of the nonprofit sector to specified "worthy" enterprises require that we agree on how the intersectoral debate should be resolved. I assert that no resolution is possible.[285] Often the best law is no law, so that activi-

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282. *See, e.g.*, Henry Hansmann, *The Changing Roles of Public, Private, and Nonprofit Enterprise in Education, Health Care, and Other Human Services, in* INDIVIDUAL AND SOCIAL RESPONSIBILITY: CHILD CARE, EDUCATION, MEDICAL CARE, AND LONG-TERM CARE IN AMERICA 246-51 (Victor Fuchs ed., 1995) (discussing benefits and detriments of market economies on nonprofit organizations).

283. To the extent the nonprofit sector holds passive assets, such as stocks and bonds, recent studies show an increase in modern investment strategies by charitable endowments and foundations. *See, e.g.*, Uniform Mgmt. of Institutional Funds Act (1972), 7A U.L.A. 705 & 1996 Supp. at 300; WILLIAM L. CARY & CRAIG B. BRIGHT, THE DEVELOPING LAW OF ENDOWMENT FUNDS: "THE LAW AND THE LORE" REVISITED 7-11, 23-25 (1974); WILLIAM L. CARY & CRAIG B. BRIGHT, THE LAW AND THE LORE OF ENDOWMENT FUNDS 31-32, 69 (1969); *see generally* RESTATEMENT (THIRD) OF THE LAW OF TRUSTS (PRUDENT INVESTOR RULE) (1990).

284. *See generally* Brody, *Agents Without Principals*, *supra* note 3 (comparing how economic forces affect nonprofit and for-profit firms).

285. A court can only interpret the law—a statute must tell the courts what answers public policy wants. *See, e.g.*, BURTON A. WEISBROD, THE NONPROFIT ECONOMY 7 (1988). Weisbrod observes:

ties can be conducted by the most efficient and responsive firms, regardless of organizational form. Once we recognize the irrelevance of organizational form—as public agency, business corporation or nonprofit charity—society can focus on the aspects of firm activity that it needs to regulate more productively.

In the end, there is no one right way to allocate power and responsibility among the public and private sectors. But we can accurately frame the political questions, and do the least harm, if we limit legal solutions to legal problems. Successful reforms are likely to be narrowly targeted.[286] For example, if society does not like subsidizing certain types of nonprofits, it can remove those subsidies, such as by revoking tax exemption for nonprofit hospitals that fail to provide free charity care.[287] As a result of the limits of the law, nonprofit entities, as well as other organizations, will continue to be "governed" primarily by other social institutions. Social institutions can still—if not best—work their will within a laissez-faire legal framework.

A. *Broad Proposals for Reform*

1. *Restricting the Size of the Nonprofit Sector*

Reform proposals are not all alike. It is one thing to decide to withhold a government subsidy, such as an income tax exemption. It is quite another to deny a nonprofit charter, as the federal government did to the Rockefeller Foundation. I have no problem with tailoring subsidies to the conditions that exist from time to time. Indeed, I believe that subsidies are just one of the fluid char-

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> Public policy toward nonprofits—to the extent there is one—can be described most aptly as confused. Government simultaneously encourages and discourages nonprofits—subsidizing and restricting them, proclaiming their virtues and distrusting them. This is not surprising, since there is little consensus as to what goals society should achieve by fostering nonprofits. . . . And without a consensus there cannot be tests of whether goals are being reached or even approached.

Id.

286. *See also* Laura B. Chisolm, *Accountability of Nonprofit Organizations and Those Who Control Them: The Legal Framework*, 6 NONPROFIT MGMT. & LEADERSHIP 141, 144-45, 149-50 (1995) (reviewing reform available through corporation law, common law of charitable trusts, state law regulating general welfare and federal tax exemption law). "Efforts to 'fix' the legal rules to address one kind of perceived accountability problem ought not to be undertaken without careful thought to the impact of the change on other aspects of accountability." *Id.* at 150.

287. *See* Evelyn Brody, Making the Subsidy Fit the Times (Oct. 30, 1996) [hereinafter Brody, Subsidy] (unpublished manuscript, on file with *Villanova Law Review*) (discussing existing tax treatment of charities, effects of fundamental tax reforms on exempt organizations and merits of converting tax subsidies to direct expenditures).

acteristics of our mixed economy. What if, however, the State of New York had also refused to give the Rockefeller Foundation a charter? Why should states want to say to *any* enterprise, "Thou shalt be owned?"[288]

Society's concern over the size of the nonprofit sector has two independent aspects, one external and one internal. First, there is the problem of the benefactor who has tied the hands of the charity but the restriction has outlived its purpose. Second, there is the problem of the unfettered nonprofit organization whose management clings to the traditional use of its assets, free from the rigors of the marketplace.

Professor Simes called the perpetual charitable trust "a balancing of two imponderables."[289] Implicitly, the state determines that net social welfare increases even by permitting the dead hand of the testator to govern the enjoyment of his or her wealth into perpetuity, subject to the *cy pres* power. Donors, of course, make trade-offs of their own in choosing between the benefit of devoting the property to perpetual charitable use versus devising the property to family. Donors take into account the likelihood that their donated property will remain governed by their wishes. Any limitation, whether based on purpose or the passage of time, will reduce the value of the charitable bequest both absolutely and in relation to the value of an alternate devise.[290]

In the case of the charity that has lost its purpose, if the charity exists in trust form, the trustees may be as eager as anyone to apply

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288. A more modern example of the problem, and one which involves a public charity rather than a grant-making foundation, is the (admittedly extreme) case of Shriner Hospitals for Crippled Children. As of 1987, $2.2 billion of its $2.6 billion in assets were invested in securities, real estate and other passive holdings. Carl Milofsky & Stephen D. Blades, *Issues of Accountability in Health Charities: A Case Study of Accountability Problems Among Nonprofit Organizations*, 20 NONPROFIT & VOLUNTARY SECTOR Q. 371 (1991).

289. SIMES, *supra* note 202, at 181.

290. While the Dartmouth College case involved a charitable corporation rather than a charitable trust, similar concerns arise. As Justice Marshall wrote: "[O]ne great inducement to these [charitable] gifts is the conviction felt by the giver, that the disposition he makes of them is immutable." Trustees of Dartmouth College v. Woodward, 17 U.S. 518, 647 (1819). In his brief for the college, Daniel Webster warned of the perverse incentives in permitting the legislature to alter the charter of a charitable corporation:

> Benefactors will have no certainty of effecting the object of their bounty; and learned men will be deterred from devoting themselves to the service of such institutions, from the precarious title of their offices. Colleges and halls will be deserted by all better spirits, and become a theatre for the contention of politics. Party and faction will be cherished in the places consecrated to piety and learning.

Id. at 599.

to the courts to have the purposes of the charity reformed. A liberalized *cy pres* doctrine, or even permitting the trustee absolute discretion consistent with any charitable purpose, could bring much needed sense to outdated or wasteful trusts.[291] Moreover, a willing and unconstrained corporate charity can usually alter its activities, merge with another charity, or sell its assets and distribute the liquidated proceeds to another charity.[292]

For these policy reasons, I am very disturbed by the positions taken by a few state attorneys general and judges in regard to the conversion of nonprofit hospitals to for-profit enterprises. A Michigan judge, ruling in favor of the state attorney general, recently barred a joint operating arrangement between a nonprofit hospital and the for-profit Columbia/HCA.[293] Pending its appeal, the nonprofit is now negotiating for an outright sale of its assets, a course to which the judge had no legal objection.[294] Worse, some state attorneys general and courts favor a tight adherence to the *cy pres* principles, that, they maintain, apply to nonprofit hospital corporations.[295] As a result, for example, the attorney general of California would like to see the cash proceeds resulting from a sale of assets be used to benefit other nonprofit hospitals.[296] This

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291. Atkinson, *supra* note 198, at 1143.

292. For an example of one state that applies a quasi-*cy pres* doctrine, see *supra* note 210 and accompanying text. States also see a legal problem in assuring fair valuation of sold charitable assets, particularly when the purchasers of the charity's assets are also the charity's insiders. *See, e.g.*, DeMott, *supra* note 253, at 142 (analogizing these directors to for-profit directors who evaluate a management buy-out proposal).

293. Kelly v. Michigan Affiliated Healthcare System, Inc., No. 96-83848-CZ (Mich. Cir. Ct. Sept. 5, 1996), transcript of oral court ruling, *available in* LEXIS, Fedtax Library, TNT file, 96 TNT 187-18 (ruling that nonprofit could sell its assets but could not commit them to joint venture whose profits would be shared with for-profit company); *see also* Kelly v. Michigan Affiliated Healthcare System, Inc., complaint (June 17, 1996), *available in* LEXIS, Fedtax Library, TNT file, 96 TNT 187-16 ¶ 15 ("This deal will abrogate a heritage of nonprofit, community based healthcare grounded in principals of charity and benevolence, in exchange for a delivery system driven by shareholder greed and motivated by profit and return on investment.").

294. Marlis L. Carson, *Exempt Health Care System Negotiating Outright Sale*, 73 TAX NOTES 397, 397 (Oct. 28, 1996).

295. *See generally* Robert A. Boisture, *State Attorneys General's Legal Authority to Police the Sale of Nonprofit Hospitals and HMOs*, 13 EXEMPT ORG. TAX REV. 227 (1996) (discussing powers of state attorneys general in regulating sales of healthcare organizations).

296. *See, e.g.*, Greg Jaffe & Monica Langley, *Fledgling Charities Get Billions from the Sales of Nonprofit Hospitals*, WALL ST. J., Nov. 6, 1996, at A1, A5 (quoting Jim Schwartz, deputy attorney general of California, "Foundation assets must be used for *real* health care—hospitalization, physician care to the sick, particularly indigents . . . . Wellness and prevention may be worthwhile, but they're not part of the trust for which the money was originally raised."); Queen of Angels Hosp. v.

makes no sense where economic efficiency dictated the sale in the first place. If the hospital subsector is indeed contracting, then the sale proceeds should be devoted, at best, to other health care purposes, and perhaps even to any charitable purpose.[297]

A private nonprofit sector still rests the efficient use of charitable assets with the trustees and directors. The problem of the incompetent trustee or director still remains. The state cannot dislodge the lazy or complacent fiduciary as long as the fiduciary breaches no legal duties owed to the charity. This situation, however, only appears helpless. Their organizational form does not of itself cause nonprofits to be managed worse than for-profits.[298] Nonprofits must compete for donations, volunteers, labor and contracts in the same way for-profit entities compete for employees, supplies and customers, and competition improves operating efficiency. Viewed from the other direction, business enterprises are not the paragons some make them out to be, suffering as they do from many of the same inefficiencies found in nonprofit structures. We should not compare actual nonprofits to a proprietary ideal that does not exist.

Should the state decide that the charitable exception to the Dead Hand prohibition leads to unacceptable social waste, it can alter the law in one of several ways. These options, however, have uncertain practical results. Extreme proposals would raise serious "final-period" problems. Both an absolute ban on charitable bequests and a 100% estate tax would induce donors to make lifetime gifts to charity.[299]

Younger, 66 Cal. App. 3d 359, 365 (1977) (requiring sale proceeds to be used to carry out charity's original purpose: operation of a hospital).

297. *See* Thomas Silk, *Conversions of Tax-Exempt Nonprofit Organizations: Federal Tax Law and State Charitable Law Issues*, 13 EXEMPT ORG. TAX REV. 745, 746 (1996) (suggesting that "the sector shift is likely to encourage courts to take into account changed circumstances and thereby modify the original charitable purpose as warranted"). For example, one Tennessee foundation that resulted from the sale of hospital assets believes that federal and state programs adequately meet the needs of most uninsured patients; its board determined that education, rather than health care, was the community's biggest concern. Jaffe & Langley, *supra* note 296, at A1, A5.

298. *See* Brody, *Agents Without Principals*, *supra* note 3, at 460 ("Firms in both [for-profit and not-for-profit] sectors look a great deal alike because both the nondistribution constraint in the nonprofit sector and the theory of profit-maximization in the proprietary sector often fail to deliver on their promises.") (footnote omitted).

299. Andrew Carnegie, long before he set up his own foundation, praised confiscatory estate taxes so that "the surplus wealth of the few will become, in the best sense, the property of the many." HALL, *supra* note 1, at 158.

More moderately, if the state were to set a term limit for charities, what happens to the assets (if any) that remain? Is society better served by requiring reversion to the donor's family, to the state or, indeed, to another charity? Think of the incentives created by each of these, and how they present an exaggerated example of the ordinary conflict of interest between the holder of a life estate and the holder of the remainder interest. If the donor's family enjoys the reversionary interest and the family controls the fund, the managers will seek to minimize charitable expenditures. By contrast, if outsiders control, the charity will try to spend the funds before they revert to the heirs. If the state enjoys the reversionary interest, the state attorney general might need to constantly bring lawsuits to ensure the preservation of the assets. If assets instead must go to another charity, imagine the rules needed to stop reciprocal transfers between charities. For example, the Ford Foundation and the Rockefeller Foundation could agree to swap their assets every x years, where x is the maximum statutory life of a charity.[300] Perhaps society wants to—and could—bar such deals, but does it want to—and could it—bar a charity from distributing its assets to just a few other charities?[301]

In addition, a charity operating under a term limit will have difficulty attracting and keeping good management and staff. In 1969, the Assistant Secretary of the Treasury, Edwin S. Cohen, testified against a Senate proposal to require that a foundation distribute all of its assets at the end of a specified period of time:

> [I]f a foundation were limited to a 20-year life, and you wanted it run and managed as well as it can be, who will take on the responsibility of running it in the last 5 or 8 years? There is quite a management problem of getting people to run them when they have a deadline for the ter-

300. The Senate version of the 1969 Tax Reform Act would have imposed a 40-year time limit on the income-tax exemption of a private foundation. The proposal attacked the churning of assets by a liquidation or merger into another private foundation by tacking the transferor's life to the life of the transferee; such a rule would not apply to a "bona fide charitable grant." *See* SENATE FINANCE COMM., REPORT TO ACCOMPANY H.R. 13270, TAX REFORM ACT OF 1969, S. REP. NO. 91-552, pt. IV, at 25-27 (1969). Policing the distinction would not have been easy. In any event, the conference agreement deleted the provision.

301. Under the 1969 Senate proposal, the foundation would have been permitted to distribute its assets to a publicly supported charity or, by the end of 40 years, the foundation could have evolved into a publicly supported charity itself and thus continued its tax exemption. *Id.* Congress considered no proposals to impose term limits on publicly supported charities, presumably on the theory that we worry only about a single family indefinitely managing charitable wealth for indirect private benefit.

> mination of their life. And we were concerned with that. I have had some experience with businesses that have been ordered either by the management or by Government authorities to terminate and go out of existence at the end of 5 years' time, and the management then all want to go, and you cannot very well blame them.[302]

2. *Limiting Permitted Purposes*

To a large degree, laws governing nonprofit organizations are nearly as laissez faire as those governing proprietary enterprises.[303] Typically, a nonprofit may conduct any legal enterprise as long as it makes no distributions of profits. To Professor Hansmann, this is the right answer: Where the nonprofit form is the best way to deliver a service, a restrictive approach might "inhibit the development of these services, or push them inappropriately into the proprietary or governmental sectors."[304]

Some states make a legal distinction between mutual nonprofits and charitable nonprofits in order to focus state supervision on charities, leaving the oversight of mutuals to their members.[305] This dichotomy, however, can be difficult to defend on economic grounds. While all mutual nonprofits provide collective benefits, so do many (if not most) charities.[306] The benefits of higher educa-

302. *Tax Reform Act of 1969, Hearings Before the Senate Comm. on Finance*, 91st Cong., pt. 1, at 676-77 (Sept. 4-5, 1969) (statements and recommendations of Treasury Department).

303. *See* Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416 (1989) (discussing "enabling" structure of corporate law).

304. Hansmann, *Reforming Law*, *supra* note 224, at 526.

305. *See, e.g.*, *Introduction* to REV. MODEL NONPROFIT CORP. ACT xxviii (1987) ("As the members form a countervailing force roughly equivalent to shareholders, there is little need to give the attorney general broad jurisdiction over the activities of mutual benefit corporations."); *see also* Moody, *supra* note 240, at 268 ("[T]he Act looks at a mutual benefit corporation as the collective pocket of its members while a public benefit corporation must permanently dedicate its assets to public uses.").

306. *See, e.g.*, Henderson *ex rel.* Peck v. Eastern Star Homes of Cal., 112 P.2d 605, 607 (Cal. 1941) (holding bequest may be charitable if benefit has sufficiently widespread social value; relief of poverty is not required). To modern sensibilities, notions of altruism yield to notions of mutual advantage. Russell Hardin, *Altruism and Mutual Advantage*, 67 SOC. SERV. REV. 358, 361 (1993). Under this view, even Scrooge's satisfaction of his urge to help the poor constitutes fair value, whether for moral or political reasons, in return for his transfer. As economists Mark Pauly and Michael Redisch observed:

> If there are barriers to entry by profit-seeking firms (as there are in higher education and, to some extent, in the hospital industry as well), potential consumers may be willing to contribute if that is the only way that output, which yields them consumers' surplus, can be made available. It is not surprising that private not-for-profit firms which sell out-

tion are captured in large part by the students, and the benefits of hospital procedures are captured in large part by the patients.[307] Nevertheless, the law views these organizations as producing public goods, rather than exclusively private goods, because of the positive benefits of an educated populace and the availability of hospital-based treatment.[308] But if the law were to reclassify hospitals and universities as mutual nonprofits, thereby depriving them of the ability to offer tax deductibility for contributions and other tax benefits, on what basis could the law avoid reclassifying a *church* as a mutual nonprofit?[309]

In a rough way, the inability to rigorously distinguish between a charity and a mutual benefit nonprofit—with greater restrictions for charities—indirectly supports the current law's expansive approach to nonprofit eligibility. Tax benefits, as well as conditions on tax exemption, can and should be decided separately. We leave it to institutions other than the law to govern people's decision to withhold support from charities that do no "good," whether to the poor or to themselves.

> put—hospitals, universities, symphony orchestras—tend to provide output which is used *not* by the poor, but partly by the contributors themselves.

Pauly & Redisch, *supra* note 226, at 98 (footnote omitted).

307. *See* Evelyn Brody, *Paying Back Your Country Through Income-Contingent Student Loans*, 31 SAN DIEGO L. REV. 449, 451 (1994) (noting college education is profitable for student and family of student).

308. *But see* Henry Hansmann, *Economic Theories of Nonprofit Organization*, *in* THE NONPROFIT SECTOR, *supra* note 10, at 27. Hansmann observed:

> [T]he appendectomy performed in a nonprofit hospital, the child care provided by a nonprofit day-care center, the education provided by a nonprofit preparatory school, the nursing care provided by a nonprofit nursing home, and the entertainment provided by a nonprofit symphony orchestra are all difficult to characterize as public goods in the usual sense.

Id. at 29. So on what basis does the law draw the line? After all, a healthy *business* in the community also produces positive externalities—jobs, which lead to social stability and well-being. Nevertheless job-production, in itself, generally does not merit nonprofit status, much less charity status.

309. Similarly, many a charity can look like a governmental unit if the community is discrete and homogeneous enough. Is there really much difference between a private or public hospital, or a private or public high school, in Beverly Hills? The federal tax system treats assessment for "mutual" *public* undertakings the same as charitable contributions by granting an income tax deduction for state income and property taxes. I.R.C. § 164 (1996).

B. *A New Federalism?*

1. *Uniform Law of Charity*

The yearning for a uniform or single law of charity, while understandable, must yield to the facts of life under our federal system. While it is true that many charities operate in more than one state, so do many proprietary businesses. Why is a national law of charity the right answer if a national business corporation law is not? In addition, although state laws eventually tend to resemble each other, states sometimes do compete with each other by providing more hospitable legal environments for certain activities.[310] Nonprofits would not happily give up the ability to shop for a favorable state of incorporation.[311]

Moreover, nonprofits sometimes find themselves subject to multiple laws because they perform multiple roles. It makes sense to have one set of rules concerning internal governance and another for entitlements, such as tax exemption. Lawmakers similarly impose regulations, separate from the corporation code, on businesses that engage in certain activities.

2. *State (or Federal) Charity Board*

Closer government supervision would not necessarily alter nonprofit operations.[312] Certainly the state attorney general can bring a charity into court. But under what circumstances will a suit succeed?[313] Because of judicial deference to business judgments,

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310. While the powerful institutional force of isomorphism (conformity) operates on legislation, there is sometimes a "race to the bottom" to attract desired enterprises. *See* Roberta Romano, *The State Competition Debate in Corporate Law*, 8 CARDOZO L. REV. 709, 740-52 (1987) (discussing Markov Model and impact on states competing over varying laws).

311. For example, some states limit the monetary damages recoverable from directors of nonprofit corporations who breach their duty of care. *See Introduction* to REV. MODEL NONPROFIT CORP. ACT xxxv-xxxvi (1987).

312. Enforcement does not necessarily mean prosecution of cases in court. For example, the assistant attorney general who directs the charity office in Massachusetts "takes a 'public health' stance, which includes prevention, education, and rehabilitation." Bograd, *supra* note 244, at 4 (adding that Connecticut assistant attorney general would like his office to perform similar functions, but lacks sufficient resources).

313. *See* Karst, *supra* note 242, at 460 (observing that enforcement of duty of care has been less strict for charitable trustees than for private trustees in part out of gratitude for volunteer service); *see* Francis J. Leazes, Jr., *The Federal Courts and Nonprofit Administration: Is it Purely a Private Affair?*, 25 ADMIN. & SOCIETY 243 (1993) (discussing political science approach to suits against charities by attorneys general).

run-of-the-mill poor management of a nonprofit is effectively unreviewable.[314]

Here at last we get to the real question: What is a charity board (or "stronger" attorney general or IRS) supposed to do? The director who engages in gross negligence or harmful conflicts of interest, once caught, can generally be dealt with under current law, either informally or formally.[315] But reconsider the examples in Part II. What, besides the Aramony malfeasance,[316] is *legally* wrong in those cases? Would a charity commission dictate salary levels, lobbying restrictions, membership requirements, fee structures and limits on activities? Would a charity commission keep proprietary businesses out of "traditionally" nonprofit fields, and keep charities out of "traditionally" proprietary fields? Would a charity commission ban nonprofits from competing with each other, or parcel out geographic or market turf—and donor bases? The political considerations involved in such questions boggle the mind.[317]

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314. *See, e.g.*, Miller v. Bargaheiser, 591 N.E.2d 1339, 1342 (Ohio Ct. App. 1990) (noting board of trustees given broad discretion in management of charity). As Professor Hone commented on the Revised Model Nonprofit Corporation Act:

> It is my impression, from talking with state Attorney Generals [sic], that it is almost impossible to win cases involving only inattentive management .... Therefore, the Act has adopted a duty of care which imposes liability only in particularly egregious cases. If one could show years of inattention, then there would be liability. But if one had just a single lapse, a terrible judgment, the business judgment rule would protect directors .... The trust standard would hold directors personally liable for mere negligence. ... It was the subcommittee's opinion that if that were the standard ... very few sensible people would serve on the boards of nonprofit organizations.

Hone, *supra* note 223, at 772.

315. *See, e.g.*, *Boston U. Agrees to New Policies on Top Officers*, N.Y. TIMES, Dec. 17, 1993, § 1, at 31 (reporting Massachusetts Attorney General's Office negotiated changes in how Boston University defines conflicts of interest, chooses trustees and pays top officers); Randy Kennedy, *New Board Puts Garden Back on Feet*, N.Y. TIMES, Nov. 7, 1993, § 13, at 9 (noting Botanical Garden Society's 268 members elected new board members, thereby returning control of garden to society); Steven Lee Myers, *New York to Remove Directors of Garden*, N.Y. TIMES, Dec. 5, 1992, at A23 (stating New York Attorney General's Office found that actions of Queens Botanical Garden Society board wasted charitable assets; New York City revoked Garden Society's license and removed directors).

316. For a discussion of the Aramony/United Way scandal, see *supra* notes 107-121 and accompanying text.

317. *See, e.g.*, *A Chronology of the Methodist Charity-Care Battle in Texas*, MODERN HEALTHCARE, June 7, 1993, at 3. In 1990, the State of Texas sued a hospital to require increased charity care. *Id.* In 1992, the hospital's chief executive officer said in deposition, "In my view, it is a charitable purpose to provide care to a rich man or a poor man." *Id.* In 1993, a district court judge dismissed the case on the ground that the state has no power to dictate how charities allocate their resources. *Id.* Five months later, the state passed legislation requiring nonprofit hospitals to provide charity care as a condition of their property tax exemptions. *Id.*

One proposal advocating a national charity commission implicitly recognizes these practical limitations:

> The primary focus of the proposed commission would be on the organization, the functioning, and the results of private philanthropy, as well as the relationships between donors and donees. It would have no enforcement powers (except to require submission of reports), but would achieve its objectives through studies, dialogue, and dissemination of its findings and recommendations. It would engage in a continuous process of interpreting the philanthropic sector to the general public and interpreting changing public attitudes to the private sector.[318]

The regulators' lack of enforcement zeal reveals more than a lack of resources. The hard reality is that governments do not want to take over the business of running charities. The directors of three of the better-staffed state charity offices (in New York, Connecticut and Massachusetts)[319] said in interviews that they:

> share a conviction that their role in relation to troubled nonprofits should be limited. For varying reasons, they believe that they should not try to expand their role in monitoring nonprofit organizations; they should not attempt to provide early-warning systems for groups in trouble; they should not counsel failing groups to consider closing down. They think that they should not get involved when a group is having financial troubles, unless illegal conduct is alleged, nor should they intervene in the internal battles of a group with active participants. They think that nonprofit groups should not be required to ask their permission before obtaining mortgages or taking other financial risks. They should not "micromanage" a group nor substitute their own judgment for that of the board and staff.[320]

In short, these assistant attorneys general "do not view themselves as the 'ultimate owners' of the underlying assets of all charitable orga-

318. Yarmolinsky & Fremont-Smith, *supra* note 247, at 2858.

319. Everything is relative. It appears that over half the states have only one part-time attorney or no attorney assigned exclusively to charity cases; perhaps ten states have five or more attorneys on these cases. Connecticut has four (and a case load of 625 annual reports per attorney), Massachusetts has seven (1,498 reports each) and New York has seventeen (1,588 reports each). Bograd, *supra* note 244, at 5-6, 8-11.

320. *Id.* at 5-6 (footnote omitted).

nizations, though they do represent the public, donors, and beneficiaries in certain legal proceedings."[321]

3. *Conforming Fiduciary Standards*

Professor Hansmann asserts that his liberal view towards nonprofit permitted purposes "makes it all the more important that appropriate measures are taken to assure that all nonprofits adhere to their fiduciary duties."[322] To this end, he would apply to any entity choosing nonprofit corporate status the same fiduciary rules that apply to charitable trusts.[323]

Elsewhere, however, Professor Hansmann recognizes that "ethical constraints may be far more important than legal sanctions in causing the managers of nonprofits to adhere to their fiduciary responsibilities."[324] More important, his proposed ban on dealings between charities and their substantial contributors and fiduciaries could gut much of the sector. Self-dealing transactions frequently arise in the charitable sector. Indeed, people often make desirable directors because of their ties to certain businesses and their ability to obtain certain goods or services for the nonprofit on terms favorable to the nonprofit.[325] Barring such insider transactions would cost the nonprofit sector dearly.

Recognizing this dilemma, recent federal legislation will tax only the "excess benefits" obtained by the insider in self-dealing transactions.[326] While the charitable sector supports the goals of

321. *Id.* at 6; *see also* Fishman, *supra* note 18, at 671 ("Today, we live in an age of deregulation. There are few who believe that another agency with additional resources is a sufficient cure for any social ill.").

322. Hansmann, *Reforming Law*, *supra* note 224, at 527.

323. Under Professor Hansmann's proposal, mutual nonprofits, which commonly further the financial interests of their members, would come under the law that applies to cooperatives. *Id.* at 588-96.

324. Hansmann, *Role of Nonprofit Enterprise*, *supra* note 249, at 875-76. Hansmann finds that these ethical norms operate at different levels, more strongly in older industries such as hospitals and schools (particularly those affiliated with religious groups) and in large organizations (where more employees can monitor the managers, and bureaucratization restricts discretion) and less strongly in newer sectors and in mixed sectors such as the nursing home industry (where "the standards of service and conduct set by the proprietary firms eventually may be taken as an acceptable minimum even among the nonprofits"). *Id.* at 876.

325. *See, e.g.*, REV. MODEL NONPROFIT CORP. ACT § 8.31 cmt. 1 (1987) ("The Model Act recognizes that many individuals are elected to nonprofit boards because of their ability to enter into or cause an affiliate to enter into a transaction with and for the benefit of the corporation."). *But see* DeMott, *supra* note 253, at 140 (observing "the prospect of self-dealing may entice some directors to serve" and indeed to believe themselves to have "a reciprocal entitlement to self-deal").

326. For a further discussion of the Internal Revenue Code provision on excess benefit transactions, see *supra* notes 255-57 and accompanying text.

such a rule, many still worry that determining the presence of excess benefits will require excessive interference with charitable activities and chill desperately needed economic arrangements with insiders.[327]

C. *Expanded Standing to Sue and Increased Disclosure*

The IRS information return required of tax-exempt organizations covers many pages and requests a great deal of information.[328] Charities must report, among other things, their primary activities, their sources of funding, the salaries earned by managers, and any relationships they have with other nonprofit and proprietary organizations.[329] The wealth of data demanded by the IRS inspired the following exchange between a member of the American Bar Association and the IRS's special assistant for exempt organization matters:

> *Mr. Gallagher*: Howard, what does the IRS do with all this stuff?
>
> *Mr. Schoenfeld*: It's not so much what the IRS does with all this stuff. It's also what the public does with all this stuff. That's an equal part, I think, of what the question should be.[330]

But what, then, is the public to do with all this stuff? Access to information should help the public determine which charities are worthy of their future support. However, should the public—either as donors or as beneficiaries—be offered expanded standing rights to sue charities based on this (and other) information?[331]

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327. *Cf.* Fishman, *supra* note 18, at 668 (suggesting that separate "close nonprofit corporation" scheme could permit a more relaxed mechanism for transactions with insiders of small organizations).

328. *See* IRS Form 990 (information return of organization exempt from tax). Small charities can file abbreviated Form 990EZ. Private foundations must file Form 990-PF. Churches and very small charities are exempt from filing.

329. *Id.*

330. *Edited Transcript of the Morning Sessions of the August ABA EO Committee Meeting in New Orleans, Panel III, The Role of the IRS in Promoting Public Accountability of Exempt Organizations*, 10 EXEMPT ORG. TAX REV. 805 (Oct. 1994).

331. *See* Pamela A. Mann & David G. Samuels, *Standing to Pursue Claims Involving Charitable Organizations*, N.Y. L.J., July 30, 1993, Outside Counsel sec., at 1 (Ms. Mann was then Assistant Attorney General of New York, in charge of Charities Bureau, and Mr. Samuels was then her deputy). *See generally* Blasko et al., *supra* note 258 (discussing private parties' rights to pursue litigation against charitable organizations).

The law quite clearly has determined that "despite the fact that the organization is legally bound by specific terms of the gift, *legally* it is not the donor's concern. It is *society's* concern, to be pursued (or not) by society's representative, the attorney general."[332] Similarly, a "central premise of the traditional legal framework . . . is that the direct beneficiaries of a charity's activities are but the vehicle by which the charity delivers a social good to society at large, and it falls to the representative of society at large (the attorney general) to call charities to account for their failures."[333] Already, information from dissatisfied insiders constitutes a key resource for state attorneys general. Even setting aside the question of reimbursement for costs,[334] if private parties can prosecute suits, what makes us think they would have a better chance of success?

Mandatory stakeholder oversight is not a solution. Institutional beliefs frequently clash with economic needs. Today's charity faces competition from a myriad of other charities, as well as high fundraising and administrative costs. At the same time, the public seems jaded with social problems, and uninterested in supporting monolithic organizations as opposed to causes. The public appears uneducated about the fiscal needs of charities, as many people express surprise that nonprofit managers are paid at all and reveal ignorance of charities' productive demands.[335] The public seems less inclined, not more, to become involved in collective activity.[336] A public that does not understand cost constraints cannot perform effective oversight.[337] A public whose oversight focuses on the wrong considerations induces charities to adopt inefficient and ineffective behaviors.

If charities want to alter the public's resistance to certain activities, the charities have educational work to do. The law does

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332. Chisolm, *supra* note 286, at 149.

333. *Id.*

334. *See* Fishman, *supra* note 18, at 674 (proposing that fund, under supervision of attorney general, could be established for benefit of successful public-spirited citizens or public interest law firms).

335. Rayna Skolnik, *Rebuilding Trust: Nonprofits Act to Boost Reputations*, PUB. REL. J., Sept. 1993, at 30 (quoting American Cancer Society public relations director: "This is not an amateur undertaking. We try to tell people about the kind of professionalism that's needed.").

336. *See* Robert D. Putnam, *Bowling Alone: America's Declining Social Capital*, 6 J. DEMOCRACY 65, 65 (Jan. 1995) ("There is striking evidence, however, that the vibrancy of American civil society has notably declined over the past several decades.").

337. *See, e.g.*, Skolnik, *supra* note 335, at 29 ("Even the Girl Scouts of the USA have recently come under fire for using too large a share of cookie-sale profits for administration, rather than rebating them to the troops that made the sales.").

not stand in the way. That is, the law does not *prevent* charities from making disclosures that are in their interests to make. Charities should voluntarily be providing *at least* the information demanded by the IRS and state regulators.[338] Nonprofit scholar Virginia Hodgkinson and her colleagues observe in their most recent version of the *Nonprofit Almanac*: "As organizations compete for private contributions and government funds, accountability and performance will become increasingly more important. Organizations will have to demonstrate the efficient use of funds and positive outcomes will be required to produce quantifiable measures of program achievement and effectiveness to donors, foundations and government funding agencies."[339] With the growing acceptance of the Internet, we are beginning to see an explosion of Websites created by charities, charity monitors and governments, all presenting information on the sector.[340]

The voluntary disclosure of information also serves charities that do not solicit contributions. In cases where a charity does not depend on donations for its operations, state governments worry less about false solicitations, but the public's concern over unaccountable and inefficient use of resources intensifies. Even a charity totally self-sufficient on income from the performance of services and endowment cannot necessarily keep its activities to itself. The nonprofit sector continues to need institutional legitimacy. An informed public is, hopefully, a sympathetic public. All nonprofits remain politically vulnerable—not just to the removal of subsidies, but also to the danger of unwise legislation.

VI. CONCLUSION

There are limits on what laws can accomplish. Formal laws are just one of a myriad of social institutions that govern all aspects of human interaction. Indeed, asking too much of the law by codifying too many rules interferes with the ability of society to alter the

338. Presently, charities provide information to third-party rating bureaus, such as the Better Business Bureau, in order to attract donations. *See* Peter G. Meek, *Self-Regulation in Private Philanthropy*, *in* 5 FILER COMM'N RES. PAPERS, *supra* note 41, at 2781. For a further discussion of rating bureaus, see *supra* note 267 and accompanying text.

339. HODGKINSON ET AL., *supra* note 159, at 17.

340. *See, e.g.*, Internet Nonprofit Ctr. (visited Nov. 15, 1996) <http://www.nonprofits.org.>; State of Maryland's charity Website (visited Nov. 15, 1996) <http://www.gov.state.md.us/sos/charity/html>; Website of Charity Accountability Discussion Group, called "Cyber-Accountability" (visited Nov. 15, 1996) <http://www.bway.net/~hbograd/cyb-acc.html>.

constant trade-offs and accommodations made between complex and often conflicting institutional demands.

The many ways in which modern nonprofit organizations struggle to survive has captured headlines. As nonprofits become more businesslike and competitive, however, they necessarily challenge current institutionalized beliefs of what nonprofits "should" and "should not" do. Nonprofits also generate increased calls for reforming the law in order to keep them in their place—or at least in a place we nostalgically like to believe once existed in a golden age.

As this Article describes, however, throughout American history, nonprofits have never had a defined place.[341] Rather, in different times and in different places society has variously called on all types of organizations—public, proprietary or nonprofit—to conduct collective activity. The resolution of this eternal debate is a political issue, best decided under a laissez-faire nonprofit law. Accordingly, I do not believe that significant legal reform of nonprofit law is called for.

But *regulating* nonprofits is a separate question from *subsidizing* nonprofits. As I will explore in a future article, the recent sea changes in the nonprofit sector illustrated in this Article require society to rethink current subsidies.[342] Subsidies mean more than tax exemption. They range in form from favorable government contracts and support, to liberal fiduciary liability laws, to exemption from constitutional due process and equal protection requirements. Monetary subsidies could be replaced with targeted "output" subsidies of worthy activities—whether conducted by nonprofit *or* proprietary enterprises—to better allocate our scarce collective resources.

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341. For a discussion of the variety of nonprofit activity through history, see Part II, *supra* notes 10-144 and accompanying text.

342. *See generally* Brody, Subsidy, *supra* note 287 (examining how evolving functions of nonprofits requires new structure for subsidies).