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MIXTURES OF PROFIT AND NONPROFIT CORPORATION PURPOSES AND OPERATIONS

Howard L. Oleck*

I. INTRODUCTION

The law has traditionally subjected profit and nonprofit organizations to different forms of regulation. This is at least in part because of the belief that the search for profit is an inherent element of economic activity, and that nonprofit organizations, due to the fundamental difference in profit motive, ought to be governed by rules appropriate to moral, social, political, charitable, or cultural purposes rather than by the legal rules of for-profit organizations.

Today, however, corporations and other legal entities often mix profit-seeking with nonprofit purposes and operations. Such mixtures blur the traditionally sharp dichotomy between profit and nonprofit organizations. The old view, that nonprofit operations are essentially private activities of no interest to the state, is now in the process of being replaced by a recognition of their social importance, vast influence, and great economic effect. “Purely profit” business organizations now routinely engage in significant nonprofit operations, while “purely nonprofit” organizations engage in significant profit operations.

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1. One illustration of a normal modern “mixed” operation is that now common in colleges and universities. Many schools engage in some profit-seeking activity. Thus, such organizations often are active in real estate ventures, corporate research contracts, patent negotiations, and other partnerships with business.

2. For example, McDonalds “fast food” chain opened a Houston branch at the visitors/staff/patient hospital restaurant in Texas Childrens Hospital in December, 1987, the sixth joint operation of such a mixed profit-nonprofit venture since McDonalds’ first such partnership, ten years ago, with Childrens Hospital of Philadelphia. L. Belkin, Fast Food Fattens Hospital Income, N.Y. Times, syndicated in St. Petersburg (FL.) Times, Dec. 25, 1987, at 20A.

3. Common examples of purely nonprofit organizations that engage in significant profit operations are local governments that provide utilities, transportation systems, hospitals, toll bridges, and liquor stores run by local governments. L. Hay, Accounting for Governmental and Nonprofit Entities 305 (7th ed. 1985).
Profit seeking organizations often proclaim their recognition of "social responsibility." Profit seeking organizations often seek "unrelated business income" in order to achieve their nonprofit purposes. It has become difficult to categorize such entities, especially where entrepreneurs deliberately seek spurious nonprofit tax-exempt status for profit making and taking purposes, or where the nonprofit form is used for such entrepreneurial activity as religious or political activism, vacation or retirement "clubs," or sports associations.

The Germans have recognized this significant development by creating legal distinctions between "idealistic associations" (Idealverein) and "economic associations" (Wirtschaftlichverein) based on the presence or absence of "business" enterprise. The French and Italians allow the use of the nonprofit form for profit-seeking if the "destination" (purpose) of those profits is furtherance of nonprofit purpose. The latter view is followed in the United States. It is usually expressed in statutory definitions taken from the 1964 American Bar Association Model Nonprofit Corporation Act. The Model Act's definition of a nonprofit corporation is "a corporation no part of the income or profit of which is distributed as dividends to its members, directors or officers."

The American Bar Association's Revised Model Nonprofit Corporation Act which was adopted by the Subcommittee on the

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6. Specific examples may include nonprofit organizations involved in housing projects for the elderly and store front churches and other church organizations that may have for profit motives.
7. For example, an agricultural society is not a charity for financial reporting requirement purposes, where profit of members is not barred. Attorney General v. Brockton Agric. Soc'y, 400 Mass. 1006, 509 N.E.2d 1198 (1987).
9. See Oleck, supra note 5, at chs. 1 & 3; see also S. Rose-Ackerman (ed.), Economics of Nonprofit Institutions (Yale University Studies on Nonprofit Organizations) (Oxford University Press; N.Y., N.Y. 1986).
Model Nonprofit Corporation Law of the Business Law Section in the summer of 1987 does not define the term nonprofit corporation in its subchapter of definitions. The ABA's subcommittee proposed instead a distinction of public benefit corporations from mutual benefit corporations. Public benefit corporations are formed for a public or charitable purpose. They include foundations and all I.R.C. 501(c)(3) (federal tax exempt) organizations. Mutual benefit organizations, on the other hand, are those formed for profit-seeking purposes. The deliberate omission of a statutory definition of nonprofit organizations in the Model Act is significant, as will be explored below. The remainder of this Article analyzes the economic overlapping and interdependence of these mixtures of profit and nonprofit operations and addresses the difficulty of planning a single system of law for such organizations.

II. THE NUMBER AND ROLE OF NONPROFIT ORGANIZATIONS IN THE UNITED STATES

The difficulty of planning a single system of law for nonprofit corporations that also engage in profit operations (and vice versa) is compounded by the sheer number and diversity of persons, organizations, and endeavors involved.

It may well be true that nonprofit organizations play a more important role in the lives of most contemporary Americans than business operations. Some students of American history believe that democracy causes many people to feel a sense of personal isolation that is counterbalanced by the sense of "joining" and "belonging" derived from membership in nonprofit organizations. Throughout United States history, Americans have been involved in such nonprofit groups as church organizations; schools; political organizations; sports, fraternal, scientific, and hobby groups; service and trade associations; mutual benefit societies;
civic clubs; and many other kinds of social and "interest" organizations.\textsuperscript{17}

The types of nonprofit organizations continue to proliferate. Growing numbers of Americans live in condominiums and retirement colonies. They belong to neighborhood associations that are organized as nonprofit groups. Daily, people are deluged by mail, telephone, and television pleas to "send money" to a bewildering variety of charitable, educational, and religious associations.

The number of people and the amounts of money involved in the nonprofit sector are enormous. In 1985, for example, an Internal Revenue Service report revealed that 54.5 million of the 96.3 million taxpayers claimed $38 billion in deductions for charitable contributions.\textsuperscript{18} These figures do not include all nonprofit groups. In 1983, for example, Americans donated $64.93 billion to America's nearly 300,000 charitable organizations.\textsuperscript{19} In that same year, a survey of 500 major United States corporations tallied $1.4 billion in gifts to charities, and estimated that total donations by all United States corporations amounted to $3 billion.\textsuperscript{20} Also during that year, Florida residents' gifts to charities averaged $564 each, while half of those polled reported working as volunteers approximately 7.5 hours per month.\textsuperscript{21} By 1985, Americans gave an estimated $79.8 billion to charity.\textsuperscript{22} Note that these figures refer only to charities, not to all of the many other types of nonprofit organizations.

The figures on officially recognized nonprofit organizations also demonstrate the nonprofit corporations' large pervasive role in contemporary society. The I.R.S. cumulative list of organizations given tax exempt status numbers almost one million organizations.\textsuperscript{23} The combined budgets of philanthropic organizations in

\textsuperscript{17} \textsuperscript{OLECK, supra note 5, at 4-5. In 1831 the extraordinary book by Alexis de Tocqueville, \textit{Democracy in America}, exclaimed about how Americans "are forever forming associations" for "trade, political, literary and religious interests." DE TOCQUEVILLE, DEMOCRACY IN AMERICA (J. Mayer and M. Lerner, eds. 1966).}
\textsuperscript{19} \textsuperscript{American Association of Fund Raising Councils Report; St. Petersburg, Fla., Times, July 2, 1984.}
\textsuperscript{20} \textsuperscript{N.Y. City Conference Board Report; Miami, Fl., Review, Nov. 7, 1988 at 9.}
\textsuperscript{21} \textsuperscript{Univ. of Fla. Survey; Miami, Fl., Review, Nov. 6, 1984, at 3.}
\textsuperscript{22} \textsuperscript{W. Briston (ed.), \textit{Charitable Giving Techniques Newsletter}, Pinellas County Review (Fla.), Apr. 19, 1985, at 9.}
\textsuperscript{23} \textsuperscript{IRS "Cumulative list of Organizations"—actually a published list by the IRS containing the qualified charitable, educational, scientific, etc. organizations.}
the United States totaling expenditures of over $130 billion exceed the national budgets of all nations except the United States, France, West Germany, the United Kingdom, Japan, and probably China and the Soviet Union.\textsuperscript{24}

Counting only religious bodies of more than 50,000 members each, there are more than 345,000 churches in the United States, with more than 141 million members.\textsuperscript{25} Church contributions equal approximately $10 billion, or more than $220 per capita.\textsuperscript{26} By the middle of this decade, major national nonprofit associations in the United States numbered approximately 17,000.\textsuperscript{27}

An examination of the number of nonprofit organizations in a typical state further illustrates the size of the nonprofit sector. In 1980, Florida listed approximately 500,000 condominium association units (certainly more today), and approximately 2300 nonprofit organizations statewide including 540 business associations; 120 professional; 540 labor; 800 civic, social, and fraternal; 36 political; 65 religious; and 170 miscellaneous other types.\textsuperscript{28}

On the national level, the American Legion had 2.6 million members in 1984.\textsuperscript{29} The American Automobile Association had 13.6 million members in 1972 increasing to 25.1 million by January, 1985.\textsuperscript{30} The Order of Eastern Star, the women's branch of the Masonic Order, had approximately 2.5 million members in 1984.\textsuperscript{31} Typical labor union numbers in 1983 were Teamsters, 2 million; automobile, 1.15 million; carpenters, 80,000; and machinists, 943,280.\textsuperscript{32} The American Bar Association had 320,000 members in 1985.\textsuperscript{33}

\textsuperscript{24} G. Rudney, Yale Research Reports (Yale Institute for Social & Policy Studies; NPO Program) #1 (Sept. 1981) and succeeding reports. Annual expenditures are estimated at over $130 billion.
\textsuperscript{26} Id.
\textsuperscript{27} ENCYCLOPEDIA OF ASSOCIATIONS (Gale Publishing Co. 9th ed. 1985). The Encyclopedia of Associations furnishes details on nearly 21,500 national and international nonprofit trade and professional associations, social welfare and public affairs organizations, religious sports and hobby groups, and other types of organizations in the United States consisting of voluntary members.
\textsuperscript{28} FLORIDA STATISTICAL ABSTRACT (Univ. of Fla., Gainsville, 1982 ed.).
\textsuperscript{29} THE WORLD ALMANAC AND BOOK OF FACTS 1987 (1986).
\textsuperscript{30} Id.
\textsuperscript{31} Id.
\textsuperscript{32} Id.
\textsuperscript{33} Telephone query to ABA staff member in Chicago (July, 1985).
A perusal of the Yellow Pages of any United States city discloses an astonishing number and variety of local nonprofit organizations large enough to show an office and telephone in its name: associations, chambers of commerce, charities, churches, clubs, condominiums, foundations, fraternal orders, hospitals, labor unions, libraries, museums, religious organizations, research institutes, schools and colleges, social service organizations, societies, trade associations, and others. If one then includes government agencies, and notes that most of the smaller voluntary organizations—PTAs, local sports and hobby groups, cultural, ethnic, veterans, retirees, geographic and military alumni groups, employee clubs, neighborhood associations, and other social groups that maintain no office or telephone listing—then the size and impact of American nonprofit organizations becomes impressive indeed.

III. BLURRED DISTINCTIONS

A. Mixed Profit and Nonprofit Operations

In the modern age, many of the types of nonprofit organizations listed above have turned to mixing profit and nonprofit operations in order to gain tactical advantages. Nonprofit corporations today routinely employ many development options or business-type devices for supporting their ultimate nonprofit purposes.34 These may involve such diverse projects as housing, publishing, real estate, communications, financial underwriting, and manufacturing operations. These activities, in turn, may employ sale-lease-backs, tax-exempt or floating bond issues, equity syndications, joint venture building (e.g., housing) developments, telephone and cable television systems, and many other devices.35 A church bingo game, for example, is a business operation for fund raising. A business corporation, on the other hand, may fund a free child care foundation as a public relations project that ultimately will increase the corporation's profits—with tax benefits as a collateral "profit."

34. See OLECK, supra note 5, at ch. 4.

Bruce Hopkins, a specialist in representing nonprofit organizations, has noted the following examples of mixtures of profit and nonprofit operations: a nonprofit hospital which sold music records produced by volunteers; a nonprofit health organization sold computerized financial programs to its members; a public service broadcasting station which produced and sold television commercials and rented out space in its facility; and a children’s aid organization which sold goods listed in a Christmas catalogue that it produced. Colleges regularly rent space in their facilities for conferences and meetings. Research groups rent out use of their computers. A handicapped persons’ rehabilitation organization obtained a contract from the state for its beneficiaries to pick up roadside litter. Museums regularly sell reproductions of works displayed in their exhibition halls.

1. Cooperatives and Condominiums

A long-established example of the mixing of nonprofit and profit corporation purposes and operations is the cooperative. Modern “consumer” cooperatives trace their lineage back to one organized in England in 1844. The cooperative is defined as “a democratic association of persons organized to furnish themselves an economic service under a plan that eliminates entrepreneur profit and that provides for substantial equality in ownership and control.” A cooperative association may be a “corporation for-profit or not for profit” that holds the association’s cooperative property and is responsible for its operations. Some distinctive features of cooperatives are democratic control by voting, regular and frequent meetings, sharing in economic profits or benefits either equally or in proportion to use made of the association.

36. Bruce K. Hopkins is a professional lecturer in law at the George Washington University National Law Center and has served as chairman of the Tax Exempt Organization Committee of the American Bar Association.
37. See, e.g., The Nonprofit as Entrepreneur; Fundraising Weekly (newsletter) (Hoke Communications, Inc., Garden City, N.Y., current ed.); Directory of Corporate Affiliations (Bimonthly reports and book) (National Register Publishing Co.; Skokie, Ill.); Fund Raising Management (monthly magazine) (Hoke Communications, Inc., Garden City, N.Y., current ed.); Fund Raising Institute Monthly Portfolio (newsletter) (Fund Raising Institute; Ambler, Pa., current ed.).
39. Id. at 2.
facilities, limited return on "investment," and often doing most of its business with its own members. 41

A major type of cooperative today is the condominium association. Each member owns his own unit subject to his mortgage plus his proportionate interest in "common areas" such as halls, elevators, and the land on which the condominium stands. 42 The use of condominiums for housing has become widespread since World War I. 43

Some other examples of cooperatives are consumer cooperatives (consumer stores, housing, health, and utility cooperatives), marketing cooperatives, business purchasing cooperatives, worker's productive cooperatives, financial cooperatives (such as credit unions and savings and loan associations), insurance cooperatives, labor unions, and trade associations. 44

The concept of "developer" plays a central role in determining the nature of cooperatives and their mixture of profit and non-profit operations. It is when the developer of a cooperative desires to retain a profit from the cooperative that a complex interplay of profit and nonprofit interests and restraints results. A developer either creates a condominium or cooperative or offers units for sale. 45 After a certain number of units are sold, the purchasers form the association to operate the entire development. Often the developer attempts to retain an interest in the property by "service contracts" or by the management or leasing of abutting recreation facilities such as a swimming pool or clubhouse. Under the elaborate statutory schemes regulating cooperatives and condominiums which are now found in every state, 46 a key problem is usually the establishment and enforcement of the developer's duties to the property owners' association. These duties have been derived from corporate law principles of fiduciary duty. 47

41. 18 AM. JUR. 2D Cooperative Associations § 2 (1985).
42. Packel, supra note 38, at 3.
43. See 2 REAL ESTATE TRANSACTIONS COOPERATIVE HOUSING LAW AND PRACTICE § 1.01 (1986).
44. Packel, supra note 38, at 11-23.
45. See, e.g., FLA. STAT. ANN. § 719.103(12) (West 1988).
46. Florida's provisions are illuminating. See, e.g., FLA. STAT. ANN. ch. 718 (Condominiums) & ch. 719 (Cooperatives) (West 1988).
47. See, e.g., Old Port Cove Property Owners Ass'n v. Ecclestone, 500 So. 2d 331 (Fla. Dist. Ct. App. 1986) (citing Avila Condominium Ass'n v. Kappa Corp., 347 So. 2d 599 (Fla. 1977)).
Further challenges for legislatures attempting to deal with profit/nonprofit mixtures were presented in the mid-1970s by the emergence of "time share" condominiums and cooperatives. Time sharing, involves a form of communal ownership, usually of resort or vacation housing, with "owners" entitled only to short-term occupancy each year, (e.g., two weeks) at less than unit cost rates. In time sharing arrangements, the developer often retains title. This is mixture of profit and nonprofit purposes and operations indeed. Statutory regulation of this device is growing rapidly.

Condominium developments and cooperatives are now generally held to be valid combinations of profit and nonprofit purposes and operations rather than improper burdens on economic commerce or public policy. Tax laws continue to be very kind to cooperative and condominium associations.

2. Trade Associations

Perhaps the best known example of nonprofit corporations existing mainly for economic-profit purposes are "trade associations." They are nonprofit associations of for-profit business concerns joined together to improve the economic profits of their members. They may even consist of members that are themselves other trade associations. Trade associations developed in the mid-1800s, and have been both damned as conspiracies against the public and praised as enlightened community friends. In the modern economic environment, however, there is little doubt that such associations play an important and privileged role in American economic life. Professional organizations, such as the American Bar Association, are closely akin to them.

50. See id.
52. The 1986 Tax Code amendments [I.R.C. § 644(c) (1988)], for example, permit cooperatives to elect deduction of separate taxes and interest.
B. Affiliations and Consortiums Between Profit and Nonprofit Organizations

Organizations are evermore frequently exploring the advantages of affiliation or consortium with other organizations—profit or nonprofit. Little law has, as yet, been developed on this practice. Provided the affiliation does not violate law or public policy, and especially if the purposes of the organizations are kindred or supplemental, such combinations seem to be valid. Statutes seem to particularly favor merger of a for-profit corporation with a nonprofit corporation where the latter is the remaining entity. Only seldom is the Investment Company Act applied to affiliation contracts, usually when five percent or more of the voting stock of the subsidiary is controlled, thus involving "Holding Company" law. Affiliations may be parent-and-subsidiary, brother-and-sister, or other and more complex relationships.

One example of profit-nonprofit affiliation is that of a nonprofit hospital with a commercial laboratory for medical testing work; the joint venture enables the hospital to share the investment expenses and reduce its own overhead expenses. These arrangements must not violate such rules as those against practice of medicine by a hospital.

IV. NONPROFIT CORPORATIONS AND STATUTORY OBFUSCATIONS

It is this writer's belief that modern American nonprofit corporation statutes too often serve to obfuscate, rather than to illuminate, the proper nature and powers of such organizations. This obfuscation is partially the unintentional result of a misguided quest of "simplicity," wherein such statutes are merely slight modifications of the state's business corporations provi-

55. OLECK, supra note 5, at 989-992.
58. See generally, 3 OLECK, MODERN CORPORATION LAW § 1469 (1978).
59. See OLECK, supra note 5, at § 330 for a detailed discussion.
60. See Trickel, Focus on Consolidation by Not-for-Profit Hospitals, 58 FLA. B. J. 142 (1984).
sions. In some bar association and legislative committees, however, this obfuscation is deliberate.

Even more than is usually the case in other areas of law, there are lawyers who view corporation statutes—both business and nonprofit—as mainly "enabling law" for obtaining privileges, such as personal-liability-exemption or tax-exemption. These lawyers are little interested in the details of guarding pro bono publico voluntaryism or cooperative altruism. But, as Chamfort said, "It is easier to make certain things legal than to make them legitimate." 62

A. A Definitional Maze

Consider the statutory definition of "nonprofit corporation." The 1964 Model Nonprofit Corporation Act 63 defined it as "a corporation no part of the income or profit of which is distributable to its members, directors or officers." Kentucky's statute is a verbatim adoption of this definition. 64 The Kentucky adoption of the ABA Model Act does give this state a modestly utilitarian statute, amended in 1968, 1974, and 1978, and supplemented in 1984 with a detailed, new "Community Action Corporations" section. 65 The Florida statute, contains a virtually identical definition. 66

By comparison Ohio's statutory definition is a masterpiece of clarity and detailed explanation. It states that a non-profit corporation means a corporation which is not formed for the pecuniary gain or profit of, and whose net earnings or any part thereof is not distributable to, its members, trustees, officers, or other private persons; provided, however, that the payment of reasonable compensation for services rendered and the distribution of assets on dissolution as permitted by section 1702.49 of the Revised Code shall not be deemed pecuniary gain or profit or distribution of earnings. 67

Ohio's statute, overall, represents one of the most reasonable and complete schemes in the nation.

63. MODEL NONPROFIT CORPORATION ACT § 2(c) (1964).
65. Id. at § 273.405-453.
66. FLA. STAT. ANN. § 617.01(2) (West 1977).
67. OHIO REV. CODE ANN. § 1702.01(C) (Baldwin 1987).
North Carolina's statutory definition adds the significant, though hard to prove, test of intention. A nonprofit corporation "means a corporation intended to have no income or intended to have income none of which is distributable to its members, directors, or officers...."\textsuperscript{68}

New York's 1970 revision of its definition spoke of a corporation "exclusively for a purpose or purposes, not for pecuniary profit or financial gain . . . , and (2) no part of the assets, income, or profit of which is distributable to, or inures to the benefits of, its members, directors, or officers except to the extent permitted under this statute."\textsuperscript{69} But it was the 1970 New York statute that also introduced the then-novel classifications of various "non-business" types [A, B, C, D] of not-for-profit corporations, of which Type D may be for "business or nonbusiness, or pecuniary or nonpecuniary . . . specified by other [corporate] law, whether such purpose or purposes are also within Types A, B, C above or otherwise."\textsuperscript{70} A system more likely to befuddle the distinction between profit and nonprofit purposes would be hard to devise, but California adopted an even more convoluted system in 1980.\textsuperscript{71} It divided nonprofits into three general areas of operation: (1) public benefit, (2) mutual benefit, and (3) religious corporations. Legal analysts said of this system, "[a]lthough many of these changes are positive, some appear unclear or unwise."\textsuperscript{72} Above all, it clearly authorized profit-making activity if the profits were applied to furtherance of the nonprofit purpose.\textsuperscript{73} But this was tied to the Internal Revenue Code rules concerning federal tax exemption\textsuperscript{74}—as is now done in many state statutes. Ironically, it is the Internal Revenue Code (and IRS) far more than any state law, that has set rules for nonprofit organizations.\textsuperscript{75}

\textsuperscript{68} N. C. GEN. STAT. § 55A-2(8) (1982).
\textsuperscript{69} N.Y. NOT-FOR-PROFIT CORP. LAW § 102(a)(5) (1970).
\textsuperscript{70} Id. at § 201(b).
\textsuperscript{71} CAL. CORP. CODE § 5000-10810 (West Supp. 1988).
\textsuperscript{73} CAL. CORP. CODE § 5059 (mutual benefit corp.); § 5060 (public benefit corp.); § 5061 (religious corp.) (West Supp. 1988).
\textsuperscript{74} Fryer & Haglund, supra note 72, at 13.
These few illustrations show serious confusion as to even the most basic principles that should be followed. An able analyst, Henry B. Hansmann of the University of Pennsylvania Law School, in a study conducted for the Program on Non-Profit Organizations, at the Institute for Social and Policy Studies, Yale University, summed it up thus:

[T]he basic corporate law applicable to nonprofit organizations is at a remarkably immature state of development, and remains startlingly uninformed by either principles or policy. Confusion continues to surround even the most fundamental issues, including the purposes for which nonprofit corporations may be formed, the distinction between nonprofit and cooperative corporations, and the appropriate limits on distributions from nonprofit corporations to individuals who are associated with them.... [T]he various recent efforts at statutory reform, [are], in fundamental respects, misconceived and badly flawed....

Professors Henry G. Henn and Jeffrey Boyd of Cornell Law School said of this:

Recent growth in the economic power of nonprofit organizations, as well as the ascendancy of the nonprofit organization as an important alternative form of commercial enterprise have spawned significant legislation....

Because the motives behind corporate organization range from pure altruism to unabashed cupidity, drafters of nonprofit corporation statutes should understand thoroughly the purposes of nonprofit corporations ... one statute covering both profit and nonprofit corporations can hardly satisfy such needs; nor can separate business corporation and nonprofit corporation statutes if drafted under the same sponsorship. 77

This reference to "the same sponsorship" means the ABA Corporate Laws Committee, 78 which was responsible for both the Model Nonprofit Corporation Act and the Model Business Corporation Act. 79 It echoes what the writer has long been urging—a different kind of "sponsorship." In 1987 when the ABA changed

78. Id. at 1107 n.21.
79. See Preface to ABA-ALI paperback issue of the MODEL NONPROFIT CORP. ACT, VII-VIII (1964), and Foreword to its issue of the MODEL BUS. CORP. ACT (1978).
the name of the Section of Corporate, Banking, and Business Law to simply the Section of Business Law, the inappropriateness of the drafting of a nonprofit statute by a Business Law group became startlingly clear.

B. The Internal Revenue Code as Corporate Regulatory Law

Tax law, especially income tax law, is fundamentally a body of rules meant to enable government to obtain funds needed for diverse governmental and administrative purposes. It is not the proper vehicle for selecting and establishing public morality-policy. Yet American tax law—especially federal income tax law—is the main body of legislation that in practice chooses and establishes the law of nonprofit tax-exempt privilege, and determines what mixtures of profit and nonprofit purposes and operations are valid.80

In fact, many lawyers think of “nonprofit organizations” as important only insofar as they are tax-exempt organizations.81 They speak of tax-exempt organizations (i.e., those granted tax exemption by the IRS) as though any other kind of nonprofit organization is not worth mentioning.

Tax law continues to be the main avenue both for favoring and regulating mixtures of profit and nonprofit operations. However, decisions in various jurisdictions have been inconsistent. Two recent decisions suffice to outline the present uncertain state of the law. For example, Illinois recently held that incidental acts of charity by a fraternal lodge were not enough to justify property tax exemption, where the main purpose of the lodge was to provide a building for social use by its members. The court held that use of the property must be “exclusively” for charitable purposes.82 In a Florida case, however, it was held that

80. I.R.C. § 501(c)(3) and 26 C.F.R. § 1.501(c)(3)-1 specify the organizational and operational tests for determining the tax exempt status of a nonprofit organization.


a tax exemption will apply to nonreligious use of property by a tax-exempt church (as a parking lot) where the religious use is the "predominant" use or the "most significant activity" on land which may support multiple activities.\textsuperscript{83}

Many state corporation law statutes now contain at least one specific section that refers to the Internal Revenue Code's rules as the definition of "prohibited transactions" for nonprofit organizations.\textsuperscript{84} The 1987 Revised Model Nonprofit Corporation Act also refers to I.R.C. § 501(c)(3) as the test standard for distributions of assets of both tax-exempt and non-tax-exempt nonprofit corporations upon dissolution.\textsuperscript{85}

In practical effect, therefore, the IRS is the chief architect of public policy as to legal status of nonprofit organizations' mixed profit and nonprofit purposes and operations. The key idea in state law seems to be that property of a tax-exempt organization satisfies the "exclusive use" requirement for tax-exemption if it is primarily used for the exempted purpose, even though it is used for a secondary or incidental purpose.\textsuperscript{86}

Many states\textsuperscript{87} gear their income tax structures to "taxable income" as defined under the federal Internal Revenue

\textsuperscript{84} For example, the Florida statute says "as used in this section, section references, unless otherwise indicated, shall refer to the Internal Revenue Code of 1954, Title 26 of the United States Code, as in effect on December 16, 1971, including corresponding provisions of any subsequent federal tax laws." FLA. STAT. ANN. § 617.105 (West 1988). Other states which refer to the Code include Alabama, Alaska, Arkansas, California, Kentucky, Louisiana, Minnesota, New Mexico, North Carolina, Ohio, Oklahoma, Rhode Island, Tennessee and Texas.
\textsuperscript{85} REVISED MODEL NONPROFIT CORPORATION ACT § 14.06(a)(6) (1987).
Code. I.R.C. section 501(c) lists twenty-three types of associations, corporations, and trusts that can qualify for federal tax exemption, plus subdivision (c)(24) trusts under ERISA section 4049, and section 501(c)(25) real estate title holders or distributors to nonprofit organizations. The major exempt-purpose classifications under section 501(c)(3) are religious, scientific, charitable, and educational; but Congress has added such new purposes as prevention of cruelty to children and fostering of international athletic competitions. The service itself has added exemptions such as that for aid to distressed persons. There are now many more such exemptions.

The gearing of state tax rules to federal tax law means that by engaging in "prohibited transactions," as defined in the federal statute, some trusts, pensions or other such plans will lose their tax-exempt status if they lend funds without adequate security, pay unreasonably high salaries, give preferences, pay unduly high prices, sell at unduly low prices, or otherwise cause substantial diversion of assets. Self-dealing, as defined in I.R.C. section 4941(d), will have the same result in private foundations. There are many other federal tax law rules which influence the operation of nonprofits.

C. State Tax Exemptions

The tax structures of various jurisdictions also affect what mixtures of profit/nonprofit organizations and activities will be
granted tax-exempt status. State taxation includes incorporation fees, annual franchise taxes, income taxes (not in all states), property taxes, death and gift taxes, and more. Charitable organizations are granted exemption from many state taxes. To a lesser extent, "merely nonprofit" (other than charitable, religious, and the like) organizations that are somewhat public in nature are similarly exempted.\textsuperscript{96} This applies to franchise taxes,\textsuperscript{97} income taxes,\textsuperscript{98} sales and use taxes\textsuperscript{99} and especially to property taxes of charitable and similar organizations.\textsuperscript{100} Only the property used for "charitable" purposes is exempt, however.\textsuperscript{101} The requirement that such use be exclusive is satisfied if that use is the primary one, even if it also is used for other purposes.\textsuperscript{102}

The inconsistency between state schemes is illustrated by the following examples. In some states, property held by an exempt organization under a lease, even though used to produce income (e.g., a college dormitory) is not entitled to the exemption because it is not owned.\textsuperscript{103} In other states the lessor of property can get the tax exemption by renting the property to such a nonprofit organization as a church.\textsuperscript{104} There is need for legislative clarification of public policy of such mixtures of profit and nonprofit purposes and operations.

V. Favoritism in Regulation of Mixed Profit-Nonprofit Operations

The primary justification of favoritism for nonprofit organizations, and of benign tolerance of mixtures of profit with their nonprofit aspects (especially for tax-exemption privileges), is that they provide services that otherwise would have to be provided

\textsuperscript{97} See, e.g., Ohio Rev. Code Ann. § 5733.01 (Baldwin 1988).
\textsuperscript{99} See, e.g., N.Y. Tax Law § 1105, 1116 (McKinney 1987).
\textsuperscript{100} See, e.g., Ohio Rev. Code Ann. § 5739.02 (Baldwin 1988).
\textsuperscript{102} See, e.g., Benedictine Sisters of the Sacred Heart v. Dep't of Revenue, 155 Ill. App. 3d 325, 508 N.E.2d 470 (1987).
\textsuperscript{103} See, e.g., Wheaton College v. Dep't of Revenue, 115 Ill. App. 3d 945, 508 N.E.2d 1136 (1987).
\textsuperscript{104} See, e.g., Skycrest Baptist Church case (Fla. 2d Dist., June 19, 1987). But the county property appraiser was appealing the case, lest it "open the floodgates" of tax exemption of profit organizations and owners.
by the state at taxpayers' expense. Other justifications exist, of course, such as the social utility of charitable and voluntaristic public service.

A clear statement of public policy concerning the special benefits to be afforded nonprofit operations is contained in a 1987 amendment to Florida's corporation statute which provides:

Section 1. (1) The legislature finds that the service of qualified persons on the governing boards of nonprofit corporations and associations is critical to the efficient and effective conduct of such organizations in the provision of services and other benefits to the citizens of the state. The legislature further finds that, within reasonable limits, persons offering their services as directors of such nonprofit organizations should be permitted to perform without undue concern for the possibility of litigation arising from the discharge of their duties as policy makers.

The Florida statute grants immunity from civil and, in some situations, criminal liability to officers, directors, and employees for conduct performed in the course of duties for nonprofit organizations. The statute also provides for indemnification for expenses of legal defense.

The rationale for such a law is that business corporation boards are hard put to obtain directors. A 1986 survey conducted by Peat Marwick indicated that about thirty-six percent of the 8,000 directors polled said they would be willing to serve on not-for-profit boards without director and officer's liability coverage, while one in seven would refuse to serve on a board without protection and approximately four percent had already resigned from boards without such coverage.

The laxity of some states' exemption statutes regarding certain types of nonprofit activities is illustrated by Florida's Solicitation of Funds statute (currently being phased out). This law defines a "charitable organization" as "a group which is or holds itself

105. See OLECK, supra note 5, at 22-24.
107. Amending Fl. Stat. § 607.014, 607.1645, 607.165, 617.028 (West Supp. 1988). In 1987 similar bills were offered to Congress by HR 911 (John Porter, R-Ill.) and SB 929 (John Melcher, D-Mt.).
108. PETE WARWICK, Directors' and Officers' Liability: A Crisis in the Making (a report made available by the international accounting firm of Peat Marwick & Co. for the benefit of its clients).
out to be a benevolent, educational, health, philanthropic, humane, patriotic, religious, or eleemosynary organization or any person who solicits or obtains contributions for charitable purposes.109 Religious institutions, however, are exempted.110 Such a broad definition invites abuse.

Other attempts at needed government regulation have occurred, such as Florida's enactment of a licensing law requiring state examination, licensing, and annual continuing education for all persons who wish to be managers in any type of community association.111 The governor urged colleges to offer courses for the training now required. Florida also toughened its Solicitation of Funds regulation statutes, effective 1987, and ending (unless then renewed) on October 1, 1994.112

VI. THE WRONG COMMITTEE

This writer and others113 have long argued that a different committee than that which currently drafts laws pertaining to for-profit enterprises should draft nonprofit corporation statutes. Thus, in my 1980 treatise on the subject,114 I stated:

Perhaps a new Committee, not confined in its composition to corporate, finance, and business lawyers, might be the best source of a final draft, made after due study of the purposes and problems peculiar to nonprofit organizations—especially after emphasis of the fact that a sound nonprofit corporation is in essence a manifestation of voluntaryism and altruism.115

Renewing this call for a new committee, with different insights and perspectives, I suggest a wholly new approach to enactment of nonprofit corporation law. First, the subject should be removed from the Bar Associations’ Section of Corporation, Banking, and Business Law, because that section is the wrong one for planning law for altruistic, voluntaristic, pro bono organizations—organi-

109. FLA. STAT. ANN. § 496.02(1)(a), (b) (West 1988).
110. Id. at § 496.02(1)(b).
111. Fla. Div. of Land Sales, Condominiums, and Mobile Homes, Emergency Rule No. 7 DER 87-4, (eff. until September 30, 1988); and then all community managers must be licensed after October 1, 1988; pursuant to 1987 Fla. Laws, ch. 87-343 (July 1987); FLA. STAT. § 468.431 (Dept. of Bus. Reg. Stat.).
112. 1987 Fla. Laws, ch. 87-283 (C.S. for H.B. 780 (1987)).
113. See supra note 77 and accompanying text.
114. OLECK, supra note 5, at 1189.
115. Id.
zations whose purposes are supposed to be selfless, spiritual, and in the public service.

Secondly, a planning committee should be appointed which would consist of a theologian, an anthropologist, a psychologist, an historian, a teacher, a statistician, a parliamentarian, and other such social and political scientists. These are the kinds of people who can best set forth the concepts and principles that are most likely to produce successful and socially constructive nonprofit organizations.

Thirdly, lawyers skilled in “group operations”—such as corporation and business lawyers—should be the supporting tier members of the planning committee, not the primary tier.

Finally, the planning should envisage stern supervision by public officials of nonprofit organizations, because of the certainty that privileged status—which nonprofit organizations have—will attract unprincipled exploiters who want the privileges but who do not intend to accept the concomitant burdens of public duty and pro bono selflessness.

VII. THE 1987 ABA REVISED MODEL NONPROFIT CORPORATION ACT

Invited to comment on the Exposure Draft by the Committee, I informed them of my criticisms. Without going through every provision in the Model statute, the few mentioned below seem to show the tenor and philosophy presented—a philosophy that is permissive, vague, contrary to a wise estimate of human nature, and almost certain to multiply confusion of valid and invalid—profit and nonprofit—purposes and operations.

The following are a few examples of the provisions that seem to me to be unwise and undesirable.

Section 1.25 provides that the secretary of state must file articles of incorporation even if he finds them to be contrary to general legal principles. No discretion is given, and any decision is likely to increase litigation later.

According to Section 1.30 the secretary of state may not enforce even very clear public policy. Rather he must leave it to

117. Id. at § 1.25 comment 1, 4.
the attorney general only.\textsuperscript{118} This legislates decreased supervision by public officials as does the Model Business Corporation Act’s parallel rule.\textsuperscript{119}

Subchapter D, definitions, pointedly omits any definition of “nonprofit Corporation,” and instead defines “Distribution.”\textsuperscript{120} This is confusing, and makes more difficult any discussion of what a nonprofit corporation is. Not to define the title of a law is to multiply uncertainty. In the same section, “Public Benefit Corporation” is also not defined, but is only mentioned with reference to other sections and the Introduction to the statute.\textsuperscript{121} Again, a very confusing technique.

One-man Incorporation is allowed in section 2.01,\textsuperscript{122} questionable in business corporations, and very questionable public policy in nonprofit—especially tax-exempt—corporations.

Purposes allowed by section 3.01 include “engaging in any lawful activity unless a more limited purpose is set forth in the articles of incorporation.”\textsuperscript{123} The Comment says that abusers of nonprofit status are not authorized “with impunity,” and “should be prevented” from using it to enrich themselves “if the corporation had misled the people from whom it received funds.” The attorney-general is said to possess power to punish such fraud; but the statute in reality aids the “entrepreneur” and then hopes that someone will punish him when he misbehaves.

Some other provisions are even more surprising, such as cumulative voting for directors\textsuperscript{124}—a very business-like device for the protection of minority shareholders in a stock corporation. It echoes the business corporation attitude of many bar association corporation-law-section members. Corporate power may be given to one person, instead of a board.\textsuperscript{125} This is a great rule for one-man control of what looks like a board of directors to outsiders. Further, directors may set their own compensation.\textsuperscript{126} This is a

\textsuperscript{118. Id. at § 1.30 comment.}
\textsuperscript{119. MODEL BUSINESS CORPORATION ACT § 1.30 (1984).}
\textsuperscript{120. Id. at § 1.40(10).}
\textsuperscript{121. Id. at § 1.40(28) comment, and § 2.02 comment.}
\textsuperscript{122. Id. at § 2.01.}
\textsuperscript{123. Id. at § 3.01.}
\textsuperscript{124. Id. at § 7.25}
\textsuperscript{125. Id. at § 8.01}
\textsuperscript{126. Id. at § 8.12.}
direct contrast to the common law rule and an invitation to self-enrichment. This is pay just for being a director.

The worst provision, without a doubt, is section 8.13, which states that "no more than 49 percent of the individuals serving on the board of any public benefit corporation may be financially interested persons."\(^{127}\) This even includes paid employees or contractors of their relatives, and this does not "affect the validity or enforceability of any transactions entered into by the corporation."\(^{128}\) Instead of forbidding conflicts of interests, this provision legalizes them.

Further blurring of the distinction between profit and nonprofit operations is seen in the highly business flavored rules about directors' standards of conduct.\(^{129}\) It adopts the "business judgment rule" for directors, and expressly bars "trustee" status of property.\(^{130}\) Director conflict of interest liberalization is elaborate.\(^{131}\) The rules as to indemnification\(^{132}\) of directors and officers are more than permissive, if an accused director showed "good faith and reasonable belief that the conduct was in or not opposed to the best interests of the corporation." This approach is said to be desirable, even though "[i]ndemnification against conduct which is criminal under state or federal statutes may be particularly sensitive...."\(^{133}\) All in all, adoption of the 1986 Revised Model Nonprofit Corporation Act would make the distinction between profit and nonprofit purposes and operations almost impossible to draw even in many cases of outrageous conduct.

VIII. CONCLUSION

The present state of the law, concerning mixtures may be summed up in the statement of J.K. Notz, Jr., Subcommittee Chairman, Illinois Not-for-Profit Act Revision Subcommittee: "Presence or absence of equity shares is the single clear feature distinguishing a business corporation from a not-for-profit corporation."

\(^{127}\) Id. at § 8.13.

\(^{128}\) Id. at § 8.13(c).

\(^{129}\) Id. at § 8.30.

\(^{130}\) Id. at § 8.30 comment 3.

\(^{131}\) Id. at § 8.31.

\(^{132}\) Id. at § 8.45-58.

\(^{133}\) Id. at Introductory Comment 2.
Mixture of profit and nonprofit corporate purposes and operations, both ways, is now general practice. Yet there are few who seriously argue that there ought not be distinctions between nonprofit and profit-seeking organizations. If nothing else, the privileges granted by the law to altruistic (pro bono publico) purposes should not be granted equally to profit-seeking (selfish purposes). But the modern corporation statutes have blurred the distinction almost to the point of obliteration.

If such obliteration is the new public policy, that policy should be clearly stated by legislatures. If a distinction and the privileges accompanying it is to be preserved, then our codes need prompt and thorough reexamination and revision. It is for the legislatures to declare what our public policy is, and should be, and for their own or the state bar associations' drafting committees to help to effectuate it by proposing revisions to current statutes.

There is growing evidence that balancing and counterbalancing forces and attitudes are increasingly pressing each other regarding mixtures of profit and nonprofit purposes and operations. Which views will dominate is still uncertain at the time of this writing. But recognition of the existence of a problem is the first step toward its solution.

The advantages of "charity" classification for some business corporation operations, as usual, is most readily apparent in its tax-exemption advantages. But the dangers and limitations of such classifications are also becoming more apparent. Limitations are growing as the IRS continues to elaborate its control systems over both business and nonprofit organizations' utilizations of the tax laws. Congress will soon tell the IRS to be less tolerant of the use of profit-seeking operations by nonprofit organizations than it has been recently.

135. See White, Consequences of Corporate Giving, 126 Tr. & Est. 35 (Aug. 1987).
The dangers of commercializing tax exemptions now are widely recognized. The practice is being challenged. The dangers of unfair competition between tax-exempt and commercial entities have been noted, for example, in regard to the taxable or non-taxable aspects of "unrelated advertising income" of the organization's periodicals. Increasingly serious attempts to regulate (e.g., license) the business of fund raising companies and individual solicitors is a parallel and growing tendency in many states, such as Florida and Virginia.

Congress is developing stricter rules for mixtures of profit and nonprofit enterprise. Federal proposals made in late 1987 dealt with tax-exempt partner-income divisions, exemption of charitable gift annuities in commercial insurance policies, athletic-scholarship donor benefits, excessive political lobbying by nonprofit agencies, reporting rules, sharing of personnel and assets, and more. Unbridled mixtures of profit and nonprofit operations soon will be rare.

America's nonprofit organizations long have been, and are, the finest flower of our democracy. They have been favored by the law because of that appraisal. Their immense value to our society ought not to be allowed to be eaten away by misguided or hypocritical abuses. The distinction between profit and nonprofit corporate purposes and operations ought to be preserved.

The hodge-podge development of nonprofit organization law, and its hodge-podge nature today, are evident in almost every aspect of that law, but nowhere more strikingly than in the "philosophy" and "regulation" of mixtures of nonprofit and profit corporation purposes and operations. That piecemeal, almost chaotic, state of the law is in harsh contrast to the highly privileged and respected status of nonprofit organizations. Clearly, such

unique legal and social status ought not to be left so vulnerable to abuse and perversion. Charitable, religious, and educational organizations and operations, above all, should not be left so easily open to misuse by amoral or immoral entrepreneurs.

The fact is that American legislatures have been remiss in their handling of this important facet of our society. A new and thoughtful approach to nonprofit organizations and operations law is long past due. There is nothing inherently wrong in the combination of profit and nonprofit purposes and operations. But to leave such matters to hit-or-miss, patchwork regulation, while continuing the legal privileges of both, is an invitation to abuses of those privileges.
I. INTRODUCTION

With the publication of the Revised Model Nonprofit Corporation Act in 1988, the most extensive project ever undertaken with respect to nonprofit organizations will have been completed. A project of the Section of Corporation, Banking, and Business Law of the American Bar Association,1 the revision of the Model Non-Profit Corporation Act consumed a decade of work (and thousands of hours of nonchargeable time) by the members of a subcommittee of the Committee on Nonprofit Corporations2 of that section. The result of these efforts was a complete revision of earlier model acts, taking into account the developments in the area of nonprofit law and of corporation law which had occurred since their promulgation.

The original Model Non-profit Corporation Act3 was approved by the Committee on Corporate Laws of the Section of Corporation, Banking, and Business Law of the American Bar Association in 1952. It was patterned on the Model Business Corporation...
The Act of 1950. The 1952 Act, and the later amended versions, were to serve as the model for much of the state legislation on nonprofit corporations which was to be passed during the succeeding fifteen years, in much the same way that the Model Business Corporation Act was to serve as the model for much of the corporation legislation which was enacted during the 1950s and 1960s. Revisions to the 1952 Act took place in 1957 and in 1964, but little further attention was given to it until the project described in this Article began in the late 1970s. The result was a completely new model statute differing in both approach and completeness from the earlier versions.

It is the purpose of this Article to describe the Revised Model Nonprofit Corporation Act project including the persons who contributed to it, the procedures adopted for its promulgation and the major features of the Revised Act which resulted. Section II will describe the history and personnel of the Revised Act project; Section III will describe the process of revision; Section IV will discuss the major areas of controversy with respect to the Revised Act; and Section V will look at the major features of the Revised Act.

II. HISTORY AND PERSONNEL OF THE REVISED MODEL NONPROFIT CORPORATION ACT PROJECT

The very nature of federalism is such that although it allows for diversity among the sovereign states, these states also share

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4. In the Foreward to the 1952 Act the Committee stated: "It is a companion to the Model Business Corporation Act prepared by the Committee. In organization, style and procedures, the Model Non-Profit Corporation Act follows the Model Business Corporation Act as closely as the subject matter permits."

5. The style of the title of the Act later was changed from Model Non-Profit Corporation Act to Model Nonprofit Corporation Act.

6. In the Preface to the 1964 Edition the Committee lists the following as having adopted the Model Non-Profit Corporation Act in whole or in part: Wisconsin, Alabama, North Carolina, Virginia, Nebraska, North Dakota, Oregon, Texas, and the District of Columbia.

Other states listing the Model Act as the basis of the state enactment include: Arizona, Alaska, Iowa, Hawaii, and Montana.

7. MODEL NON-PROFIT CORP. ACT (1957) [hereinafter 1957 ACT].

8. MODEL NONPROFIT CORP. ACT (1964) [hereinafter 1964 ACT].

9. In 1979 the Committee on Nonprofit Corporations published for Comment a proposed revision of § 5A of the 1964 ACT to require private corporations which are foundations to comply with I.R.C. § 508(e). See Changes in the Model Nonprofit Corporation Act Affecting Private Foundations, 35 BUS. LAW. 295 (1979). No further piecemeal efforts to revise the 1964 ACT were made as the total revision was then in process.

10. A major improvement in the Revised Act is the inclusion of Official Comments which had not been a feature of the earlier Acts.
many common needs with respect to legislation. These common needs are recognized by myriad attempts to provide pattern statutes for the various jurisdictions.\textsuperscript{11} These include the efforts of the American Law Institute,\textsuperscript{12} the Commissioners on Uniform Laws,\textsuperscript{13} and other organizations as well as the American Bar Association. The American Bar Association's involvement in the codification of state law through model act projects began with a draft of a Model Business Corporation Act in 1943.\textsuperscript{14} The procedure developed at that time continues to the present with some variations. It is completely controlled by the Section and the preparation of the statute is generally delegated to a committee or subcommittee of the Section. Generally, funding for the project is provided by the Section and by the committee members' voluntary contributions of both time and expenses.

With the exception of the minor revisions to the Model Nonprofit Corporation Act made in 1957 and 1964, nonprofit corporations suffered from neglect by the Committee on Corporate Laws.\textsuperscript{15} Until the late 1970s, the Committee on Nonprofit Corporations also made little effort to effect statutory reform.\textsuperscript{16} Amendments to state nonprofit corporation laws or new enactments during that period were affected much more by revisions to the Model Business Corporation Act and resulting changes in state business corporation law (frequently with mirror image revisions to the state's nonprofit corporation law) than by any activities with respect to the Model Nonprofit Corporation Act.

\begin{footnotesize}
\begin{enumerate}
\item See 1952 ACT, supra note 3, Forward, where the Committee states: General statutes relating to non-profit corporations now exist in almost endless variety. Some are elaborately designed as to scope, administration and regulation; others consist of a mere paragraph or so, wholly devoid of administrative and procedural guidance; while others are interwoven with business corporations in an over-all statute. This lack of uniformity or systematic approach to an important field of statutory law is probably attributable more to inattention than to the inherent difficulties of drafting a suitable general statute. The Committee believes that a very useful purpose is served by supplying to the states a model draft of such a general statute.
\item See, e.g., UNIFORM COMMERCIAL CODE.
\item See, e.g., UNIFORM PARTNERSHIP ACT, 6 U.L.A. 5 (1969), (Commissioners' Prefatory Note, 1914).
\item MODEL BUSINESS CORP. ACT (Prelim. Draft 1943).
\item See Oleck, Mixtures of Profit and Nonprofit Corporation Purposes and Operations, 16 N. KY. L. REV. 225, 238 (1989). Professor Oleck maintains that a committee appointed by a section devoted to business law is the “wrong committee” to draft a nonprofit corporation statute.
\item See Committee on Nonprofit Corporations, supra note 9.
\end{enumerate}
\end{footnotesize}
Since the Model Business Corporation Act had formed the pattern for the Model Non-profit Corporation Act, this did not constitute an unusual phenomenon. In any event, the Model Non-profit Corporation Act had failed to keep up with the times.

Between 1964 and 1978, in addition to a general wave of business corporation law reform, there were several important developments related to nonprofit corporations. Nonprofit corporations increased in number, in importance, and in visibility during this period. Tax laws relating to nonprofit corporations were revised extensively and became the major source of regulation.\footnote{17} The tax law requirements dictated certain state law provisions which were necessary for compliance.\footnote{18}

In 1967, New York adopted a Not-for-Profit Corporation Law which departed dramatically from other state statutes applicable to nonprofit corporations.\footnote{19} In the 1970s, legislative activities with respect to nonprofit corporations increased considerably in a number of states. California adopted a nonprofit corporation statute which introduced new approaches to this area of law.\footnote{20} Other states also embarked on projects to consider new nonprofit corporation legislation.\footnote{21} At the same time, board members of nonprofit corporations became concerned about potential liability, and the public reacted to highly publicized scandals affecting charities.\footnote{22} Previous model acts had provided little in the way of standards of conduct or methods of achieving a degree of accountability by the managers in such corporations. These factors finally led the Committee on Nonprofit Corporations to embark on a major revision of the 1952 Model Non-profit Corporation Act.

\footnote{17}{I.R.C. §§ 501-527; 4940-4947 (West Supp. 1988).}
\footnote{18}{See Committee on Nonprofit Corporations, supra note 9.}
\footnote{19}{N.Y. NOT-FOR-PROFIT CORP. LAW §§ 101-1411 (McKinney 1988).}
\footnote{21}{These, \textit{inter alia}, included: Michigan, New Jersey, and Pennsylvania. See also Fessler, Codification and the Nonprofit Corporation: The Philosophical Choices, Pragmatic Problems, and Drafting Difficulties Encountered in the Formulation of a New Alaska Code, 33 MERCER L. REV. 543 (1982).}
\footnote{22}{See Moody, State Statutes Governing Directors of Charitable Corporations, 18 U.S.F. L. REV. 749 (1984).}
The Revised Act was to supersede the previous Model Nonprofit Corporation Act and was to be managed by the Committee on Nonprofit Corporations rather than the Committee on Corporate Laws. The Section also approved the appropriation of funds to provide expenses for a reporter for the project. Michael Hone, Professor of Law at the University of San Francisco Law School, was chosen as the Reporter. He had previously served in a similar position with respect to the California Nonprofit Corporation Act. Although the Committee on Nonprofit Corporations was the original drafting committee, as the interest in nonprofit corporations increased among section members, the Committee was divided into subcommittees, one of which was the Subcommittee on the Model Nonprofit Corporation Act. The Subcommittee eventually took full responsibility for drafting the Revised Act. Frank Morris, Jr., who was the Chairman of the Committee on Nonprofit Corporations, continued as the Chairman of the Model Act Subcommittee until he became chairman of the Section of Corporation, Banking, and Business Law in 1985. At that time, the author of this Article became the chair of the Subcommittee and completed the work on the Model Act. Lawrence Berger was the Secretary of the Nonprofit Corporations Committee and Ira Elman, Professor of Law at Arizona State University, who had also been involved with the California project, was appointed Secretary to the Drafting Committee. Other members of the Drafting Committee were practitioners, academicians, and government officials, all of whom had substantial experience and expertise in nonprofit corporations, and several of whom had been involved in drafting state nonprofit corporation laws. Membership on the Drafting Committee was frozen for

23. Partner; Porter, Wright, Morris and Arthur, Columbus, Ohio.
25. The other members who were active throughout the project: William A. Boylan, Partner in the firm of Gould and Wilkie, New York, New York; John H. Clymer, Partner in the firm of Hutchins and Wheeler, Boston, Mass; Julia Donovan Darlow, Partner in the firm of Dickinson, Wright, Moon, Van Dusen and Freeman, Detroit, Michigan; Robert L. Knauss, Dean and Distinguished University Professor, University of Houston, Houston, Texas; Daniel L. Kurtz, Partner in the firm of Lankenau, Kovner and Bickford, New York, New York and former Assistant Attorney General-in-Charge of the Charities Bureau in the New York State Attorney General’s Office; Robert S. Lesher, East Aurora, New York; Jesse Margolin, Partner in the firm of Becker, Ross, Stone, DeStefano and Klein, New York, New York; John H. Myers, Partner in the firm of Williams, Myers and Quiggle, Washington, D.C.; Paul F. Perkins, Jr., Partner in the firm of Ropes and Gray, Boston,
the duration of the project in order to maintain consistency of approach.

Shortly after the initiation of the project, the Committee on Corporate Laws embarked on the major revision of the Model Business Corporation Act which resulted in the Revised Model Business Corporation Act (RMBCA). The Drafting Committee chose to maintain a close liaison with the development of the Revised Model Business Corporation Act and the Chairman attended the meetings of the Committee on Corporate Law throughout the revision process.

III. THE PROCESS OF REVISION

The Drafting Committee met four to five times a year for several days at a time during a period of eight years. Meetings were devoted not only to the consideration of policy but to the actual drafting of the text of the Act and the working of the official comments, working from drafts furnished to the members by the Reporter. Early concerns related to: the effect of a new statute on existing nonprofit corporations, the definition of entities which would be eligible to be considered as nonprofit and the problems of corporations organized for religious purposes. Some of these issues were settled early in the discussions, but others continued to plague the Committee to the end of its deliberations.

Several decisions were initially made with respect to the revision. It was determined that the Revised Act would parallel the Revised Model Business Corporation Act except when the nature of nonprofit corporations or policy reasons applicable to nonprofit corporations dictated otherwise. The Revised Act was to be a single integrated statute designed to apply to all nonprofit organizations incorporated in the jurisdiction. The idea of a series

Mass; Milton Small was a member of the Committee until his death in 1984, he resided in New York; Daniel R. Swett, Partner in the firm of Sonnenschein, Carlin, Nath and Rosenthal, Chicago, Illinois; Allen M. Terrell, Jr., Partner in the firm of Richards, Layton and Finger, P.A., Wilmington, Delaware; and J. Warren Wood III, Special Counsel to Smith, Lambert, Hicks and Miller, Princeton, New Jersey and General Counsel for The Robert Wood Johnson Foundation.

26. See Minutes of the Meeting of the Committee on Nonprofit Corporations (Nov. 9-10, 1979).

27. See Minutes of the Meeting of the Committee on Nonprofit Corporations (Sept. 26, 1980).
of separate acts applicable to specified categories or organizations was rejected. The Revised Act was to attempt to provide a framework in which an organization could be structured by its creators to implement their goals and allow them flexibility in operation and design. One of the major reasons for the revision was to make sure that the Revised Act included official comments, the lack of which had been a major omission from prior model nonprofit corporation acts.

The major areas of controversy among Subcommittee members during the Drafting Committee's discussions related to ultra vires, conflicts of interest, voting rights, indemnification, and distributions. The procedure of the Drafting Committee was to determine such matters by majority vote of the Committee after frequently lengthy discussion. It was not unusual for the subject matter to be revisited in light of a new development or new insight with a reversal of the former decision.

The provision on ultra vires contained in the Act attempts to eliminate the doctrine. The validity of corporate action under the provision can only be challenged by the attorney general, a director, or by a member in a derivative proceeding where a third party has not acquired rights. The provision is quite different from the corresponding provision in the Revised Model Business Corporation Act which does not go so far in protecting third parties. The section was finally approved by a close vote, although many members expressed considerable concern about the ability of members or trustees to enjoin transactions involving the sale of unique tangible property such as art objects. Some felt that the approach taken by the Model Business Corporation Act, which is not as protective of third parties, would be appropriate. It ultimately was decided to retain the Reporter's language with a provision covering assets subject to a charitable trust and transactions involving unique property.

28. See Minutes of the Meeting of the Committee on Nonprofit Corporations (Nov. 9-10, 1979).
29. REvised Model Nonprofit Corporation Act § 3.04 comment (1987) [hereinafter Revised Act].
30. Id. at § 3.04(b) and (c).
32. See Minutes of the Meeting of the Committee on Nonprofit Corporations (Sept. 26, 1980).
33. Revised Act, supra note 29, at § 3.04 comment.
The Drafting Committee found the sections on proxies and cumulative voting difficult in the context of nonprofit organizations which commonly do not employ either of these.\textsuperscript{34} It was finally resolved that the section would contain a presumption in favor of proxies which could be eliminated in the articles of incorporation or bylaws.\textsuperscript{35} The opposite result, \textit{i.e.}, a presumption against the device, was achieved with respect to cumulative voting for directors. Although few members of the Committee had ever experienced cumulative voting in nonprofit organizations, it was determined that such a provision could cause little mischief and might be useful to certain types of organizations.\textsuperscript{36}

It was recognized that the provisions covering indemnification in prior model acts was inadequate. The general approach was to accept the RMBCA provision, but questions did arise about the application to nonprofit corporations, particularly charities. Differences of opinion also arose concerning indemnification related to issues of inquiry and criminal acts. Some felt that one should be particularly sensitive to indemnification against criminal conduct in a nonprofit corporation because it might be viewed as frustrating public policy, while others cited instances where criminal sanctions may be imposed where the conduct was taken in the best interests of the corporation, not knowing it to be unlawful.\textsuperscript{37}

The conflicts of interest section provided some of the most lively discussions during Committee deliberations. Some argued that the rule adopted in the Revised Model Business Corporation Act should be adopted for all nonprofit corporations as well. Others believed that self-dealing transactions should be entirely prohibited in nonprofit organizations.\textsuperscript{38}

The Committee was often split between the need for accountability to the public and the fact that many nonprofit corporations are small, operate informally, and have little in the way of legal or accounting advice. Throughout, there was an attempt to find some way of accommodating these diverse interests.

\textsuperscript{34} Minutes of the Meeting of the Committee on Nonprofit Corporations (March 26, 1981 and June 28, 1981).

\textsuperscript{35} \textsc{Revised Act}, \emph{supra} note 29, at § 7.24.

\textsuperscript{36} Id. at § 7.25; \textit{see also} Minutes of the Meeting of the Committee on Nonprofit Corporations (June 28, 1981).

\textsuperscript{37} \textsc{Revised Act}, \emph{supra} note 29, at § 8.51.

\textsuperscript{38} \textsc{RmBCA}, \emph{supra} note 31, at § 8.31; \textit{see also} Minutes of the Meeting of the Model Act Subcommittee (Oct. 7-8, 1983).
In the minutes of the meeting of September 25, 1981, a schedule was distributed contemplating the completion of the Model Act in June, 1982. That schedule turned out to be overly optimistic. The complexity of the statute, the diversity of opinion, and the attempts to follow the Revised Model Business Corporation Act required a much longer period of work than had ever been contemplated.

By 1986, the Drafting Committee had completed an exposure draft.\textsuperscript{39} Paralleling the procedure used by the Committee on Corporate Laws for the Revised Model Business Corporation Act, the Committee circulated the Exposure Draft widely for comment among the members of the nonprofit community including bar associations, attorney generals, the Internal Revenue Service, law professors, and counsel for nonprofit organizations. Although the comments received were not numerous, they were extremely influential in arriving at the ultimate text.\textsuperscript{40} These comments served to focus the central discussion with respect to the final draft.

IV. MAJOR AREAS OF CONTROVERSY DURING THE COMMENT PERIOD

The bulk of the comments directed to the Exposure Draft were directed to one or more major areas of controversy. These were the failure to provide a separate category for religious corporations; the failure to place limitations on the purposes for which

\textsuperscript{39} 1986 REVISED MODEL NONPROFIT CORPORATION ACT (EXPOSURE DRAFT March 1986) [hereinafter EXPOSURE DRAFT].

\textsuperscript{40} See Minutes of the Meeting of the Model Act Subcommittee (Dec. 8-9, 1986).

Among the comments received were those of John K. Notz, Jr., Chair of the Illinois Not-For-Profit Advisory Subcommittee and Partner in the firm of Gardner, Carton, and Douglas, Chicago, Illinois; Stephen W. Reed, Partner in the firm of Brown, Reed, and Gibson, Pasadena, Ca.; David J. Conroy a retired corporate attorney who has spent time as director and student of nonprofit corporations; Professor Howard Oleck, author of Nonprofit Corporations, Organizations and Associations (1980); Kevin A. Suffern, Director, Division of Public Charities Public Protection Bureau, Boston, Mass; Michael L. Sullivan, Partner in the firm of Baird, Holm, McEachen, Pedersen, Hamann and Strasheim, Omaha, Nebraska; Cynthia L. Sanders, Partner in the firm of Baird, Holm, McEachen, Pedersen, Hamann and Strasheim, Omaha, Nebraska; E.D. Coleman, Director Exempt Organizations Technical Division, Internal Revenue Service, Washington, D.C.; John C. Stophel, Chairman, and Wendell R. Bird, Member, Subcommittee on Religious Organizations of the Committee on Exempt Organizations, American Bar Association Section of Taxation. Lisa Runquist, Chair of the Subcommittee on Religious Organizations, made a substantial contribution to the ultimate revisions relative to "religions" corporations.
a corporation could be formed; the failure to include a provision permitting the corporation to include in its articles of incorporation a provision limiting or eliminating the liability of a director for monetary damages to the corporation or to a third party; the attempt to eliminate the doctrine that corporations organized for charitable purposes hold their assets in trust for the stated purposes at the time of the acquisition of such assets and that the directors are trustees with respect thereto.\(^{41}\)

By far, the largest number of comments were directed to the problem of religious corporations. In the Exposure Draft all nonprofit corporations were to be classified as either *public benefit* or *mutual benefit* corporations. The Drafting Committee had determined not to include a separate category for *religious* corporations although the Reporter had urged it to do so.\(^{42}\) The Exposure Draft provisions contemplated that corporations formed for religious purposes, depending upon the circumstances, could be formed as either public benefit or mutual benefit corporations. As stated in the official comment, the Drafting Committee believed,

[...]this approach allows religious corporations to be formed and to operate under the Model Act on the same basis as other nonprofit corporations except where there is a constitutional or policy reason for treating them differently. Religious corporations, their directors and members, are entitled to the same benefits as the Model Act provides to other nonprofit corporations.\(^{43}\)

The Exposure Draft did contain a chapter with respect to religious corporations. It contained only two sections: one providing that the Act applies to religious corporations\(^{44}\) and the other\(^{45}\) expressly excepting religious corporations from certain provisions, including: the procedure on termination;\(^{46}\) notice to the attorney general;\(^{47}\) provisions with respect to a financially disinterested majority of the board;\(^{48}\) loans or guarantees;\(^{49}\) and

\(^{42}\) See Minutes of the Meeting of the Committee on Nonprofit Corporations (Nov. 9-10, 1979).
\(^{43}\) EXPOSURE DRAFT, supra note 39, at § 18.01 Official Comment.
\(^{44}\) Id. at § 18.01.
\(^{45}\) Id. at § 18.02.
\(^{46}\) Id. at § 6.21.
\(^{47}\) Id. at § 1.70.
\(^{48}\) Id. at § 8.13.
\(^{49}\) Id. at § 8.32.
receivership or custodianship.\textsuperscript{50} It further provided:

If religious doctrine governing the affairs of a religious corporation is inconsistent with the provisions of this Act on the same subject, the religious doctrine shall control to the extent and only to the extent, required by the Constitution of the United States or the constitution of this state or both.\textsuperscript{51}

The constant theme of the comments, however, was that the Drafting Committee's approach to religious corporations had not gone far enough in differentiating religious corporations from mutual benefit and public benefit corporations as contemplated by the Act. Several concerns were expressed. One stated that the requirements for qualifying under I.R.C. § 501(c)(3) dictated that a religious corporation would necessarily have to qualify as a public benefit corporation under the Model Act, eventhough it had much in common with mutual benefit corporations. It was thought that, although tax treatment did not dictate that there be a special category for religious corporations, certain features of the unique tax treatment afforded to religious corporations made it expedient to treat them as a separate category.\textsuperscript{52} Others thought that present state laws allowing for religious corporations as well as the constitutional status of religious corporations very nearly mandated a religious corporation category.\textsuperscript{53} Additional problems thought to follow from the lack of a religious corporation category included the possibility that limiting religious corporations to those "organized and operating primarily or exclusively for religious purposes" in accordance with definitions in the Exposure Draft in order to qualify for the exclusions in the chapter on religious corporations would have the practical effect of inviting state officials to deny that corporations carrying on social service activities were religious corporations.\textsuperscript{54} It was also thought that the lack of a religious corporation category would inevitably encourage religious organizations to form as a trust rather than as a nonprofit corporation.\textsuperscript{55}

Another area of criticism during the comment period was the absence of a requirement for the statement of a purpose in the

\textsuperscript{50} Id. at § 14.32.
\textsuperscript{51} Id. at § 18.02(b).
\textsuperscript{52} See Letter from John C. Stephel to Professor Lizabeth A. Moody (Nov. 22, 1986).
\textsuperscript{53} See Letter from Stephen W. Reed to Michael C. Kone [sic], (July 7, 1986).
\textsuperscript{54} Id.
\textsuperscript{55} See supra note 52.
articles of incorporation of a nonprofit corporation under the Revised Act. Under the provisions of the Revised Act, where no purpose is stated, the corporation has the "purpose of engaging in any lawful activity unless a more limited purpose is set forth in the articles of incorporation." The provisions in the Exposure Draft did not attempt to define a nonprofit corporation. This is in contradistinction to the 1964 version of the Model Nonprofit Corporation Act which defined a "nonprofit corporation" as "a corporation no part of the income or profit of which is distributable to its members, directors or officers." Many state nonprofit corporation statutes also contain explicit definitions of a nonprofit corporation. Commentators were uncomfortable with the absence of such a definition; some indicating that it invited entrepreneurial activities to masquerade under the nonprofit umbrella, leaving the Internal Revenue Code as the only regulator of nonprofit purpose for such corporations. The Drafting Committee, on the other hand, took the position that provisions of the Revised Act such as the election between public benefit and mutual benefit status, the limitations on distributions to members or controlling persons in a public benefit corporation, restrictions on unreasonable compensation, and the regulatory powers of the attorney general provided ample regulation to insure nonprofit operation. In addition, the Drafting Committee

56. Revised Act, supra note 29, at § 3.01(a).
57. 1964 Act, supra note 8, at § 2(c). A similar definition is found in the 1952 Act, supra note 3, at § 2(c) and in the 1957 Act, supra note 7, at § 2(c). The 1964 Act contained alternative provisions with respect to purposes. One provided:

Corporations may be organized under this Act for any lawful purpose or purposes, including, without being limited to, any one or more of the following purposes: charitable; benevolent; eleemosynary; educational; civic; patriotic; political; religious; social; fraternal; literary; cultural; athletic; scientific; agricultural; horticultural; animal husbandry; and professional, commercial, industrial or trade association; but labor unions, cooperative organizations, and organizations subject to any of the provisions of the insurance law of this State may not be organized under this Act. 1964 Act at § 4.
The other provided:

Corporations may be organized under this Act for any lawful purpose or purposes except . . . [list, if any], 1964 Act at § 4 (alternative provision).
59. See Oleck, supra note 15.
60. Revised Act, supra note 29, at § 3.01 comment.
61. Id.
62. Id.
63. Id.
had concluded that the ability of any corporation to limit the corporate purposes in its articles of incorporation provided ample protection and allowed the corporation to obtain tax exempt status and attract specific contributions. 64 Other protections are provided by state statutes which prohibit any organization from incorporating as a nonprofit corporation for particular purposes or only after receiving the consent of a regulatory body. 65

Another area, about which there was concern and disagreement, was the express authority of the attorney general to regulate the nonprofit corporation and particularly the public benefit corporation. Members of religious corporations were particularly concerned with the provisions concerning notice to the attorney general on dissolution and the requirements of a distribution to a public benefit corporation. One commentator stated:

Section 14.30 of the Model Act creates an interesting problem where a religious nonprofits are involved. As an example, how is the attorney general to determine that the corporation has continued to exceed or abuse the authority conferred on it by law.... Does this create a further invitation to the attorney general to invade areas which are peculiarly religious in nature and therefore arguably protected by the constitution? 66

Another commentator, however, suggested that during the course of his service as the chairman of a state committee with respect to the drafting of a not-for-profit corporation act he had developed a bias in favor of deferring to the attorney general of matters other than the most "ministerial." 67

The Drafting Committee had been virtually unanimous in rejecting the doctrine that corporations formed for charitable purposes hold their assets in trust for the stated purposes at the time of the acquisition of the respective assets and that the directors are trustees with respect thereto. It was the express purpose of the drafters to eliminate the application of this doc-

64. Although the Revised Act does not automatically allow public benefit corporations to be classified as §501(c)(3) organizations, it does provide a framework whereby the organization may include all provisions necessary to come within the I.R.C. exemptions by careful drafting.
65. N.Y. NOT-FOR-PROFIT CORP. LAW § 404 (McKinney 1988).
66. See supra note 53.
67. Letter from John K. Notz, Jr. to Lizabeth A. Moody and Michael Hone (July 29, 1986).
trine to nonprofit corporations formed under the Revised Act. 68 This view was opposed in that it resulted in a lower standard of care being applied to charitable assets held in corporate form than those held in trust form. Without this doctrine, a corporation can amend the articles of incorporation to state new purposes or to merge into another public benefit corporation. One comment stated: "Those who give to a home for abandoned animals do not anticipate a future board amending the charity's purpose to become research vivisectionists." 69 The writer of the comment further argued that if the reservations of power to amend or repeal allowed the legislature to abrogate trust rights or other vested rights the result would be the impairment of contracts under the theory of Trustees of Dartmouth College v. Woodward, 70 due process, and separation of powers. 71

The matter of the standard of conduct for directors attracted substantial comment. The publication of the Exposure Draft coincided with the liability insurance crisis which spawned a number of statutes attempting to protect officers and directors against unwarranted liabilities. About the same time, Delaware enacted a provision allowing a corporation to include a provision in its articles of incorporation limiting or eliminating the liability of a director for monetary damages to the corporation or to a third party. 72 No such provision had been included in or considered with respect to the Exposure Draft. The drafters had provided that the standard of conduct for directors of business corporations was to be the appropriate standard of conduct for the directors of a nonprofit corporation. 73 As other states followed Delaware, however, it became apparent that there would be a demand for such provisions in any state's subsequently adopted version of the Revised Act. 74

All comments received by the Committee were carefully considered. The knowledge and expertise represented by those who

68. Minutes of the Committee on Nonprofit Corporations (Sept. 26, 1980).
70. 17 U.S. (4 Wheat.) 518 (1819).
71. See supra note 69.
73. RMBCA, supra note 31, at § 8.30.
74. An additional provision similar to that adopted by many jurisdictions exempting volunteers from liability in certain instances was also discussed. It was determined to be inappropriate in a corporation statute. See Minutes of the meeting of the Model Act Subcommittee (Oct. 10, 1986).
had made comments were such that they could not be easily ignored. The comments also represented the kind of objections that the Revised Act would likely meet when presented in the respective state legislatures for adoption. Although there was considerable reluctance to do so, the weight of the comments persuaded the Drafting Committee to include a category of religious organizations in the final draft. The other significant change precipitated by the comments was to include an optional section on the Delaware model allowing the articles of incorporation to contain a provision "eliminating or limiting the personal liability of a director to the corporation or members of the corporation for monetary damages for breach of any such director's duties to the corporation and its members." The Drafting Committee, however, held firm on the broad powers placed on the attorney general to regulate public benefit corporations and on the elimination of the trust doctrine.

V. MAJOR FEATURES OF THE FINAL VERSION OF THE REVISED MODEL NONPROFIT CORPORATION ACT

The final version of the Revised Act was approved at a meeting of the Drafting Committee in July of 1987. While the earlier model nonprofit corporation statutes were designed to be primarily enabling, i.e., to give the nonprofit community an opportunity to obtain limited liability through a general incorporation statute, the Revised Act is both an enabling and a regulatory statute. It emerged as something of a hybrid between the California Act and the Revised Model Business Corporation Act. Although the Revised Act was true to the initial policy decision that it would parallel the Revised Model Business Corporation Act except where the nature of nonprofit corporations or policy reasons unique to them dictated otherwise, there were many areas where the exception applied rather than the rule. It may be said that the Revised Act as a whole more nearly resembles the California Nonprofit Corporation Act than the Revised Model Business Corporation Act.

The Revised Act closely follows the Model Business Corporation Act with respect to ministerial provisions such as filings

75. See Minutes of the Meeting of the Model Act Subcommittee (Feb. 27-28, 1987).
76. Id. See also REVISED ACT, supra note 29, at §§ 2.02(b)(5) and 8.30(d) (alternative provisions).
with and the power of the Secretary of State, names, office, and agent.\textsuperscript{77} This result was imminently practical inasmuch as any jurisdiction adopting both the Revised Model Business Corporation Act and the Revised Model Nonprofit Corporation Act would be able to administer them as a unified whole.

The Revised Act adopts the California approach in that it accepted the classifications used by California to wit: public benefit,\textsuperscript{78} mutual benefit,\textsuperscript{79} and religious corporations.\textsuperscript{80} It also incorporates much of the regulatory aspects of the California statute with respect to the powers of enforcement entrusted to the Attorney General.\textsuperscript{81}

Business corporations, whether Joe's Grocery Store or U.S.X. Corporation, generally are organized on the common principle of making a profit for their shareholders. The vast diversity of nonprofit corporations makes it difficult to find a similar commonality which will apply in each instance. The major features contained in the final form of the Revised Act included: (1) using as an organizing principle the classification of all organizations into three major categories: public benefit corporations, mutual benefit corporations, and religious corporations; (2) the absence of a limitation on the purposes for which a corporation could be formed; (3) extensive provisions regulating both the definition and the rights of members; (4) the adoption of extensive provisions regulating and defining the rights, duties, and obligations of directors; (5) provisions regarding indemnification; (6) provisions for dissolution and merger; (7) record keeping requirements; and (8) broad powers over public benefit corporations vested in the attorney general.

A. Public Benefit, Mutual Benefit and Religious Corporations

Although the Drafting Committee, at an early point in its deliberations, rejected the idea of using a series of acts, the final version classifies nonprofit organizations into three major categories. Many provisions of the Act are common to all three

\textsuperscript{77} \textit{Revised Act, supra} note 29, at §§ 1.20-1.30, 4.01-4.03, 5.01-5.04.


\textsuperscript{81} \textit{See, e.g., Cal. Corp. Code} § 5250 (West Supp. 1988). This section allows the Attorney General to investigate or to institute proceedings against public benefit corporations.
categories; however, at significant points in the Act the categories receive different treatment. For new corporations, the particular category is self-determined by the incorporator. *Public benefit* corporations are corporations incorporated under the Revised Act and declared to be "public benefit" corporations.82 *Religious corporations* are corporations incorporated under the Revised Act and declared to be "religious" corporations.83 *Mutual benefit* corporations are corporations incorporated under the Revised Act and declared to be "mutual benefit" corporations.84 On the other hand, corporations in existence on the effective date of the Revised Act are classified on the basis of specific guidelines incorporated into the Revised Act: Corporations in existence on the effective date will be public benefit corporations if designated by statute as public benefit corporations or if organized for a public or charitable purpose and which upon dissolution must distribute its assets to the United States, a state or, a person recognized as exempt under section 501(c)(3) of the Internal Revenue Code.85 Religious corporations in existence on the effective date are those designated by statute as a religious corporation or organized primarily or exclusively for religious purposes.86 Mutual benefit corporations in existence on the effective date are those designated by the statute as a mutual benefit corporation or those which do not come within the definition of a public benefit corporation or a religious corporation.87 Thus, the catchall category for nonprofit organizations is that of mutual benefit corporation.

The major differences between the three categories of corporations under the Revised Act relate to the ability to make distributions to, or to repurchase memberships from, members or controlling persons; the differing standards for conflict of interest transactions; the procedure for indemnification; and the powers of supervision vested in the attorney general of the state of incorporation. With these exceptions all nonprofit organizations are treated alike under the statute.

82. *REVISED ACT*, supra note 29, at § 2.02(a)(2)(i).
83. *Id.* at § 2.02(a)(2)(iii).
84. *Id.* at § 2.02(a)(ii).
85. *Id.* at § 17.07(1), (3) and (4).
86. *Id.* at § 17.07(1)-(2).
87. *Id.* at § 17.07(1) and (5).
The latitude for distribution is a significant factor when choosing among classifications. All distributions by a nonprofit corporation are forbidden except in instances where they are expressly allowed. In permitting distributions, the 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. The result is that mutual benefit corporations may purchase memberships if the corporation is not insolvent or would not be rendered insolvent by the purchase; however, public benefit corporations may only transfer their assets to another public benefit corporation.

Conflict of interest provisions apply the business corporation rule to transactions between a director and a mutual benefit corporation, but such transactions between a director and a public benefit or religious corporations must have advance approval and meet a fairness test or be approved by a court or the attorney general. A director of a public benefit corporation may not be indemnified until the attorney general has been notified.

The categories of corporations also differ with respect to the powers of supervision vested in the attorney general of the state of incorporation with respect to such corporations. The attorney general must be notified after anyone commences a proceeding in the nature of a derivative suit with respect to a public benefit corporation. The attorney general must only be notified if such an action is commenced with respect to a mutual benefit corporation if it concerns assets held in trust. The attorney general may approve a conflict of interest transaction with respect to a public benefit corporation. Unless the attorney general is notified, a public benefit corporation may only merge with another public benefit or religious corporation or a foreign corporation which would qualify as a public benefit or religious corporation.

88. Id. at § 13.01.
89. Id. at § 13.02.
90. Id. at § 14.06.
91. Id. at § 8.31(c).
92. Id. at § 8.31(b).
93. Id. at § 8.55(d).
94. Id. at § 6.30(f).
95. Id.
96. Id. at § 8.31(b)(2).
97. Id. at §§ 11.01-11.02.
A public benefit corporation or a religious corporation must give written notice to the attorney general twenty days before it sells, leases, exchanges or otherwise disposes of all or substantially all of its property.\textsuperscript{98} Public benefit and religious corporations must give written notice to the attorney general if they intend to dissolve.\textsuperscript{99} Under the Revised Act, religious corporations, for the most part, are treated as public benefit corporations; however, they have much less regulation, in that the U.S. Constitution mandates that canon law shall apply to the internal operation of religious organizations.\textsuperscript{100}

\textbf{B. Corporate Purposes}

The Revised Act generally follows the Revised Model Business Corporation Act in placing no restrictions on the purposes for which a corporation may be organized.\textsuperscript{101} The Revised Act provides:

\begin{quote}
Every corporation incorporated under this act has the purpose of engaging in any lawful activity unless a more limited purpose is set forth in the articles of incorporation.\textsuperscript{102}
\end{quote}

The lack of a corporate purpose does not mean that there are no limitations upon the activities of the corporation. As stated in an official comment to the Revised Act:

\begin{quote}
The failure to set forth an explicit limitation on a nonprofit organization's activities does not mean that an enterprising entrepreneur can improperly and with impunity operate in the nonprofit form. In general, public benefit and religious corporations cannot make distributions to members or controlling persons ... unreasonable compensation cannot be paid to members or controlling persons
\end{quote}

\begin{footnotes}
\item[98.] Id. at § 12.02.
\item[99.] Id. at § 14.03.
\item[100.] See Ellman, \textit{Driven from the Tribunal: Judicial Resolution of Internal Church Disputes}, 69 CALIF. L. REV. 1878 (1981).
\item[101.] See supra note 56 and accompanying text. The problem of purposes was not one unique to the Drafting Committee of the Revised Act. In the Preface to the 1964 Act the Committee stated:

\begin{quote}
The most difficult decision of policy in drafting the Model Non-Profit Corporation Act is the determination of the purposes for which corporations may be organized under it. A majority of the Committee are of the opinion that the purposes should be limited to those which are not for pecuniary profit.... The committee feels it sufficient to call attention to these possibilities while restricting the Act to the basic provision of the Model form. 1964 ACT, supra note 8, at preface.
\end{quote}
\item[102.] REVISED ACT, supra note 29, at § 3.01.
\end{footnotes}
in addition, the attorney general has broad powers to ensure that a public benefit corporation is not operating for the private benefit of any individual. 103

Those organizing the corporation are free to impose any limitations which they choose on the use of the corporation's assets, the corporation's purposes or the operation of the corporation. In addition, the Revised Act gives corporations formed under it many express powers, including many powers which have been questioned in the past, such as the power to establish pension and benefit plans for its officers, directors, and employees; the power to carry on a business; the power to make donations; the power to issue guarantees; the power to lend money and invest and reinvest funds; the power to establish conditions for membership and to impose dues and assessments; and the power to enter into a partnership or a joint venture. 104 This nondefinition of purpose along with the self-declaration of classification allows the incorporator a broad range within which to work and accommodates the fact that nonprofit activities cover a broad universe.

C. Membership Provisions

In many of the state enactments governing nonprofit corporations, particularly those which mirror corresponding business corporation provisions, members are equated to shareholders and an attempt is made to simply substitute “member” in the corresponding “shareholder” provisions. 105 In nonprofit corporations, however, members generally relate to the organization by participation rather than by the financial interest generated by an investment. The Revised Act attempts to define “member” to take into account the governance functions fulfilled by members in nonprofit organizations. Calling some person or category of persons a “member” does not create them as such under the Revised Act. 106 Members are defined as persons who, “pursuant

103. Id. at § 3.01 comment (citations omitted).
104. Id. at § 3.02.
106. The term “members” is frequently used by nonprofit corporations who engage in public fund raising not to describe those who participate in governance but as a fund raising device whereby a “member” is anyone who donates a fixed amount. This can result in irresponsible management. The Revised Act seeks to avoid this result. See REVISED ACT, supra note 29, at § 1.40 comment 6 where it is stated:

If a person is called a member by a nonprofit corporation, but does not have the right to vote for directors, that person is not a member for the purposes of the Model Act.
to a provision of a corporation's articles or bylaws, have the right to vote for the election of a director or directors."\textsuperscript{107} A person is not a member by reason of any rights the person may have as a delegate; any rights the person may have to designate a director; or any right a person may have as a director of the corporation.\textsuperscript{108}

Membership rights are closely connected with the function of members of a nonprofit organization. More than any other part of the Revised Act, the provisions with respect to membership are enabling.\textsuperscript{109} A nonprofit corporation formed under the Act does not need to have members.\textsuperscript{110} It can be a totally trusted organization with self-perpetuating trustees. On the other hand, the provisions for membership allow the corporation, through its articles of incorporation and bylaws, to determine the numbers, classes, and voting rights of members.

A nonprofit corporation law can be helpful not only by enabling the organization to define and structure membership provisions which will support the mission of the organization but also by affording a legal structure for the enforcement of such rights through provisions governing voting and termination. The membership provisions of the Revised Act set up a series of norms. For example:

All members shall have the same rights and obligations with respect to voting, dissolution, redemption and transfer unless the articles and bylaws establish classes with different rights or obligations. All members shall have the same rights and obligations with respect to any other matters except as set forth in or authorized by the articles or bylaws.\textsuperscript{111}

The Revised Act for the most part establishes sufficient norms for members' meetings and voting so that an adequate set of bylaws could be organized by copying its provisions.\textsuperscript{112} Several matters which had proved to be difficult in the period between the promulgation of the 1964 Act and the Revised Act are settled

\begin{footnotes}
\item[107] Id. at § 1.40(21).
\item[108] Id.
\item[109] See generally id. at chs. 6 & 7.
\item[110] Id. at § 6.03.
\item[111] Id. at § 6.10.
\item[112] Corporations organized under the Revised Act are required to have bylaws. Id. at § 2.06.
\end{footnotes}
in the Revised Act. These include action by written consent,\footnote{113}{Id. at § 7.04.} proxy voting,\footnote{114}{Id. at § 7.24.} cumulative voting,\footnote{115}{Id. at § 7.25.} and voting by ballot.\footnote{116}{Id. at § 7.08.} The provisions for written consent depart substantially from those of the Revised Model Business Corporation Act and from provisions in state statutes which require unanimous consent.\footnote{117}{See, e.g., OHIO REV. CODE ANN. § 1702.25 (Baldwin 1982 & Supp. 1988).} Any action required or permitted to be approved by the members may be approved without a meeting of members if the action is approved by the written consent of at least eighty percent of the voting members.\footnote{118}{REVISED ACT, supra note 29, at § 7.04. This was a matter of considerable debate among the members of the Drafting Committee. See Minutes of the Meeting of the Nonprofit Corporation Committee (June 21-23, 1984).} If all of the members do not consent, written notice shall be given to those who have not signed such a consent.\footnote{119}{REVISED ACT, supra note 29, at § 7.04(d).}

Provisions which allow action to be taken by written ballot are probably more important to nonprofit corporations than many other rules governing voting. The Revised Act provides that any action which may be taken by the members may be taken without a meeting if the corporation delivers a written ballot to every member entitled to vote on the matter setting forth the proposed action and providing an opportunity to vote for or against such action.\footnote{120}{Id., at § 7.08.}

The Revised Act, by several miscellaneous provisions on voting, accommodates the varied needs of nonprofit entities. Departing somewhat from previous norms, proxy voting is allowed unless the articles or bylaws prohibit it or limit it.\footnote{121}{See H. Oleck, NONPROFIT CORPORATIONS, ORGANIZATIONS AND ASSOCIATIONS § 202 (4th ed. 1980).} The proxy provisions generally follow the proxy provisions in the Model Business Corporation Act for shareholders.\footnote{122}{Id.; see also RMBCA, supra note 31, at § 7.24.} Although cumulative voting is not established as a norm, the Revised Act allows members to provide for cumulative voting in the articles of incorporation or bylaws and establishes a procedure for its use.\footnote{123}{REVISED ACT, supra note 29, at § 7.25.}
may provide in its articles or bylaws for election of directors by members or delegates: (1) on the basis of chapter or other organization unit; (2) by region or other geographic unit; (3) by preferential voting; or (4) by any other reasonable method."\(^\text{124}\)

The Revised Act also contemplates that members may enter into voting agreements which will be specifically enforceable.\(^\text{125}\) Such agreements with respect to public benefit corporations must have a reasonable purpose not inconsistent with the corporation's public or charitable purposes.\(^\text{126}\)

Whereas in a business corporation, shareholders usually come and go in connection with the purchase and sale of their stock, in a nonprofit corporation, the membership relation is much more personal and thus expulsion or suspension becomes a much more significant activity. Under the Revised Act, members in public benefit and mutual benefit corporations may only be expelled or suspended pursuant to a procedure which is fair, reasonable, and carried out in good faith.\(^\text{127}\) A safe harbor exists which declares a procedure to be fair and reasonable if it is set forth in the articles or bylaws and if it provides for prior written notice of the intended expulsion or suspension and an opportunity to be heard before the effective date thereof.\(^\text{128}\)

Members' rights are often dependent upon their ability to obtain information from the corporation. The Revised Act attempts to effectuate membership rights by giving members access to corporate information. Members, therefore, have the right to inspect and copy the records of the corporation, including accounting records, minutes of meetings of the members and of the board of directors, and membership lists. The right of inspection may not be eliminated by the articles of incorporation or bylaws, but it is not unlimited. Certain records may only be obtained on demand and the statement of a proper purpose. The right of inspection may be enforced by a summary court proceeding where the corporation fails to allow it within a reasonable time.\(^\text{129}\)

\(^\text{124}\) Id. at § 7.26.
\(^\text{125}\) Id. at § 7.30(b).
\(^\text{126}\) Id. at § 7.30(a).
\(^\text{127}\) Id. at § 6.21.
\(^\text{128}\) Id.
\(^\text{129}\) Id. at §§ 16.02-16.04.
The Revised Act attempts to settle a longstanding debate over whether or not a member of the corporation may bring a derivative action in the right of the corporation. It authorizes any director or members of a corporation subject to the Act holding five percent or more of the voting power or fifty members, whichever is less, to bring a derivative suit on behalf of the corporation.130 The requirement of a substantial interest in the corporation as well as provisions for contemporaneous ownership and a demand upon the directors of the corporation, as well as the right of the court to require complainants to pay defendants' expenses incurred in defending the suit, were considered sufficient to protect the corporation and its directors against strike suits.131

D. Provisions with Respect to Directors

More attention was lavished on the provisions with respect to directors than on any other chapter of the Act. The provisions in this chapter recognized that the relationship of directors to the corporation is central to any general act allowing incorporation but particularly important in the nonprofit area, where considerations of liability and director responsibility may determine the course of the corporation. Many nonprofit corporations do not have members; therefore, it is essential to find devices to hold directors accountable. In the Revised Act, such devices include: a multi-person board of directors; an expressed standard of conduct; rules covering transactions between the corporation and its directors; and rules respecting loans, guarantees, and other payments to directors. The final form of the Revised Act requires a board of directors composed of at least three persons.132 Thus there can be no "one person" corporation as is often found in business corporations.133

The norm established by the Act is that all corporate powers shall be exercised by or under the authority of, and the affairs of the corporation managed under the direction of, its board.134 As a result, the corporation has great latitude in structuring its

130. Id. at § 6.30.
131. Id. at § 6.30 comment 1.
132. Id. at § 8.03(a).
133. Cf. RMBCA, supra note 31, at § 8.03.
134. REVISED ACT, supra note 29, at § 8.01 comment.
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management. While every corporation must have a board of directors, one or more persons may exercise some or all of the powers which are otherwise exercised by the board. 135

The Revised Act adopts a standard of conduct for directors almost identical to that of the Revised Model Business Corporation Act 136 to wit:

A director shall discharge his or her duties as a director, including his or her duties as a member of a committee: (1) in good faith; (2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and (3) in a manner the director reasonably believes to be in the best interests of the corporation. 137

This section clearly settles the dispute as to whether directors of nonprofit corporations should be held to the standard of the director of a business corporation or the standard of a trustee by adopting the former. The section also clarifies the relationship of the director to the property of the corporation by adding:

A director shall not be deemed to be a trustee with respect to the corporation or with respect to any property held or administered by the corporation, including without limit, property that may be subject to restrictions imposed by the donor or transferor of such property. 138

An alternate provision allows the corporation to adopt a standard of care eliminating or limiting the personal liability of the director to the corporation or its members. 139

The conflict of interest provisions of the Revised Act depart to a certain extent from those adopted for business corporations but reflect a general theme of treating mutual benefit corporations like business corporations and applying a higher standard to public benefit and religious corporations. The Revised Act not only enables the corporation to enter into transactions between the corporation and its directors, but also establishes a procedure for validating such transactions. 140 A director may enter into a

135. Id.
137. REvised ACT, supra note 29, at § 8.30(a).
138. Id. at § 8.30(e).
139. Id. at §§ 2.02(b)(5) and 8.30(d) (Alternative provisions). See also discussion supra in Part II.
140. Id. at § 8.31. Cf. RMBCA, supra note 31, at § 8.31.
transaction with a public benefit or religious corporation only if the transaction is approved in advance by disinterested members of the board or a committee of the board, who after full disclosure believe that the transaction is fair to the corporation; by the attorney general; or by a court in an action in which the attorney general is a party. The provisions further allow a director to enter into transactions with a mutual benefit corporation if the transaction is approved or ratified by disinterested members of the board or a committee of the board after full disclosure; the transaction is approved or ratified by disinterested members of the corporation after full disclosure; or the transaction is found to be fair to the corporation.

Because of the potential for abuse, insider financial dealings of any kind are frowned upon in the Revised Act. Since the purposes of the corporation may be unlimited, the provisions in the Revised Act prohibiting corporations from making payment to their members, officers, or directors are essential to the nonprofit character of the corporations organized thereunder. Corporations may only make payments to members, officers, or directors in special circumstances: payments for reasonable compensation for services; benefits to members in conformity with the purposes of the corporation; payment to repurchase memberships in a mutual benefit corporation; and payments of the net assets on dissolution to the members of a mutual benefit corporation (or to the members of religious or public benefit corporations who are also public benefit or religious corporations). These provisions basically guarantee the dedication in perpetuity of charitable assets and protect the members of a mutual benefit corporation from the diversion of assets. Loans to insiders are a special problem for nonprofit organizations where there may be few "to watch the watchers." Departing from the business corporation rules which have been increasingly enabling, the Revised Act forbids loans to, or the guarantee of obligations of, directors or officers by the corporation.

141. Revised Act, supra note 29, at § 8.31(b).
142. Id. at § 8.31(c).
143. This problem also is reflected in the prohibitions placed on private foundations by the Internal Revenue Code of 1964. I.R.C. §§ 4940-4949 (1964).
144. Revised Act, supra note 29, at §§ 13.01-13.02.
145. Id. at § 8.32. The Revised Act provision follows the earlier Model Nonprofit Act, supra note 29, at § 8.32.
E. Indemnification Provisions

Many nonprofit associations incorporate solely because express statutory provisions providing for indemnification of directors and officers are available only through incorporation. Prior to the inclusion of express provisions in state corporation statutes, the law was entirely unclear as to the extent to which a director might be entitled to indemnity if sued or found liable in a legal action. Without a statutory provision, indemnity may depend entirely upon the often somewhat bizarre application of the principles of charitable trusts, agency, or contracts. As a result, the Revised Act incorporates broad provisions for indemnity in keeping with almost every modern corporation law. It further tries to balance competing policy considerations of accountability and appropriate protection of those who serve the corporation usually as volunteers.

The indemnity provisions included in the Revised Act are very similar to those included in the Model Business Corporation Act. These provisions allow the corporation to indemnify officers and directors against judgments, settlements, fines, penalties, and expenses incurred in a proceeding arising out of service to the corporation if the director: acted in good faith and reasonably believed that the conduct was in (or not opposed to) the best interests of the corporation; or in the case of a criminal proceeding had no reasonable cause to believe the conduct was.

Corporation Act. 1964 ACT, supra note 8, at § 27. Cf. RMBCA, supra note 31, at § 8.32 which provides:

(a) Except as provided by subsection (c), a corporation may not lend money to or guarantee the obligation of a director of the corporation unless:

(1) the particular loan or guarantee is approved by a majority of the votes represented by the outstanding voting shares of all classes, voting as a single voting group, except the votes of shares owned by or voted under the control of the benefited director; or

(2) the corporation's board of directors determines that the loan or guarantee benefits the corporation and either approves the specific loan or guarantee or a general plan authorizing loans and guarantees.

(b) The fact that a loan or guarantee is made in violation of this section does not affect the borrower's liability on the loan.

(c) This section does not apply to loans and guarantees authorized by statute regulating any special class of corporations.


147. RMBCA, supra note 31, at §§ 8.51-8.58.
unlawful.\textsuperscript{148} On the other hand, the corporation may not indemnify a director in connection with a proceeding by or in the right of a corporation in which the director was adjudged liable to the corporation on the basis of receiving a personal benefit.\textsuperscript{149} Indemnification can be made only on a case-by-case determination that the director has met the appropriate standard of conduct. This determination is made by the board of directors by majority vote of a quorum consisting of directors not at the time parties to the proceeding; a majority vote of a committee duly designated by the board of directors consisting solely of two or more directors not at the time parties to the proceeding; by special legal counsel; or, by the disinterested members of a mutual benefit corporation.\textsuperscript{150}

Other provisions allow the corporation to purchase insurance which would indemnify a director whether or not the corporation would have power to indemnify against the same liability under the indemnification provisions.\textsuperscript{151} The corporation also may advance reasonable expenses for litigation upon an undertaking to repay if it is determined that the director, officer, or employee is not entitled to indemnification for such expenses.\textsuperscript{152} Mandatory indemnification is required where a director is wholly successful on the merits or otherwise in the defense of any proceeding to which the director is made a party because he or she is or was a director of the corporation.\textsuperscript{153}

\textit{F. Dissolution}

The Revised Act provides that a corporation incorporated thereunder may be dissolved in one of three ways: (1) by the voluntary action of the members, directors, or third persons depending upon the structure of the corporation and the provisions in its articles of incorporation;\textsuperscript{154} (2) by the administrative action of the secretary of state when the corporation has failed to pay taxes or penalties, deliver its annual report, has no

\textsuperscript{148} \textit{Revised Act, supra} note 29, at § 8.51.
\textsuperscript{149} \textit{Id.} at § 8.51(d).
\textsuperscript{150} \textit{Id.} at § 8.55.
\textsuperscript{151} \textit{Id.} at § 8.57.
\textsuperscript{152} \textit{Id.} at § 8.53.
\textsuperscript{153} \textit{Id.} at § 8.52.
\textsuperscript{154} \textit{Id.} at §§ 14.01-14.02.
registered agent or registered office, or does not notify the secretary of state that its registered agent or registered office has been changed, or that the corporation's period of duration has expired;\textsuperscript{155} or (3) by judicial decree.\textsuperscript{156} These provisions differ little from the provisions on dissolution in the Revised Model Business Corporation Act.\textsuperscript{157} During the process of a judicial proceeding to dissolve a nonprofit mutual benefit or public benefit corporation a court may appoint a receiver or custodian. It is important to note that a court must make a finding in a judicial dissolution proceeding that there are no reasonable alternatives to dissolution, that dissolution is in the public interest if the corporation is a public benefit corporation, and that dissolution is the best way of protecting the interests of members if the corporation is a mutual benefit corporation. Thus the court has wide discretion in determining whether dissolution will in fact be granted and may refuse to order dissolution even if it finds that the grounds for dissolution are present.\textsuperscript{158}

G. Provisions for Merger

Mergers of nonprofit corporations into other nonprofit corporations or into business corporations are increasingly common. Merger is an area in which nonprofit corporations may or may not differ from business corporations but, in any event, are lightly treated by state statutes. The law is unclear about such mergers, especially as to who can merge with whom and the condition under which it may happen. Many nonprofit organizations seek to merge into business corporations, other nonprofit corporations, or foreign corporations. Laws which parallel business corporation laws leave open many questions about the mergers of nonprofits, particularly the disposition of the assets of the disappearing corporation. The Revised Act, however, provides that corpora-

\textsuperscript{155} Id. at § 14.20.

\textsuperscript{156} Id. at § 14.30. The section provides that the corporation may be dissolved by judicial decree in a number of ways: in an action brought by the attorney general on the grounds of fraud, abuse of authority, misapplication of assets or waste, or inability to carry out its purpose if one is stated; in an action brought by members, directors or third persons on the grounds of deadlock; illegal, fraudulent, or oppressive activities of the directors; misapplication of assets or waste; or inability to carry out its purposes; or in actions brought by creditors of the corporation.

\textsuperscript{157} RMBCA, supra note 31, at §§ 14.30-14.33.

\textsuperscript{158} Revised Act, supra note 29, at § 14.34.
tions may merge into any other corporation; provided, however, that if the corporation is a public benefit or religious corporation the surviving corporation must be either a public benefit or a religious corporation, unless the assets, prior to the merger, are transferred to a public benefit or religious corporation, or unless prior approval is obtained from a court with notice to the attorney general. These provisions parallel the distribution provisions and again protect the public benefit corporation's assets against diversion, assuring their permanent dedication to a public or religious purpose.

H. Record Keeping Under the Revised Act

A recurrent theme with respect to nonprofit corporations is the problem of accountability in situations where there may be no members to whom the directors may be accountable, where there is not a continuum of management, or where for the most part the persons managing the organization may be volunteers. The Revised Act approaches accountability in such circumstances by setting minimum levels of record keeping for every organization incorporated under it. Corporations formed under the Revised Act must maintain permanent records of all meetings and transactions of the members, directors and board committees. The statute also provides that the corporation shall keep copies of its articles, bylaws, resolutions of the board of directors, minutes of meetings and written communications to members, business or home addresses of the directors and officers, and the most recent annual report delivered to the secretary of state. The corporation is required to keep "appropriate" accounting records and membership lists. Since many nonprofit corporations operate on an informal basis and with volunteer staff, the Drafting Committee did not contemplate that appropriate records would require that the corporation either retain auditors or use generally accepted accounting principles; however, the corporation is required upon demand to furnish the latest financial statements, accompanied by a statement of either a public ac-

159. Id. at § 11.02.
160. Id. at § 11.02 comment.
161. Id. at § 16.01.
162. Id. According to the Revised Act, "appropriate" records are those prepared so as to fairly present the financial condition and results of operations of the corporation. Id. at § 16.01 comment 2.
countant or the president or chief financial officer of the corporation, stating both the reasonable belief that the records were prepared on generally accepted accounting principles and the basis of any inconsistencies from accounting of prior years.\textsuperscript{163}

Many states presently require that certain nonprofit organizations file annual reports with a state official describing the status of the corporation and containing various other kinds of information.\textsuperscript{164} The Revised Act, following a general theme of disclosure, expands this requirement to every corporation incorporated thereunder.\textsuperscript{165} Such an annual report is a public document open to inspection by members of the general public and allowing anyone interested in the corporation to locate the various officials thereof.\textsuperscript{166}

I. The Powers of the Attorney General Under the Revised Act

Since the enactment of the Statute of Charitable Uses in the sixteenth century, a major device for regulating charities has been the power of the attorney general to regulate or investigate charitable trusts. Over time, this power has been recognized and applied to nonprofit corporations organized for charitable purposes. The Revised Act has extended this concept to reach all nonprofit corporations in varying degrees. The state under the Revised Act has limited power to regulate mutual benefit and religious corporations, but it has broad power of supervision over the public benefit corporation. This is one of the features of the Revised Act that is both most criticized and most complimented. The Drafting Committee, however, accepted such provisions on the rationale that public benefit corporations, which usually have no participants with a sufficient economic interest to assure oversight, can only be made accountable for their use of assets if there are broad powers of regulation in a state officer. To that end, the Revised Act provides standing to the attorney general to protect the public interest.\textsuperscript{167} The Act requires notice to the attorney general of all significant corporate transactions by a

\begin{footnotes}
\item[163.] \textit{Id.} at § 16.02.
\item[164.] \textit{See e.g.}, N.Y. \textsc{Not-For-Profit Corp. Law} § 520 (McKinney 1988).
\item[165.] \textit{Revised Act, supra} note 29, at § 16.22.
\item[166.] \textit{Id.} These provisions parallel provisions in the Internal Revenue Code requiring that exempt organizations make their tax returns available.
\item[167.] \textit{Id.} at § 1.70.
\end{footnotes}
public benefit corporation, such as indemnification, the transfer of substantially all assets, merger, and dissolution.\footnote{Id. at §§ 6.30, 14.21, 14.31, 14.02, 14.03, 8.55, 11.02, 8.10, 12.02 and 3.04.}

Religious corporations generally are exempted from attorney general oversight because of notions about the limitations placed by the U.S. Constitution on state interference. Mutual benefit corporations, usually having members to regulate their activities, are treated more like business corporations.

\section*{VI. Conclusion}

What served as a nonprofit corporation law a quarter of a century ago, no longer serves. As many states turn to the revision of their present statutes or seek to adopt new ones, there is a perceived need for a "model" from which to work. This need is evidenced by the fact that two states (Mississippi and Tennessee) substantially adopted the Revised Act after it was published as an Exposure Draft. At least five other states are now considering it as a basis for their projected revision. For the foreseeable future it will be the centerpiece for discussion whenever nonprofit law revision is the topic of concern. It is a complex and sophisticated statute which takes into account the collective experience with nonprofit corporations of over a quarter of a century. It also recognizes the importance of such entities to our society with the corresponding desire that their special needs be accommodated.

At the very least, the Revised Act accomplishes the Drafting Committee's goals of updating and clarifying the existing law. By looking at nonprofit corporations as unique entities, rather than business corporations with members in lieu of stockholders, the Drafting Committee took a giant step from the place where earlier committees started. On the other hand the Drafting Committee appreciated that nonprofit corporations are much more like business corporations than trusts, partnerships, or agencies. It allows for many configurations of organization and for the vast range of activities in which nonprofit organizations engage.

The open questions, however, are many. Is the reliance on the attorney general's power to enforce its scheme of accountability optimistic in the light of underfunded and frequently politically motivated state officials, inviting benign neglect on one hand and
harassment on the other? Are its reporting and record keeping requirements too complex for the local garden club—to be honored much more in the breach than in the observance? Does its deference to the religious corporation go further than the Constitution requires, leaving members unprotected and exploited?

The answers to these questions will only come with experience as states adopt the Revised Act. Whatever the answers the Revised Act provides a working document which will inform debate, invite comparisons, and stimulate the development of an area of law too long left in the shade.
COMMERCIAL ACTIVITIES OF EXEMPT ORGANIZATIONS—JOINT VENTURES AND TAXABLE SUBSIDIARIES

Ronald E. Heinlen*

I. INTRODUCTION

Organizations exempt from federal income tax under section 501(a) of the Internal Revenue Code of 1986 are becoming increasingly involved in commercial and other income-producing activities. On May 14, 1987, the Subcommittee on Oversight of the House Committee on Ways and Means announced hearings to consider, among other things, the extent to which exempt organizations and for-profit businesses are competing in the same income-producing activities; the extent to which exempt organizations are engaging in commercial activities with for-profit businesses through joint ventures and limited partnerships; the way in which the existing law is being administered by the Internal Revenue Service; whether the existing rules permit exempt organizations to compete unfairly with for-profit businesses; and, if so, how the rules should be changed to remedy this.

After noting that the number of exempt organizations had doubled since 1969, the Deputy Assistant Treasury Secretary for Tax Policy observed in his statement to the Subcommittee that this growth has been accompanied by a trend toward increasing commercial activity by the nonprofit sector. Although no specific proposals were made, the Treasury Department suggested that the Subcommittee consider: (1) more detailed reporting by exempt organizations to improve enforcement and compliance in determining whether the organization’s activities are related to its

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exempt purposes; (2) aggregating the activities of an exempt organization and its subsidiaries in determining whether the exempt organization qualifies under section 501(a) of the Code; and (3) a thorough review of the issues raised by exempt organizations participating in joint ventures and limited partnerships.\(^3\)

The likely result of these inquiries will be either a change in the law further restricting the ability of exempt organizations to engage in commercial activities, or, at the very least, more vigorous enforcement of the existing rules by the IRS. By either legislative or administrative action (or a combination thereof) there will be a contraction in the type and scope of commercial and business activities that may be carried on by exempt organizations without jeopardizing their exempt status or creating unrelated business income. These may include such activities as the sale of merchandise through gift shops or bookstores operated by museums, zoos, and conservation organizations; the sale of medical equipment and devices by hospitals; the sale of airline tickets, tours, and travel consulting services by religious organizations; and health fitness, athletic, and recreation activities. The increasing use by exempt organizations of joint ventures, limited partnerships, and taxable subsidiaries will also be closely scrutinized.\(^4\)

A clear understanding of the existing limitations and of the rules being developed by the IRS is essential if an exempt organization engaging in commercial activities is not to jeopardize its exempt status. This Article will discuss these limitations in the context of organizations described in section 501(c)(3) of the Code that are not classified as private foundations under section 509(a) of the Code.\(^5\)

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4. Among the recommendations under consideration are (i) requiring joint ventures between tax-exempt and for-profit organizations to allocate partnership losses in the same way they allocate partnership profits, (ii) expanding the definition of a controlled subsidiary to include subsidiaries in which the parent owns 50% or more of the stock instead of 80% or more, (iii) allowing the Treasury Department to develop rules aggregating the activities of a tax-exempt parent and its for-profit subsidiaries, and (iv) narrowing the exceptions to the unrelated business income rules.

5. An organization is classified as a private foundation under § 509(a) (and, therefore, subject to more restrictive tax rules) unless it is an organization described in § 170(b)(1)(A)
II. SECTION 501(c)(3) ORGANIZATIONS

Section 501(c)(3) exempts from tax organizations that are organized and operated exclusively for religious, charitable, educational, or scientific purposes, no part of the net earnings of which inures to the benefit of any private shareholder or individual. At first blush, by requiring the organization to be organized (the "organizational test") and operated (the "operational test") exclusively for exempt purposes, this definition would appear to preclude an organization from engaging in any commercial activity no matter how insubstantial or insignificant. This, however, is not the case.

To meet the organizational test the organization's articles of incorporation (or other document by which the organization is created) must expressly limit the organization's purposes to one or more exempt purposes. The test will not be met if the articles expressly authorize the organization to carry on, otherwise than as an insubstantial part of its activities, activities which are not in furtherance of one or more exempt purposes. Thus, an organization that is empowered "to engage in a manufacturing business" will not meet the organizational test. To meet the operational test the organization must engage primarily in activities that accomplish one or more of its exempt purposes.

Thus, notwithstanding the use of the term "exclusively" in section 501(c)(3), an organization can engage in activities that do not further its exempt purposes as long as those activities are not more than an insubstantial part of the organization's activities. On the other hand, it is clear that the presence of a single nonexempt purpose, if substantial in nature, will cause an exempt organization to lose its exemption regardless of the number of its exempt purposes. The Regulations offer no guidance in determining what is more than an insubstantial part; however, the Tax Court has indicated that an activity accounting for less than ten percent of an organization's activities is insubstantial.

(Other than clauses (vii) and (viii), or meets certain public support tests, or is operated, supervised, or controlled by or in connection with one or more of the organizations just described. See generally B. Hopkins, The Law of Tax Exempt Organizations, Part IV, (5th ed. 1987).

Organizations exempt under section 501(c)(3), therefore, are permitted to engage in commercial activities without losing their exempt status in either of two circumstances: (1) if the activities are in furtherance of the organization’s exempt purposes, the organization will be exempt even if the commercial activity is a substantial part of the organization’s activities; (2) if the activities are not in furtherance of the organization’s exempt purposes, the organization still will be permitted to engage in such activities as long as they are not more than an insubstantial part of the organization’s activities.10

To qualify under section 501(c)(3), an organization must meet two additional tests. The organization must serve a public rather than a private interest,11 and it must not allow its earnings to inure to the benefit of private shareholders or individuals.12

A. Private Benefit

An organization will not be exempt if its activities provide a private benefit to any person who is not a member of a charitable class, unless the benefit is incidental to accomplishing a larger public purpose.13 Through a series of private letter rulings and general counsel memoranda, the IRS has interpreted this requirement to have both a qualitative and quantitative aspect.14

To be incidental in the qualitative sense, any private benefit must be a necessary result of an activity that benefits the public at large. In other words, the organization must be able to establish that the only way that the organization can accomplish its exempt purposes is by benefiting certain individuals. If there is an alternative method by which the organization can accomplish its exempt purposes which does not result in a private benefit, the organization must use the alternative method or risk losing its exempt status. This places a heavy burden on the organization to explore all available alternatives before engaging in any transaction that provides a private benefit. To be incidental in the

quantitative sense, the benefit must not be substantial after considering the overall public benefit resulting from the activity.

B. Private Inurement

An organization will not be exempt under section 501(c)(3) if its net earnings inure in whole or in part to the benefit of private shareholders or individuals having a personal and private interest in the activities of the organization. This provision has generally been interpreted to apply to earnings inuring to the benefit of “insiders,” i.e., persons who are in a position to control or otherwise influence the actions of the organization, such as the organization's trustees, officers, members, founders or contributors.

III. UNRELATED BUSINESS INCOME

Although an exempt organization is not precluded from engaging in commercial activities provided that it complies with the foregoing rules, the organization may still be subject to the tax on unrelated business taxable income imposed by section 511 of the Code. Unrelated business taxable income is defined as the income derived from an unrelated trade or business which, in turn, is defined as any trade or business which is not substantially related (aside from the organization's need for income or its use of the profits from the business) to carrying out the organization's exempt purposes.

In general, unrelated business taxable income does not include dividends, interest, royalties, annuities, rents from real property, nor gains from the sale or exchange of property (other than inventory). However, interest, annuities, royalties, and rents received from an organization “controlled” by the exempt organization are subject to the unrelated business income tax. For this purpose, control, in the case of a corporation, means ownership of at least eighty percent of the corporation’s stock.

17. The unrelated business income provisions are set forth in §§ 511-515 of the Code.
18. I.R.C. § 512(a) and 513(a) (1986).
IV. JOINT VENTURES

It has become increasingly common for exempt organizations to form joint ventures or partnerships with unrelated for-profit businesses.21 This development has occurred notwithstanding a great deal of uncertainty concerning the extent to which exempt organizations can enter into this type of relationship without jeopardizing their exempt status.

In the only decided case that has considered this issue, the court held that a section 501(c)(3) organization did not lose its exempt status by becoming a general partner in a limited partnership formed for the purpose of raising capital to stage a play.22 However, the court specifically found that the partnership was formed to further the organization's exempt purposes. The position of the IRS has been less accommodating. Initially, the IRS maintained that merely being a general partner in a limited partnership would cause an automatic revocation of the organization's exempt status, based on the supposed conflict between the exempt organization's duty as a general partner to maximize the profits of the partnership and the requirement that the exempt organization be operated exclusively for exempt purposes.23 In recent years, the IRS has abandoned this automatic revocation rule and will now permit an exempt organization to be a general partner in a limited partnership if three requirements are met: (1) the partnership must serve an exempt purpose of the organization; (2) the partnership must not prevent the exempt organization from acting exclusively to further its own interests; and (3) the partnership must not result in more than an incidental benefit to the limited partners.24 Because of the factual and subjective nature of these requirements and the lack of any definitive guidelines, exempt organizations engaging in joint ventures with nonexempt partners run a substantial risk of losing their exempt status.

The first requirement is the most important and the most restrictive. As far as the IRS is concerned, the only type of

22. Plumstead Theatre Society, Inc. v. Commissioner, 74 T.C. 1324 (1980), aff'd, 675 F.2d 244 (9th Cir. 1982).
partnership that an exempt organization can engage in is one that carries on activities that are an extension of the organization's charitable purposes. Thus, even if an activity is insubstantial and could be carried on directly by the exempt organization without jeopardizing its exempt status, the activity cannot be conducted by the exempt organization in the form of a joint venture if the activity does not further the organization's exempt purposes.

The second requirement is designed to ensure that the organization act exclusively to further its own goals. The IRS no longer maintains that an exempt organization's participation in a partnership arrangement as a general partner will *per se* result in denial of exempt status. However, the partnership agreement must be structured to assure that the statutorily-imposed obligations on the general partner do not conflict with the exempt organization's ability to pursue its charitable goals. In other words, the partnership arrangement must permit the exempt organization to act exclusively in furtherance of its exempt purposes and not for the benefit of the limited partners. Among the statutorily-imposed obligations that may threaten the organization's exempt status is the general partner's liability for all liabilities of the partnership. The IRS acknowledges that an exempt general partner cannot isolate itself entirely from partnership losses, but exposure can be limited through insurance, indemnity agreements, or the nature of the activities carried on by the partnership. This, however, raises the possibility that the partnership may be classified as a corporation because of the existence of the corporate characteristic of limited liability.

The third requirement is intended to ensure that the limited partners do not receive any undue economic benefit. In other words, the limited partners must not be entitled to more than a fair return on their investment.

The concern of the IRS over the use of limited partnerships by exempt organizations is reflected in the statement of the Deputy Assistant Treasury Secretary to the House Ways and Means Subcommittee on Oversight, in which he questioned whether such partnerships are compatible with the prohibition

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against distribution of earnings to private interests and whether they create a conflict of interest for the exempt organization.\textsuperscript{27} However, in the view of one commentator, the IRS approach inappropriately singles out the partnership method of doing business and subjects it to requirements that do not apply to other methods.\textsuperscript{28}

V. TAXABLE SUBSIDIARY

An exempt organization that engages in commercial activities is confronted by several difficult issues. Is the activity in furtherance of the organization's exempt purposes? If not, is the activity more than an insubstantial part of the organization's activities? Does the activity result in a private benefit that is more than qualitatively or quantitatively incidental? Does the activity result in a private inurement of earnings? If the activity is to be carried on in a joint venture, does it comply with the requirements discussed in the preceding section? These questions are often not easy to answer, but maintaining the organization's exempt status may depend on reaching the correct result.

An exempt organization, by using a wholly-owned taxable subsidiary to carry on commercial activities, may be able to avoid these questions and engage in activities that would otherwise be improper or threaten its exempt status.\textsuperscript{29} Although any income produced as a result of the activity will be taxed to the subsidiary, this may be a small price to pay to maintain the parent organization's exempt status. Because income paid by a subsidiary to an exempt parent in the form of dividends is not treated as unrelated business income to the parent, the subsidiary can transfer its income to the parent without any additional tax liability to either entity.\textsuperscript{30} However, any payments made by the subsidiary in the form of interest, rents, and royalties that are deductible by the subsidiary will be unrelated business taxable income to the parent.\textsuperscript{31}

\textsuperscript{27} See Statement by O. Donaldson Chapoton, \textit{supra} note 3.

\textsuperscript{28} \textit{Hopkins}, \textit{supra} note 5, at § 42.6.

\textsuperscript{29} Even if the activity is conducted by the parent, the income earned by the parent may be subject to the tax on unrelated business income.

\textsuperscript{30} I.R.C. § 512(b) (1986).

\textsuperscript{31} I.R.C. § 512(b)(13) (1986).
Although the IRS has sanctioned the use of taxable subsidiaries by exempt organizations, its acceptance has not been without reservations. The primary concern of the IRS has been whether the activities of the subsidiary should be attributed to the exempt parent. If the subsidiary's activities are treated as the parent's activities, the parent's exempt status will be jeopardized if the subsidiary is engaged in activities which do not further the parent's exempt purposes (unless the activities are insubstantial) or if the subsidiary's activities result in a private benefit or private inurement.

The current position of the IRS is that the activities of a taxable subsidiary will not be attributed to the exempt parent if the subsidiary is organized for a business purpose and is not operated as a mere agent of the parent.32 The requirement that the subsidiary be operated for a business purpose is based on the Supreme Court's decision in Moline Properties, Inc. v. Commissioner,33 in which the Court held that a corporation will be recognized as a separate taxable entity as long as the purpose for which it is organized "is the equivalent of business activity or is followed by the carrying on of business by the corporation."34 This does not mean, however, in the exempt organization context, that the activity must be inherently commercial or that the corporation must have a profit motive, but only that the subsidiary must be organized for a bona fide purpose.35

The requirement that the subsidiary not be an agent of the parent in order to be recognized as a separate taxable entity was examined by the Supreme Court in National Carbide Co. v. Commissioner,36 in which the Court held that three subsidiary corporations should be treated as separate taxable entities and not as agents of the parent, despite the fact that the subsidiaries had agreed to operate as agents of the parent. The Court stated that the mere fact of the parent's control over the subsidiaries did not establish the existence of an agency relationship since such control is typical of all shareholder-corporation relationships.

33. 319 U.S. 436 (1943).
34. Id. at 439; see also Britt v. United States, 431 F.2d 227 (5th Cir. 1970).
The Court then set forth six factors to consider in determining whether a subsidiary is an agent of the parent. The first four are described as indicia of an agency relationship and the last two as requirements:

[1] Whether the corporation operates in the name and for the account of the principal, [2] binds the principal by its actions, [3] transmits money received to the principal, and [4] whether receipt of income is attributable to the services of employees of the principal and to assets belonging to the principal are some of the relevant considerations in determining whether a true agency exists. [5] If the corporation is a true agent, its relations with its principal must not be dependent upon the fact that it is owned by the principal if such is the case. [6] Its business purpose must be the carrying on of the normal duties of an agent.37

These factors were recently revisited by the Supreme Court in Commissioner v. Bollinger38 where the IRS, in order to protect the separate-entity principal of Moline Properties, urged the Court to strictly apply the six National Carbide factors. This would have resulted in a finding that no agency relationship existed and that the corporation should be recognized as a separate entity because of the absence of an "arm's-length relationship" that included the payment of a fee for agency services. The Court, however, refused "to parse the text of National Carbide as though that were itself the governing statute" and apply rigid mechanical requirements:

It seems to us that the genuineness of the agency relationship is adequately assured, and tax-avoiding manipulation adequately avoided, when the fact that the corporation acting as agent for its shareholders with respect to a particular asset is set forth in a written agreement at the time the asset is acquired, the corporation functions as agent and not principal with respect to the asset for all purposes, and the corporation is held out as the agent and not principal in all dealings with third parties relating to the asset.39

The IRS has acknowledged that the standards for finding an agency relationship are stringent and that the courts have articulated a very demanding evidentiary standard, requiring clear

39. Id. at 1179.
COMMERCIAL ACTIVITIES

and convincing evidence before the separate existence of a subsidiary can be ignored. It has, nevertheless, attempted to expand the reach of this rule in dealing with exempt organizations by attributing the activities of the subsidiary to the parent where the parent is so involved in the day-to-day operations of the subsidiary that the relationship assumes the characteristics of the relationship of principal and agent. 40

In several private letter rulings, the IRS has relied on a variety of circumstances to demonstrate that the parent is not involved in the day-to-day management of the subsidiary, such as the fact that the parent and the subsidiary do not have common trustees (or, if they do, the common trustees are less than a majority), that the parent and subsidiary have separate employees, or that they have different chief executive officers. 41 These rulings give rise to the negative inference that the IRS may attribute the subsidiary's activities to the parent if some or all of these favorable factors are not present. The IRS has recently attempted to counteract this inference by stating that the mere fact that the board of directors of the subsidiary consists entirely of board members, officers, or employees of the parent will not cause the activities of the subsidiary to be attributed to the parent. 42 The IRS has recognized the separate existence of a subsidiary where the parent and subsidiary shared offices, where employees participated in the same fringe benefit plans, where the parent transferred all of its employees to the subsidiary, and where the parent and the subsidiary shared the same equipment, telephones, and supplies. 43

The requirement imposed by the IRS for exempt organizations that the parent not be involved in the day-to-day management of the subsidiary is not supported by the authorities and is contrary to the position urged by the IRS in the Bollinger case. 44

40. See supra note 32.
42. See Gen. Couns. Mem. 39,598 (Dec. 8, 1986). ("We do not believe that the ***** GCM should be read to suggest, by negative inference, that when the Board of directors of a wholly-owned subsidiary is made up entirely of Board members, officers, or employees of the parent there must be attribution of the activities of the subsidiary to the parent.")
43. See generally Purcell, Using For-Profit Subsidiaries to Preserve Exempt Status, 67 J. TAX'N 180 (1987).
In *National Carbide*, the Supreme Court clearly states that complete ownership of a subsidiary, and the control that results from such ownership, are not enough to make the subsidiary an agent of the parent and to cause the separate identity of the subsidiary to be ignored. Even more to the point, the Court noted that undoubtedly the great majority of corporations owned by sole stockholders are dummy corporations in the sense that their policies and day-to-day activities are determined not as decisions of the corporation but by the owners acting individually. In the Court's view, therefore, factual findings such as the parent board's exercising complete domination and control over the subsidiary, or the parent's officers being in charge of managing the subsidiary's activities and executing policies and directives promulgated by the parent's board, are of no significance.

The IRS's contention that the separate identity of the subsidiary may be disregarded if the subsidiary is merely an instrumentality of the parent becomes even more untenable if one examines the principal case upon which the IRS relies to support this proposition. *Krivo Industrial Supply Co. v. National Distillers & Chemical Corp.* 45 involved an attempt by the creditors of the subsidiary to collect their debt from the parent. The court found that two elements were necessary before the subsidiary could be treated as a "mere instrumentality" of the parent: (1) the parent must be in control of the subsidiary, and (2) fraud or injustice must proximately result from a misuse of this control. 46 Reliance by the IRS on this case is difficult to justify based on the court's requirement of fraud or injustice and on the significantly different issues involved.

In view of the reluctance of the courts to disregard the separate identity of parent and subsidiary corporations, it is, not surprising that among the proposals being considered by the House Ways and Means Subcommittee on Oversight is one that would permit the Treasury Department to develop rules aggregating the activities of a "family" of tax-exempt organizations and for-profit subsidiaries. If the Treasury Department is given this authority, it can be anticipated that these rules would incorporate the current IRS position on the effect of the parent's day-to-day involvement in the subsidiary's activities.

45. 483 F.2d 1098 (5th Cir. 1973).
46. Id. at 1103.
V. CONCLUSION

Congress, in all probability, will adopt legislation significantly curtailing the ability of tax-exempt organizations to engage in commercial activities. Many activities now carried on as a matter of course either will become subject to the tax on unrelated business income or will cause the organization to lose its exemption. The ability to conduct these activities through a taxable subsidiary will be substantially narrowed.
SUNSHINE IN THE FORMULATION OF FEDERAL TAX POLICY, A CASE STUDY: THE 1988 EAGLE LODGE TAX SEMINAR FOR GOVERNMENT*

Jonathan Barry Forman**

On September 1, 1988, the United States Department of Treasury (Treasury) released some documents relating to a secret seminar on tax policy held in March of 1988.¹ According to those documents, on March 4-6, 1988, the Graduate Tax Program of the New York University School of Law sponsored the Ninth Annual Tax Seminar for Government at the Eagle Lodge resort in Pennsylvania. That seminar brought together over seventy top federal tax officials, academics, and private attorneys for discussions of current tax legislative and administrative policies.

Despite the fact that both federal officials and private individuals attended the 1988 Eagle Lodge Tax Seminar for Government, the seminar was closed to the public and the press. Moreover, the federal government has so far refused to release the attendance list or any of the documents which were actually discussed at that seminar. The purpose of this Article is to describe the 1988 Eagle Lodge Tax Seminar for Government and to consider whether or not the Freedom of Information Act² or the Federal Advisory Committee Act³ can make the sun shine in on such secret seminars.

I. BACKGROUND

The author first learned about the secret Eagle Lodge Tax Seminars for Government in 1985. In this regard, the 1985 Eagle

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Lodge Tax Seminar for Government was the subject of two articles which appeared in a popular tax publication. Those articles revealed that a number of top Treasury officials had attended the 1985 Eagle Lodge Tax Seminar for Government, criticized the secrecy that surrounded the 1985 seminar, and questioned whether or not it was appropriate for top Treasury officials to attend such secret seminars. Despite the public criticism, the secret Eagle Lodge Tax Seminars for Government have continued on an annual basis.

As a professor of tax law and a researcher interested in the formulation of federal tax policy, this author naturally became curious as to what is discussed at these secret Eagle Lodge Tax Seminars for Government. In this regard, within Treasury, formulation of federal tax policy for the Executive Branch is largely the responsibility of the Assistant Secretary of Treasury for Tax Policy and his employees in the Office of Tax Policy. Accord-


5. The Tenth Annual Tax Seminar for Government at Eagle Lodge was scheduled for the first weekend in March of 1989.


The Office of the Assistant Secretary (Tax Policy) advises and assists the Secretary and the Deputy secretary [of Treasury] in the formulation and execution of domestic and international tax policies and programs. These functions, carried out by supporting staff offices, include:

- analysis of proposed tax legislation and tax programs;
- projections of economic trends affecting tax bases;
- studies of effects of alternative tax measures;
- preparation of official estimates of Government receipts for the President's annual budget messages;
- legal advice and analysis on domestic and international tax matters;
- assistance in the development and review of tax legislation and domestic and international tax regulations and rulings; and
- participation in international tax treaty negotiations and in maintenance of relations with international organizations on tax matters.

Moreover, the Assistant Secretary of Treasury for Tax Policy and other Office of Tax Policy officials are regular attendees at the secret Eagle Lodge Tax Seminars for Government. For example, Assistant Secretary of Treasury for Tax Policy Ronald A. Pearlman, Deputy Assistant Secretary Charles E. McLure, Jr., Tax Legislative Counsel Mikel Rollyson, Assistant Tax Legislative Counsel David Garlock, and a number of attorneys from the Office of Tax Policy attended the 1985 Eagle Lodge Tax Seminar for Government. See Sheppard, *The Inner Circle at Eagle Lodge*, supra note 4.
ingly, in order to find out the nature of the tax policy discussions at the 1988 Eagle Lodge Tax Seminar for Government, on March 2, 1988, this author sent a Freedom of Information Act (FOIA) request to Treasury's Office of Tax Policy. That FOIA letter requested access to all records, attendance lists, agendas, briefing books, papers, outlines, resource materials, and documents of any kind relating to the 1988 Eagle Lodge Tax Seminar for Government.

By letter of March 23, 1988, Diane Flanigan, FOIA Coordinator for the Office of Tax Policy denied this author's FOIA request. Despite the fact that many Office of Tax Policy officials had in fact attended the 1988 Eagle Lodge Tax Seminar for Government, Ms. Flanigan's denial letter stated, in part: "We have located no documents responsive to your request in the Office of the Assistant Secretary for Tax Policy."

On April 20, 1988, this author mailed to the Office of Tax Policy a letter requesting administrative appeal of the denial of his FOIA request. By letter of May 9, 1988, Dana L. Trier, Acting Tax Legislative Counsel and Office of Tax Policy FOIA Appeals Officer, made a final denial of this author's FOIA appeal. Despite the fact that Mr. Trier himself was invited to and apparently attended, the 1988 Eagle Lodge Tax Seminar for Government, his denial started in part:


11. See infra note 24 and accompanying text.


After reviewing your appeal and original request, we have found that there are no documents that are responsive to your request either in control of, generated by, or entered into the file system and used by the Office of Tax Policy.

The Freedom of Information Act, 5 U.S.C. § 552, applies only to "agency records." Documents created by private persons, rather than by federal agency employees, are "agency records" only in limited circumstances. We have determined that those circumstances do not exist in the present case.

Having exhausted his administrative remedies, on July 8, 1988, this author filed a FOIA Complaint in the United States District Court for the Western District of Oklahoma naming as defendants the Assistant Secretary of Treasury for Tax Policy, O. Donaldson Chapoton, (Assistant Secretary Chapoton) and the United States Department of Treasury. As if unaware of the author's FOIA appeal and subsequent suit, Kevin Knopf, FOIA Officer for the Office of Tax Policy, in a letter dated September 1, 1988, wrote to the author as follows:

This is in further response to your March 2, 1988 Freedom of Information Act (FOIA) request for materials concerning a 1988 meeting at Eagle Lodge, Pennsylvania.

We have located additional materials within the scope of your original request that were not originally identified. Pursuant to further administrative review, we have determined that the enclosed materials may be released to you in their entirety.

Some fifty pages of agency records relating to the 1988 Eagle Lodge Tax Seminar were enclosed with the letter. The documents released included invitation letters from New York University School of Law Dean Norman Redlich to Office of Tax Policy officials, Treasury travel authorization forms, a seminar schedule, and a seminar participant list (as of January 25, 1988).

On September 6, 1988, defendants Chapoton and Treasury answered the author's complaint. On September 30, 1988, Treas-

16. The letter and the accompanying documents were included in the September 26, 1988 Tax Notes Microfiche Database as Document 88-7727. See supra note 1.
17. A copy of that Answer was included in the September 26, 1988 Tax Notes Microfiche Database as Document 88-7728. See supra note 1. Although the normal time for an agency to answer a FOIA complaint is 30 days from service (5 U.S.C. § 552(a)(4)(C) (1982)), on August 8, 1988, Assistant Secretary Chapoton and Treasury moved for more time to answer. On August 11, 1988, the district court granted them until September 7, 1988 to answer or otherwise plead.
ury moved to dismiss the author's complaint for lack of jurisdiction on the grounds that, with its September 1, 1988, release of documents, it had provided the author with access to all of the requested "agency records." Treasury's motion papers described several other documents which were received by the Office of Tax Policy officials who participated in the 1988 Eagle Lodge Tax Seminar for Government, including a list of seminar participants and ten tax-related scholarly articles that were delivered at the seminar. \(^{18}\) So far, however, Treasury has refused to release copies of those documents on the grounds that they are not "agency records." As more fully described in Part III below, those documents continue to be at issue in this author's FOIA action against Treasury.

II. THE 1988 EAGLE LODGE TAX SEMINAR FOR GOVERNMENT

Despite the fact that Treasury has refused to release the documents received by Office of Tax Policy officials who attended the 1988 Tax Seminar for Government, the documents released by Treasury on September 1, 1988, together with papers filed by Treasury in the author's Freedom of Information Act suit, reveal much of what occurred at that secret seminar. According to those documents, on March 4-6, 1988, the New York University School of Law (NYU) sponsored the Ninth Annual Tax Seminar for Government at Eagle Lodge, a luxurious resort in Lafayette Hill, Pennsylvania. \(^{19}\) According to the seminar schedule, participants heard speeches on such tax issues as loopholes, interest allocations, partnerships, deferral, noninterest analogues, PALS and PIGS, section 482, distributions of corporate property, and large case management. \(^{20}\)

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\(^{19}\) According to a promotional brochure about Eagle Lodge obtained by the author, Eagle Lodge is owned by the CIGNA Corporation and operated by Harrison Corporation Services. Located about 25 minutes from downtown Philadelphia, Eagle Lodge describes itself as "The Ultimate Training and Meeting Center." Eagle Lodge hosts a variety of recreational activities including its own 18-hole golf course, tennis courts, handball/ racquetball courts, an indoor swimming pool, sauna and steam room, billiard tables, and acres of rolling countryside.

\(^{20}\) According to the schedule prepared before the seminar took place, on the morning of Friday, March 4, 1988, William S. McKee of King & Spaulding was to speak to the
Attendance at the 1988 Eagle Lodge Tax Seminar for Government was by invitation only. Moreover, the 1988 Eagle Lodge Tax Seminar for Government was closed to the public and the press, and participants were told to keep the seminar proceedings confidential. For example, in his invitation letters for the 1988 Eagle Lodge tax seminar, NYU School of Law Dean Norman Redlich stressed that confidentiality was one of the ground rules for the seminar: "All participants will agree that no comments made at the Seminar are for attribution to any persons after the Seminar." Moreover, a follow-up memorandum reminded the invitees that "all participants have agreed that the Seminar proceedings are to be confidential."

Dean Redlich's invitation letters also indicated that attendees were expected to be present during the working sessions and were encouraged to participate in the discussions. Receptions and dinners were also scheduled for the participants in the seminar. Furthermore, NYU agreed to reimburse the travel expenses of those who participated in the seminar.

While Treasury has so far refused to release a list of who actually attended the seminar, the January 25, 1988, participant list identifies over a dozen members of the NYU Graduate Tax Faculty who were expected to participate. Also, about a dozen private consultants were expected to participate, including a number of private attorneys. Not surprisingly, no members of the press were on the participant list.

participants about "Loopholes," and NYU Law Professor Lawrence Lokken was to speak on "Interest Allocations." That afternoon, Harvard Law Professor William D. Andrews was to speak on "Partnerships," and Boston College Law Professor Hugh J. Ault was to speak on "Deferral." On Saturday morning, Georgetown University Law Professor Daniel Halperin was to speak on "Noninterest Analogues." That afternoon, NYU Law Professor Deborah Schenk was to speak on "PALS and PIGS," Tom Horst of Deloitte, Haskins & Sells was to speak on "Section 482," and Peter C. Canellos of Wachtel, Lipton, Rosen & Katz was to deliver a "Funny Paper." Finally, on Sunday morning, NYU Law Professor James Eustice was to speak on "Distributions of Corporate Property After the Repeal of General Utilities," and Associate Chief Counsel (Litigation) James J. Keightley was to speak on "Large Case Management—Selected Aspects."

21. In this regard, letters inviting Office of Tax Policy officials were sent to their offices at Treasury.

22. In addition to those previously mentioned, the following NYU law professors were also expected to participate: Professor Fred B. Brown, Professor Noel B. Cunningham, Professor Harvey P. Dale, Professor Laurie L. Malman, Professor Guy B. Maxfield, Professor John Peschel, Professor Fred Quattlebaum, Professor Margaret Riess, Professor Joshua Rosenberg, Professor Len L. Schmolka, Dean Stanley Siegel, and Professor Bernard Wolfman.

23. In addition to those previously mentioned, the following consultants were expected
The list of federal officials who were expected to participate reads like a veritable who's who of federal tax legislative policy. The names of over a dozen Office of Tax Policy officials were on the participant list, including Assistant Secretary Chapoton and Deputy Assistant Secretary Dennis E. Ross. Numerous Internal Revenue Service (IRS) officials were also expected to attend the seminar, including IRS Commissioner Lawrence B. Gibbs, and IRS Chief Counsel William F. Nelson. In addition, United States Department of Justice Tax Division Assistant Attorney General William S. Rose and several of his top aides were expected to participate. Also, Senate Finance Committee Staff Director William Wilkins and several other employees of the congressional tax-writing committees were expected. Even Tax Court Chief Judge Samuel B. Sterrett's name was on the participant list.

Office of Tax Policy officials who attended the 1988 Eagle Lodge Tax Seminar for Government were allowed to do so on
government time, and without having to claim vacation days. Moreover, each Office of Tax Policy official who participated in the 1988 Eagle Lodge Tax Seminar for Government received Treasury authorization to attend. In this regard, on the required Treasury travel authorization forms each Office of Tax Policy official marked a box indicating that the "NATURE" of the trip to the 1988 Eagle Lodge Tax Seminar for Government was "100% Official." Moreover, in a March 4, 1988, Treasury memorandum, Deputy Assistant Secretary Dennis E. Ross justified the Office of Tax Policy's participation in the 1988 Eagle Lodge Tax Seminar for Government as follows:

Past seminars have been the seed for a number of legislative reforms supported by Treasury, and have similarly been useful in developing new administrative approaches. In short, the interchange that occurs at the seminar clearly and directly benefits this office in carrying out its various responsibilities. (emphasis added)

According to a Declaration by Assistant Secretary Chapoton filed in the author's FOIA action, each participant at the 1988 Eagle Lodge Tax Seminar for Government received a binder containing the following documents: a seminar schedule, information about the Eagle Lodge facilities, a list of participants, and copies of the ten scholarly articles that were delivered at the seminar. Assistant Secretary Chapoton retained his binder of 1988 Eagle Lodge Tax Seminar for Government documents in a bookcase in his Treasury office where he could have ready access to them. Similarly, many other Office of Tax Policy officials retained their 1988 Eagle Lodge Tax Seminar for Government documents in their offices or in their homes. Assistant Secretary Chapoton and


The title page of the binder reads: "New York University School of Law Tax Seminar for Government, Eagle Lodge, March 4-6, 1988." The titles and authors of the articles are as follows: "Loopholes" - No author stated; "Interest Allocations" - Professor Lawrence Lokken; "Problems Concerning Partnerships" - No author stated; "Deferral" - Professor Hugh J. Ault; "Noninterest Analogues I" - Joshua D. Rosenberg and Daniel Halperin; "Reflexions on the Passive Activity Loss Provisions" - Deborah H. Schenk; "Section 482" - Thomas C. Horst; "Funny Paper" - Peter C. Cannelllos and Edward D. Kleinhard; Distributions of Corporate Property after the Repeal of General Utilities" - James S. Eustice; and "Large Case Management - Selected Aspects" - Judge Arthur L. Nims, III, Michael L. Paup, and Marlene Gross. id. at 3, 5.
other Office of Tax Policy officials who have retained their 1988 Eagle Lodge Tax Seminar for Government documents sometimes use those materials as reference materials.

III. THE FREEDOM OF INFORMATION ACT ACTION CONTINUES

The principal issue in the author's FOIA case against Treasury is whether or not the documents received by the Office of Tax Policy officials who participated in the 1988 Eagle Lodge Tax Seminar for Government are "agency records" within the meaning of FOIA. The documents in issue include the seminar schedule, information about the Eagle Lodge facilities, a list of participants, and ten tax-related scholarly articles. The major issue is whether these documents (especially the articles) are "agency records." Treasury contends that they are not. 29

FOIA requires Executive Branch agencies to make "agency records" available to individuals seeking disclosure. 30 Unfortunately, for all its attention to the treatment of "agency records" FOIA never defines that crucial phrase. 31 To resolve this issue, courts generally look to the general principles that underlie the Act as a whole. 32 The general rule is that, "all records in an agency's possession, whether created by the agency itself or by other bodies covered by the Act, constitute 'agency records.'" 33 In this regard, it is well-settled that the basic policy of the FOIA is in favor of disclosure, and the federal agency bears the burden of justifying nondisclosure. 34

29. Treasury has also suggested that even if the documents in question are "agency records" within the meaning of FOIA, the documents may be exempt from disclosure under FOIA Exemption 4 as commercial and confidential information. 5 U.S.C. § 552b(4)(1982 & Supp. 1986). The author's view is that Exemption 4 is intended only to protect business entities that submit proprietary information to the government, not lobbyists and others who submit documents to agency officials in order to influence them.


33. Id. at 1109.

34. Alirez v. N.L.R.B., 676 F.2d 423, 425 (10th Cir. 1982). Moreover, "The purpose of the Act—to give the public access to information on which the government bases action . . .—would be impeded if 'agency record[s]' excluded documents that had moved the government to act." General Elec. Co. v. United States Nuclear Regulatory Comm'n, 750 F.2d 1394, 1400 (7th Cir. 1984) (citations omitted).
Generally, the courts have indicated that materials "obtained" from private parties and "used" by a federal agency are "agency records." The essence of Treasury's defense in the author's FOIA action is that the requested documents are not "agency records" because they were never "obtained" or "used" by Treasury, but only by Office of Tax Policy officials acting in their "personal" capacities. The author's claim is that the facts show that Treasury has "obtained" and "used" the records, and so they are "agency records" which should be released under FOIA. The district court ruled in Treasury's favor, and the issue is now pending before the United States Court of Appeals for the Tenth Circuit.


36. The author believes that the following facts support his position that the documents in question are "agency records" within the meaning of FOIA:

The documents in issue were provided to and reviewed by some 16 specially-invited Office of Tax Policy officials who, on government time and with government permission, attended the "100% Official" 1988 Eagle Lodge Tax Seminar for Government. Those Office of Tax Policy officials who attended the seminar were expected to participate in the tax policy discussions at the seminar. Moreover, according to an admission by Deputy Assistant Secretary Dennis E. Ross, the Eagle Lodge Tax Seminars for Government "clearly and directly" benefited the operations of Treasury's Office of Tax Policy. The documents themselves are clearly tax-related and, indeed, were prepared for the seminar in order to influence the thinking of those Treasury officials responsible for formulating federal tax policy. Furthermore, many of those Office of Tax Policy officials have kept the documents in question in their offices at the Treasury and regularly refer to those documents. Moreover, the requested documents already have been shared with dozens of New York and Washington, D.C. private lawyers, professors, and consultants who also attended the 1988 Eagle Lodge Tax Seminar for Government.

37. The issue came before the United State District Court for the Western District of Oklahoma when Treasury moved to dismiss the author's Complaint for lack of subject matter jurisdiction on the grounds that the documents received by the Office of Tax Policy officials who attended the 1988 Eagle Lodge Tax Seminar for Government are not "agency records." The author cross-moved for summary judgment on the grounds that the undisputed facts in the record showed clearly that those documents are "agency records" which must be disclosed under FOIA. On December 12, 1988, the district court ruled in Treasury's favor and dismissed the author's Complaint. On February 1, 1989, the author appealed to the United States Court of Appeals for the Tenth Circuit. See Forman v. Chapoton, No. 88-1151R (W.D. Okla. Dec. 12, 1988).
IV. THE FEDERAL ADVISORY COMMITTEE ACT

The Federal Advisory Committee Act (FACA) was enacted precisely because Congress was concerned about policy-making by federal officials meeting secretly with private groups. FACA applies to meetings of any committee, conference, or similar group "established or utilized by one or more federal agencies in the interest of obtaining advice or recommendations." Thus, to the extent that NYU's Ninth Annual Tax Seminar for Government is "utilized" by the Office of Tax Policy, the Internal Revenue Service, and the United States Department of Justice "to obtain advice or recommendations" about federal tax policy, FACA should apply.

FACA requires that advance notice of advisory committee meetings be published in the Federal Register, that the meetings be open to the public, and that the public have access to most committee documents. Yet neither Treasury, nor the Department of Justice, is currently complying with these requirements in connection with the Eagle Lodge Tax Seminars for Government. In particular, the Eagle Lodge Tax Seminars for Government are closed to the public and the press.

By letter dated July 25, 1988, this author advised Treasury's advisory committee management officer, Jill E. Kent, of Treasury's apparent violations of FACA in connection with the Eagle Lodge Tax Seminars for Government and requested that future seminars be opened to the press and public as required by FACA. By letter dated September 26, 1988, Ms. Kent advised this author that she had concluded that no violations of FACA had occurred. While the legality of Treasury's position may be

40. FACA, 5 U.S.C. App. § 10(a) (Supp. IV 1986).
41. A copy of that letter is in the author's possession.
42. A copy of that letter is in the author's possession. In pertinent part, her letter states:
challenged under the Administrative Procedures Act, to date no such suit has been initiated.

V. CONCLUSION

As German Chancellor Otto von Bismarck once observed: "The less people know about how sausages and laws are made, the better they'll sleep at night." If Bismarck was right, then perhaps the public can sleep peacefully with the knowledge that federal tax policy is being developed in secret Eagle Lodge Tax Seminars for Government, hidden from the public and closed to the press. On the other hand, the author is of the view that such secret seminars have no place in our democratic system.

In a free society, it is imperative that the public be able to see how private organizations attempt to influence government policies. Accordingly, if neither FOIA or FACA can reveal what occurs at such secret seminars involving top government officials as the Ninth Annual Tax Seminar for Government, then those laws need to be reformed. It is essential that the process of policy formulation lets the sun shine in!

The Eagle Lodge tax conference is not an advisory committee as defined by the Federal Advisory Committee Act. The conference is not established by the government for the purpose of obtaining any specific policy advice or recommendations. Additionally, any advice that may be provided at the Eagle Lodge forum is obtained from the individual attendees. Clearly, "consensus advice or recommendations" are not sought, as would be the case if the Eagle Lodge conference was serving as an ad hoc advisory committee. See 41 CFR 101-6.1004(j) (1987).


THE ELITISM IN TAX POLICYMAKING

Ljubomir Nacev*

In this issue of the Northern Kentucky Law Review,¹ Professor Jonathan Forman informs us that for the past nine years the Graduate Tax Program of the New York University School of Law and its faculty have held a "Tax Seminar for Government" at Eagle Lodge, Pennsylvania for the benefit of top federal officials who are involved in the formulation of tax policy and tax legislative proposals. The purpose of these seminars is to bring together a select group of legal academics, private attorneys, and federal officials for discussion of current tax legislative and administrative topics. Attendance at the seminars is by invitation only. Those who do attend are given a binder of working papers prepared by the NYU law faculty on various topics in the law of taxation.² In addition to involving its faculty in the seminar, the Graduate Tax Program has made its financial resources available to facilitate the seminar. New York University, a tax-exempt institution, holds receptions and dinners for the participants at its expense and also reimburses the participants for their travel expenses.

The seminars seem to have been successful for their intended purpose. Dennis E. Ross, former Deputy Assistant Secretary of Treasury for Tax Policy, is quoted as stating that:

Past seminars have been the seed for a number of legislative reforms supported by Treasury, and have similarly been useful in developing new administrative approaches. In short, the interchange that occurs at the seminar clearly and directly benefits this office in carrying out its various responsibilities.³


2. Id. at 306. The principal dispute in Professor Forman's suit is whether the working papers ("Seminar Binders") are "agency records" for purposes of release under the Freedom of Information Act (FOIA).

Professor Forman then informs us, as he has on a previous occasion, \(^4\) that the participants at the "Tax Seminar for Government" have to agree to keep the seminar proceedings confidential and that the meetings are closed to the press and the public. It is this secrecy that disturbs Professor Forman. He ardently argues that such a proscription allows for policymaking behind closed doors and away from public scrutiny. His indictment is that "such secret seminars have no place in our democratic system." \(^5\) Professor Forman believes that such closed seminars threaten the integrity, such as it is, \(^6\) of the tax legislative process in that the seminars provide a secret forum for lobbying government officials. \(^7\) He has buttressed this moral stance with legal action. He has brought suit under the Freedom of Information Act seeking to obtain the documents received by the Treasury officials who attend the seminar. \(^8\) In doing so, Professor Forman takes seriously the admonition that the Freedom of Information Act was "enacted to facilitate a basic principal [sic] of democratic theory, that an informed electorate is essential to the operation of representative democracy." \(^9\) Moreover, Professor Forman believes the secret seminars are in violation of the Federal Advisory Committee Act which he interprets to require that any conference regularly used by a federal agency to obtain advice be open to the public. \(^10\)

I applaud Professor Forman's challenge to the way the game is played. My support goes to his moral stance. The courts will decide the legal validity of his Freedom of Information Act suit. \(^11\)

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5. Id. at 1309.
10. Forman, Eagle Lodge, supra note 1, at 309.
11. Although Professor Forman lost his FOIA suit at trial, he has appealed. Forman
The aspect of the Eagle Lodge seminar that I would like to comment on is its process, not its outcome. I would ask that Professor Forman also distinguish between process and product. In making his case, Professor Forman argues that secret or closed deliberations produce bad law, while open meetings produce the opposite.\textsuperscript{12} I do not subscribe to this proposition as a general principle. Good ideas should not be rejected no matter what their source. They are too scarce. Neither the opening nor the closing of the process guarantees good law. What matters is the integrity of the participants in the process as well as the integrity of the process itself. Stanley Surrey, a former Assistant Secretary of the Treasury for Tax Policy, himself came to rue the opening of the executive sessions of the tax-writing panels in Congress.\textsuperscript{13}

Open mark-up sessions ended only in admitting lobbyists and not much sunshine. One result is the plethora of transitional rules in recent tax legislation.\textsuperscript{14} The closing of the mark-up sessions is still debated as a parliamentary step to save the tax-writing process.\textsuperscript{15}

We know how to produce good proposals in secrecy as well as in public. We in academia, a point at issue in Professor Forman’s suit,\textsuperscript{16} do much of our thinking in isolation and much of our writing in law reviews, a forum that almost guarantees secrecy.

\textsuperscript{12} Forman, Editorial, supra note 4, at 1310.


\textsuperscript{16} Professor Forman’s editorial in Tax Notes, supra note 4, was reproduced in the November 1988 Association of American Law Schools Section on Taxation Newsletter at 14. In introducing the editorial, Professor Rebecca Rudnick observed that an issue at the core of Professor Forman’s FOIA action is the relationship between the academic community and government officials. Id. at 13.
Treasury I was drafted in secret by the Treasury Group headed by Charles McClure and Ronald Pearlman and overseen by Treasury Secretary Donald Regan. Nevertheless, Treasury I was a document that was publicly acclaimed and remains today a source of ideas for revenue options. The 1959 Ways and Means Tax Revision Compendium hearing document is an example of a public process of equal force and stature. It inspired the 1966 Carter Commission in Canada, which in turn influenced our own Blueprints for Basic Tax Reform in 1977. Good ideas can be wrought both in public and in private. Like income, ideas can be source-blind.

Nevertheless, Professor Forman’s concerns do point out a disturbing, perhaps inescapable, state of affairs: that there is an elitist, technocratic aspect to tax reform and tax policy formulation. Such formulations are not, except at times at the local level with its ballot referenda, very intuitive or democratic. Unaffected voters—the majority—are unconcerned and uninformed. The complexity in the issues, and the time and energy

17. Birnbaum & Murray, supra note 6, at 42-64.
21. In a tax system like ours, based in theory on an ability to pay, the source of incremental increases in such ability should not be determinative in deciding whether such increases should be taken into account in measuring taxpaying capacity. Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955). Likewise, ideas in tax policy should be judged for their merit in relationship to their symmetry with the criteria for measuring what ought to be taxed.
needed to overcome this hurdle, guarantees the public's lack of involvement and direct participation in the process. Indeed, this lack of involvement is the *sine qua non* for the effectiveness of the lobbyists' efforts on the tax legislative front.\(^\text{23}\) The public support for the Tax Reform Act of 1986, for example, was lukewarm at best, yet it received overwhelming congressional and presidential support.\(^\text{24}\) It is rare that a single tax issue becomes so dominant on the national agenda, except perhaps in 1984,\(^\text{25}\) that a federal election is taken as a referendum on that issue. As a result, tax structures are fashioned, even when done in public, by those in the know, the scientific policymakers,\(^\text{26}\) who are a very select group. The very nature of a group is that it excludes nonmembers. Even when it is open, it is closed.

The case against the end-product of New York University's Eagle Lodge seminars that Professor Forman makes is thus equivocal. Secrecy does not necessarily guarantee bad ideas; the tax policy process is inherently technocratic; and public input at the federal level except in general terms, *to wit*, reading lips, is minimal.

Neither do secret agendas, in themselves, necessarily generate more complex systems that benefit and perpetuate a private caste of tax lawyers and accountants, another worry of Professor Forman's.\(^\text{27}\) Walter Blum's cynical advice to legislators to never worry about too much complexity—you can never make it complex enough\(^\text{28}\)—could apply equally to a publicly formulated tax

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24. At the time the Ways and Means Committee was marking up the Tax Reform Bill of 1986, and after both Treasury I and II were released, only 39 percent of those polled in a Wall Street Journal-NBC poll approved of the idea of tax reform on personal grounds. *Birnbaum & Murray*, supra note 6, at 235.

25. I am referring here to Walter Mondale's promise during the 1984 presidential campaign to raise taxes if elected. *Birnbaum & Murray*, supra note 6, at 34-5.

26. I use the term as developed by Professor Bruce Ackerman in *Private Property and the Constitution* 10-20 (1977). The term refers to a policymaker who, while engaged in systematic thought about the ultimate objectives of a legal system, manipulates technical legal concepts so as to resolve the issue at hand in concert with the comprehensive view he or she understands to govern that legal system. *Id.* at 15. Of course, the view I express in this article is that the policymaker may apply various value systems in his or her analytic critique.


system. The public debates on a comprehensive income tax or a consumption tax base did not reveal a system less complicated than the current version. Any agenda, whether public or private, invariably will generate legal doctrine fraught with ambiguities requiring the attention of a professional class. Simplicity is not necessarily the equitable or always desired solution. Nothing would be simpler, yet more preferential to wealth, than a head tax.

To note all this, however, is not to dispute the fact that there is something disturbing about NYU’s Eagle Lodge seminars. What sets these seminars apart from other academic forums is the fact that a government agency and its personnel participated. Private thought was elicited for a public purpose, but in a very unpublic way. The meetings were closed to the public and the press, and the public participants were asked to and agreed to keep the proceedings confidential. A public dialogue was privatized.

If the government chooses to avail itself of private input, such input should be open and balanced to minimize any one ideological influence. A balanced representation of ideas should be the sought ideal. To indict NYU’s Tax Seminar for Government is to indict a process that eschews such balance. Much has been said and written lately of the pernicious influence of PACs and honoraria on the tax legislative process. Much of this commentary is founded in the public choice school of thought which portrays legislators as consumers directed by self-interest in acting on legislative matters: the Tax Reform Act of 1986 as the best tax act money can buy. It is equally justifiable to argue that ideas similarly

30. It is almost axiomatic in tax policy deliberations that there is a trade-off between equity and simplicity. For example, the case against a progressive income tax is made in part on the claim that progressivity is responsible for much of the complexity of our tax laws. Blum & Kalven, The Uneasy Case for Progressive Taxation, 19 U. CHI. L. REV. 417, 434-35 (1952). This claim is critically examined and found to be overstated in Bankman & Griffith, Social Welfare and the Rate Structure: A New Look at Progressive Taxation, 75 CALIF. L. REV. 1905, 1929-37 (1987).
31. The government officials attending the seminar characterized the nature of their participation in the seminar as “100% official” activity. Forman, Eagle Lodge, supra note 1, at 306.
32. Doernberg & McChesney, Doing Good or Doing Well?: Congress and the Tax Reform
influence events and that tax legislation influenced by ideas is as subjective as that influenced by money. The pen can be as mighty as the Gucci.

What matters, thus, is that the influences on the democratic process be open, openly displayed and openly arrived at. Openness in process, as with the case against tax expenditures, enhances political accountability. Closed meetings in which public officials seek private advice on the proper direction of tax legislation erode in a not-too-subtle way the idea of an open government. Secret seminars breed suspicion that the have-players are the beneficiaries of inside information, for the benefit of themselves and their clients. The possibility of such privilege is antithetic to a democracy. It is bad enough that preferential treatment is part of the end-product. It should not be part, or appear to be part, of the process itself. Preference is not democratic. No efficiency trade-off is necessary here. Preference does


34. The Italian shoe may forever be synonymous with tax lobbyists. Birnbaum & Murray, supra note 6, at 4, dub the hallway outside the Senate Finance Committee room “Gucci Gulch.”

“There are a lot of Guccis outside,” someone supposedly remarked to Sen. Robert J. Dole (R-Kan.) referring to the army of lobbyists anxiously encamped outside his Finance Committee’s midnight markup of the 1982 tax increase; to which Dole uttered his now-legendary reply: “They’ll be barefoot by morning.” Paul Taylor, Lobbyists Lose the Game, Not the Guccis, in M. Graetz, supra note 6, at 50.


Accountability is a flash point in a number of social structures today: Management accountability to shareholders is at the root of the debate on the efficacy of leveraged buyouts (LBOs); constitutional accountability is at the root of the Oliver North trial; and professional accountability is at the root of the resurgence in the deliberations on the ethics of the legal profession. On the latter, see Firak, “Ethical Fictions as Ethical Foundations”: Justifying Professional Ethics, 24 Osgoode Hall L.J. 35 (1986) (criticizing the lack of personal accountability for unethical conduct due to the protective cloak of a professional ethic).

36. By preferential treatment, I mean those provisions of the tax code that depart from the normative definition of the tax base, i.e., tax expenditures. See supra note 35.

37. The Reagan tax acts were driven by a conviction that too much concern over equity
not make for a more productive process—indeed, the energy needed to sustain the preference in process makes for a less neutral and efficient process. What is more, for academia to engage in such regularly closed meetings with government officials is particularly unseemly.

The question of democratic input in an inherently elitist process is especially compelling today at the federal level where incumbency assures re-election. The question is also ripe in today’s legislative environment where provisions become part of tax legislation without input by one of the parties to the process, as was the case with the Tax Equity and Fiscal Responsibility Act of 1982, or where provisions are added at the eleventh hour in conference without further congressional input or public involvement.

Given the latest ACIR poll, again depicting the income tax as the least fair tax, process is no small matter. Compounding this concern over process is the growing institutional disquiet over noncompliance. A closed process suggests that you cannot win in tax design led to efficiency losses due to the distortive effects of taxation on the supply of labor, savings and risk-taking. Nacev, supra note 33, at 301, 310; and Nacev, Tax Policy Literature: A Commentary, 30 Tax Notes 1019, 1026-27 (1986). As a result, the Reagan tax acts realigned the constant trade-off between equity and efficiency in our tax structure. See also Bittker, Tax Reform Yesterday, Today, and Tomorrow, 44 Wash. & Lee L. Rev. 11 (1987). For a classic work on this necessary trade-off, see A. Okun, Equality and Efficiency: The Big Tradeoff (1975).

38. For example, more than 90 percent of House incumbents were re-elected in 1988. Character is Destiny, 132 TIME 86 (Nov. 21, 1988).


41. In the early 1970s, polls by the Advisory Commission on Intergovernmental Relations (ACIR) showed that Americans found the federal income tax to be fairer than state and local taxes. This perception flip-flopped by 1985, with the ACIR poll showing the federal tax to be perceived as the least fair. Birnbaum & Murray, supra note 6, at 9. See also W. Klein, B. Bittker & L. Stone, Federal Income Taxation 36 (7th ed. 1987). The latest ACIR poll confirms this trend in public attitude toward the federal income tax. ACIR, Changing Public Attitudes on Government and Taxes (Washington, D.C., ACIR Publication, 1988).

unless you are on the inside, privileged. The have-nots can even the score through noncompliance. We all get what we can. Thus, how laws are made is as important as what those laws are. Justice in process is important.

Of course, there is nothing to suggest that anything undue actually occurs at the Eagle Lodge seminars. That is beside the point. The burden is not on advocates of an open process to show such untoward occurrences. If full disclosure is a principle, it stands firm. In any event, there are subtleties to consider. The ideas proposed, shared and exchanged at an exclusive, secret seminar are a form of influence in which the rest of us do not partake. The fact that those ideas are presented by academics does not rob the event of its subjectivity. We all have our prejudices, our interpretive traditions. It is too late in the day to argue about neutral scholarship. The law is not transcendentally autonomous. Where we let the tax burden rest speaks volumes about our politics. Thus, when the government lends its ears, no advice is neutral.

The argument for an open process is an argument against law as science, against trained scholars acting as Philosopher Kings. The argument for elitism in tax policymaking, on the other hand, is an argument grounded on the authority of an intellectually rigorous discipline, the science of law. Elitism depends on this scientific validation. The elite's scholarly skills validate their selection to and inclusion in the selective policymaking process. The legitimacy of an elite in a democratic society is in their claim to scientific objectivity. In turn, the elite display a complete trust in their reason, in the soundness and merit of their technically derived prescriptions. This argument falters, however, if there is no science of law that can be intellectually sustained. In such case, the objectivity that an elite claims and with which it validates its prescriptions is false. Then, what of the notion of a science of law pursuant to whose neutral scientific technique the elite can govern? The answer is that law is not scientifically autonomous, transcending personal choices. The law is, like the other social sciences, bound by its cultural setting, bound by an ideology from which it can not distance itself. Society and culture provide its context. Law is a means through which society expresses its normative choices at a particular point in time. Law is a tool for achieving desired social ends. In this view, the law is laden with cultural and ideological assumptions. As such, the
law does not describe an objective reality. Such a view argues that the law is not inevitable but is contingent on the input of pre-legal normative assumptions.\footnote{Although any of the works of the Realists will do as a detailed articulation of this argument, see generally O.W. Holmes, Jr., The Common Law (1881). For a more recent discussion of these ideas, see Rubin, The Practice and Discourse of Legal Scholarship, 86 Mich. L. Rev. 1835 (1988); and Williams, Critical Legal Studies: The Death of Transcendence and the Rise of the New Langdells, 82 N.Y.U. L. Rev. 429 (1987). For a historical overview, see Posner, The Decline of Law as an Autonomous Discipline: 1962-1987, 100 Harv. L. Rev. 761 (1987).}

This identity of law and cultural politics is particularly strong in taxation. The answer to why we pay taxes is because we buy civilization with such payments. Civilization as we see it, in our own time, in our own terms. Through taxation we commit private means for public purposes. With our annual tax payments, we participate in the communal choices and social organizations to which we have thereby consented. Indeed, what makes taxation—its amount and its type—so controversial an issue is its very political nature.\footnote{This political nature is emphasized by the statutory nature of tax law and by the constant, annual attention given taxation by Congress. This should not be taken to suggest that the common law is insulated from politics, only that a statutory and public law is perhaps more susceptible to politics. For an argument that economic insights about the common law are equally political, see Gjerdingen, The Politics of the Coase Theorem and its Relationship to Modern Legal Thought, 35 Buffalo L. Rev. 871 (1986).}

Viewed this way, the prescriptive arguments made by the participants in the NYU Tax Seminar for Government are based on consciously or unconsciously stated pre-normative positions. The participants' politics and ideology—their pre-legal normative premises—will frame the issues presented and the questions asked and will help pre-determine the answers prescribed. The participants do not come to the task of choosing alternatives behind a veil of ignorance. They come to the altar with "the effects of specific contingencies which put men at odds and tempt them to exploit social and natural circumstances ..." to the advantage of those contingencies.\footnote{J. Rawls, A Theory of Justice 136 (1971).}

Since our prescriptions cannot be said to be objective or neutral, what matters is that the process of the discourse be open to deliberation and input from all sides. If objectivity is not attainable, what remains is that all voices be heard in an open process, in an open discourse and elaboration of pre-legal nor-
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mative premises. The aim is to argue for procedural justice so that through an open dialogue the biases in the fact-value distinction are overcome. The aim is for a fair process pursuant to which any alternative chosen can be claimed to be just.\textsuperscript{46} A precondition to this communitarian approach is the constraint of publicity—the disclosure of governing principles—pursuant to which condition everyone will know which social choices and individual preferences are at stake and everyone will thus engage in a full dialogue as to their ordering and preference relations.\textsuperscript{47} Where all parties are invited to freely engage in this organic process, the contractarian outcome is of particular value to tax policy deliberations. A participatory process has the benefit of binding the participants to the alternatives chosen. A participatory process offers the same benefit to tax compliance as the benefit theory of taxation: it has the benefit of an agreed to exchange. You see your dollars buying civilization.

To reject the idea of the autonomy of law, the science of law, and to argue for an open process is not to reject the idea of law itself. Law and rules do exist. The question is how should law, and income, be measured. Even if we buy into the idea of an elite, technocratic subgroup in charge of tax policymaking, who should constitute the membership of this group? Should it be, as it is today, an all white, all (or mostly all) male enclave? Are we doing so well in structuring tax policy that we cannot hear other voices, or should we be content to listen to the same chorus? A selective, elite process will perpetuate the power of the voices with the influences to be heard and the ideas to be proffered. If so, as Louis Eisenstein suggests, the result may be simply the continuing beguiling of the majority by the minority that they are overly taxed, that the value they have created and are entitled to keep was created singularly by them alone.\textsuperscript{48}

\textsuperscript{46} Id. at 136-142. See generally B. ACKERMAN, SOCIAL JUSTICE IN THE LIBERAL STATE (1980); Cover, Forward: Nomos and Narrative, 97 HARV. L. REV. 4 (1983).
\textsuperscript{48} L. EISENSTEIN, THE IDEOLOGIES OF TAXATION 57-88 (1961). For example, opponents
The elitism in tax policymaking presents a finely-tuned case study, to use Professor Forman's description, of the tension in a democracy between the ruled and the rulers, the governed and those who govern. Plato in his *Politeia (The Republic)* argued for rule by the moral, wise elite—the Philosopher Kings. This would be a rule by those who understand and scientifically observe reality—those in the know. But what do they know, what do they understand—that is the refrain here. That is, this could also be rule by the dictatorship of the virtuous. At whose altars do they worship? Do they know who should ultimately carry the tax burden? Is there such mysticism that surrounds the question that only the trained elite can properly, optimally, answer that question? If the rest of us do not participate in the process, how far can, should, government policymaking be separated from the governed? If informed participation is the desired norm, it becomes our task in academia to educate and enfranchise the governed in order to nullify the charge that the ruled would otherwise be moved to choose according to their own uneducated sentiments.

The call for an open process in tax policymaking, as well as in other spheres of government, is founded on a belief in partici-

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patory democracy. This is a belief in a form of social arrangements—a democratic society—that is predicated on the active interest and participation of each member of society in determining its governing principles. Such a social arrangement claims citizenship as a virtue. What need for Philosopher Kings if open political deliberations result in defining the common good.50

In embracing Rousseauism, I do not go so far as to reject all divisions of labor in the polity. It would be too academic to assume that all members of society share the interest to be fully committed citizens. Indeed, when it comes to taxes, they often do not. The solution then is to give the elite, the Philosopher Kings, an opportunity to explain, to guide reflection, to teach. The solution contemplates the need and the possibility for society to listen but not necessarily to be ruled. The constraint would be an insistence on an open process and the "veil of ignorance."

The questioning of the role of elite tax law paladins is not a new realism or even cynicism. Louis Eisenstein decried the self-interest of the bar in the tax legislative process more than a quarter of a century ago.51 In addition, the revolving door between the public and private sectors has always been a source of tension and attention.52 For example, Dennis E. Ross, the former Deputy Assistant Secretary of Treasury for Tax Policy who is quoted above, will rejoin the New York law firm of Davis Polk & Wardwell, the same firm that employs Michael M. Rollyson, a seminar participant and formerly of the NYU Graduate Tax faculty.53

All may not be lost, however. It is arguable that much of this worry about openness is a concern at the margin. To be troubled about untoward and undue influence in the public process is to accept the proposition that people still matter in the tax legislative process and that legislators are free to choose the direction of our tax structure. In such a state, external influences, such as PACs and closed, selective seminars, are possible factors in

50. For a passionate call for a participatory democracy, see B. Barber, Strong Democracy: Participatory Politics for a New Age (1984).
52. The uproar that swirled around the nomination of former Sen. John Tower to be Secretary of Defense was in part due to his former association with the defense industry.
decision making. Moreover, such externalities are most influential if one adheres to a neoclassical explanation of decision making based on a self-interest postulate that portrays legislators as consumers seeking to maximize their Ways and Means utility.\textsuperscript{54} Vulnerability to influence is not as critical if this explanation of legislative behavior is not accepted. Influence is not as critical if larger structural imperatives, such as economic forces and the deficits, dictate policy choices. In such a state, individual choices based on process externalities are less extensive. To the extent people continue to matter in this view of the legislative process, it is within a more narrow parameter defined by larger macro forces. Nevertheless, at the margin, where individual externalities are still at play, open government should be practiced.

Governing is the politics of special interests. The politics of tax reform are no less so. Thus, Professor Forman's quest for democratic input is noble, though perhaps quixotic. He deserves to prevail. Should he fail, however, we will not suffer as much as in times past when elite accommodations were more possible with more far-reaching consequences.

\textsuperscript{54} See Doernberg & McChesney, \textit{supra} notes 6 and 32.
COMMENTS

Regulating the Nonprofit Corporation

Daniel E. Tobergte

The nonprofit sector in the United States today comprises a truly significant element of our economic and social structure. Nonprofit associations, organizations, and corporations are traditional throughout United States history and certainly have not been lost in modern society. The concept of "citizens combatting problems and reaching solutions on a collective basis—in association"—is inherent in the American social structure. 1

I. THE SCOPE OF NONPROFIT ORGANIZATIONS

The magnitude of the nonprofit sector is difficult to conceptualize. Accurate data on the size of the nonprofit sector is scant. A 1984 analysis of the nonprofit sector, defined to constitute only those organizations recognized by the Internal Revenue Service—some 480,000—showed that the nonprofit sector accounted for 4.2% of the total number of entities in the United States. This compares to the business sector which accounted for 94% and the governmental sector less than 1%. 2 This data does not take into account organizations, associations, societies, and clubs which do not have IRS recognition, yet collectively comprise a part of the nonprofit sector.

The rate of growth of nonprofit corporations, though, provides a valuable insight into the nonprofit sector. Professor Howard L. Oleck, a noted authority on the nonprofit sector, reports that business corporations continue to grow in the United States at a rate of three percent per year. In comparison, the rate of growth for nonprofit corporations is 5.5% per year. 3 One com-

2. Id. at 18-19.
3. Seminar presentations by Howard L. Oleck, Professor of Law, Stetson University College of Law, at Salmon P. Chase College of Law, Northern Kentucky University (Jan. 25 and Feb. 2, 1988) [hereinafter cited as Seminar Presentations].
mentator asserts that the nonprofit sector "may employ more people than the federal, state and local government put together." 4

The activities in which nonprofit organizations engage are quite diverse. Alex de Tocqueville's portrayal of the use by Americans of public associations aptly describes their nature and diversity:

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.... If it is proposed to inculcate some truth or to foster some feeling by the encouragement of a great example, they form a society. Wherever at the head of some new undertaking you see the government in France, or a man of rank in England, in the United States you will be sure to find an association. 5

This observation is further exemplified by today's divergence of nonprofit organizations that run from local sports and hobby groups, to religious groups, to chamber of commerces, to universities, to the AAA. These organizations are based on the characteristic American tendency to form groups voluntarily, for altruistic, social, religious, educational, charitable, cultural, fraternal, economic, and other purposes. 6 Generally speaking, American nonprofit organizations are a "magnificent part of [our] society, despite some disturbing abuses among them." 7

II. DEVELOPMENT OF NONPROFIT CORPORATIONS

As early as the 17th century, the corporation was used in the New World as an organizational form for charitable activities. 8 Almost all colonial corporations had charitable purposes. The rationale for seeking a corporate organizational form was the

5. de Tocqueville, Democracy in America 106 (P. Bradley ed. 1966) in B. Hopkins, supra note 1, at 11.
7. Id. at 5.
attribute of legal personality, i.e., the essence of corporateness.9 The for-profit business corporation's presence was minimal during this period.

Religious incorporation dominated early incorporation acts and statutes. Basic to the general philosophy of these statutes was the presence of a local public service function.10 Specific use of a single statute for charitable, benevolent, religious, and public service functions began in 1895 with New York's passage of the Membership Corporation Law.11 Charitable corporation statutes maintained separateness from general corporation statutes as early as the late 1800s. Refinement of this separate nature continued through the 1930s. Nevertheless, dependence upon the general law, the statutory law, and the case law of business corporations came into existence with the passage of nonprofit corporation statutes by New York, Michigan, Ohio, Illinois, Maryland, and California that corresponded to the for-profit corporation statutes in these states. Nonprofit corporations were accorded greater flexibility in internal affairs yet they were also bound by the general corporation law through this development in the 1930s.12

Professor Oleck believes that the nonprofit sector today has become dominated by organizations and associations borne of an "altruistic and voluntaristic mission."13 Oleck asserts that these characteristics are the "true bases of nonprofit organization life."14 Oleck's theory is aligned with the early 17th century recognition of organizations as nonprofit corporations because of their public service function underpinnings. Oleck comments that the reason nonprofit organizations sought the corporation form was because it is by far considered the best form of organization for most group enterprises. The corporation form combines several advantages: freedom from personal liability, continuity of existence, flexibility, and great range and scope as a result of the ability

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9. Id. at 632-33. The rationale motivating passage of early incorporation acts included advantages to the public that such incorporations be increased, convenience to individuals desiring to incorporate, relief of legislative workload and promotion of freedom of religion.
10. Id. at 637.
11. Id. at 635.
12. Id. at 636.
14. H. OLECK, supra note 6, at 40.
to join resources and efforts. Other forms nonprofit organizations have utilized include: individual enterprise, partnership, association, society, foundation, charitable trust, and the corporate sole (or one-person corporation).

In marked contrast, Professor Henry B. Hansmann views the development of the nonprofit sector from an economic perspective. He believes that the nonprofit sector is comprised of enterprises formed through forces at work in the marketplace. Hansmann's view rationalizes that nonprofit enterprise is a reasonable response to a particular kind of "market failure," which is specifically the inability to police producers by ordinary contract devices which he calls "contract failure." Hansmann's theory allows for the nonprofit form to offer consumers the protection of "another broader contract—namely, the organization's commitment, through its nonprofit charter, to devote all of its income to the services it was formed to provide."

The proliferation of the nonprofit sector has taken the law by surprise. Courts and commentators are still developing fundamental legal principles as to what nonprofit organizations are, how they should be categorized, and who should supervise them. The governmental and legal response to the nonprofit sector has been inadequate. Those persons responsible for control of nonprofits—namely lawyers, state legislators, and state administrative agencies—have been slow to adapt to the growth trend exhibited by nonprofit organizations. As a result, many of the ideas and laws currently relied upon are outdated. Nonprofit

15. Id. at 31.
16. Id. at 30, 32.
18. Id.
19. Hansmann, Reforming Nonprofit Corporation Law, 129 U. PA. L. REV. 497, 507 (1981). Another theory approaches the issue of emergence of the nonprofit corporation from a "government failure" perspective. The public has different demand functions for public goods. The manner in which the government decides how much of a public good to produce is important. Private nonprofits will tend to supply the sort of public goods for which there is not yet a demand from the majority of citizens or which a majority of the citizens are only prepared to supply and pay for in taxation in what a minority considers inadequate quantities. See Baker, Regulation of Nonprofit Corporations in Indiana, 18 IND. L. REV. 777, 779-80 n.11 (1985).
21. Id.
corporation law has not developed in the same coherent fashion as for-profit corporation statutes. In addition, existing nonprofit corporation law varies in significant respects from one state to the next.\textsuperscript{23}

Both Oleck and Hansmann agree that the foundation relied upon by the drafters of nonprofit corporation statutes in the 20th century was erroneous. Oleck calls for a broader base of drafters to compose nonprofit corporation law.\textsuperscript{24} Oleck is opposed to the reliance upon for-profit business corporation codes in drafting nonprofit statutes because of the "business mentality that infects all for-profit codes and which, when applied by cross reference to nonprofits, weakens both the prohibition upon distribution of corporate assets to 'owners' and fiduciary doctrines that ought to be the hallmarks of altruistic endeavors."\textsuperscript{25}

Hansmann likewise believes that the different corporation laws are often a poor model for nonprofit corporation law. The character of a business corporation is intended to serve and protect the interest of the corporate shareholders from those immediately in control of the corporation, including management and other shareholders. In a nonprofit corporation, the charter's restrictions in the bylaws are primarily for the benefit of the organization's patrons. Hansmann points out that this difference has been missed by those who draft and interpret nonprofit corporation law.\textsuperscript{26} As a consequence, business corporation statutes are often a poor model for nonprofit corporation law.\textsuperscript{27} Nevertheless, this reliance

\textsuperscript{23} Hansmann, supra note 17, at 836.

\textsuperscript{24} H. Oleck, supra note 6, at 39. Oleck believes that "a proper committee to draft nonprofit organization law should consist of philosophers, anthropologists, biologists, statisticians and demographers, theologians, sociologists, economists, psychologists, and the like, plus a few lawyers to crystallize the principles enunciated by the committee into workable rules of law. Lawyers who think in terms of profit-oriented organization law are basically not the right people to decide what concepts and principles should undergird nonprofit organization law."

\textsuperscript{25} See Fessler, Codification and the Nonprofit Corporation: The Philosophical Choices, Pragmatic Problems, and Drafting Difficulties Encountered in the Formulation of a New Alaska Code, 33 Mercer L. Rev. 543, 552 (1982). At this writing, Alaska had not enacted the suggested nonprofit corporations code formulated herein.

\textsuperscript{26} Hansmann, supra note 19, at 507.

\textsuperscript{27} Id. Kentucky's "Nonprofit Corporation Acts" codified in KRS § 273.161 to § 273.390 are quite similar to the "Kentucky Business Corporation Act" codified in KRS § 271A.005 to 271A.710. Kentucky's General Assembly ostensibly moved towards an even greater assimilation by the Kentucky Nonprofit Corporation Acts to the Kentucky Business Corporation Act in 1988. Essentially, during its regular session, the General
upon the business corporation's body of law for nonprofit purposes began in the 1930s and still remains in effect in many jurisdictions, including Kentucky.

III. GOVERNMENT ENCOURAGEMENT OF NONPROFIT ORGANIZATIONS

The public service function of associations, organizations, and societies in the United States was highly influential in the designation of the corporate status privilege by governmental bodies on nonprofit organizations seeking such acknowledgment. Federal, state, and local governments have encouraged nonprofit organizations through the use of the corporate status privilege and tax exemptions.

The test concerning the right of nonprofit status, in most cases, is motive. When altruistic, ethical, moral, or social motives are clearly dominant in an enterprise, that enterprise is considered nonprofit under our governmental system. Essentially, in recognition of services rendered to citizens without a profit rendered, our democratic government grants various benefits to qualified organizations. Generally, statutory incorporation language is nebulous concerning the purposes allowed for incorporation. However, Ohio's nonprofit corporation statutory language is regarded as one of the best in the country. Comparatively, Kentucky's statutory language is more indicative of the majority of the definitions. Kentucky permits incorporation for "any lawful purpose or purposes" including, inter alia, charitable, education, and religious purposes.

In addressing the issue of appropriate statutory language, Hansmann would allow all organizations and associations gov-

Assembly adopted an omnibus revision of the Business Corporation Act and also included an amendment enacting changes to the Nonprofit Corporation Acts. Changes to the Nonprofit Corporation Acts were non-substantive provisions concerning filing requirements and name availability standards to be as consistent as possible with the changes to Chapter 271A. Substantive changes included a limitation of liability for directors of nonprofit corporations. See KY. REV. STAT. ANN. § 273.2523-2526 (Michie/Bobbs-Merrill 1981 & Supp. 1988) (filing requirements); KY. REV. STAT. ANN. § 273.215(5) (limitations on director's liability).

28. See infra text accompanying notes 30-35.
29. H. OLECK, supra note 6, at 20.
30. Id. at 22.
31. Seminar Presentations, supra note 3.
erned by the "non-distribution constraint" to be worthy of the corporate privilege. The non-distribution constraint, in Hansmann's terminology, is the prohibition of distribution of profits to members of the organization.\textsuperscript{33} Hansmann labels nonprofit organizations as being virtually identical to for-profit corporations in that they are "in a sense, engaged in the sale of services," yet different because of the non-distribution constraint.\textsuperscript{34}

Recognition by the government of corporate privilege status is harder to understand under Hansmann's description. The public service function element, so distinguishable in early incorporations of nonprofit entities, is difficult to identify as the significant, controlling element of incorporation under Hansmann's theory. Nevertheless, recognizing the diversity of nonprofits that exists today, and despite the questionable presence of a definable public service element without private benefit of a pecuniary nature in such nonprofits, Hansmann's theory describes quite comprehensively the status quo of nonprofit incorporation by state government today.

In comparison, Oleck believes that the designation of the corporate privilege should be accorded to only those organizations that are truly nonprofit, \textit{i.e.}, those organized with the traditional public service function.\textsuperscript{35} The designation of corporateness by a state ultimately rests as a manifestation of encouragement of the nonprofit and its purpose(s).

The status in our society of nonprofit enterprises is very definitely a privileged one. Among the privileges are certain tax exemptions, a right to special low postage rates,\textsuperscript{36} exemption from labor union and collective bargaining under the National Labor Relations Act, exemption from statutory requirements of contributions to state or other unemployment compensation funds, and tort liability immunity for directors, officers, employees, and agents. A privilege to solicit donations, gifts, bequests, and contributions as tax deductions is also a major feature of nonprofit organizations.\textsuperscript{37}

\textsuperscript{33} Hansmann, supra note 19, at 501.
\textsuperscript{34} Id.
\textsuperscript{35} Seminar Presentations, supra note 3.
\textsuperscript{36} H. Oleck, supra note 6, at 23. These postage rates reductions have been limited in the recent past to nonprofit organizations.
\textsuperscript{37} Id. at 24.
According to one observer, “beyond these concessions, the title ‘nonprofit’ may be the most important benefit the state can confer upon an entity.”38 The public can act with “a disarmed sense of generosity in the face of such a label.”39 Oftentimes, the nonprofit structure is chosen by the incorporator “because of the positive image a nonprofit corporation conveys to the consuming public.”40 Attempting to justify these governmental incentives is significantly harder than describing their existence.41 An example of the many special kinds of ordinances and statutes with which governmental agencies provide special preference to organizations of a charitable nature can be found in the New York City Zoning Resolution. Nonprofit organizations are accorded preferential treatment in the development of their land in a number of ways, including the exemption from the “reasonable return finding” in granting an applicant’s request for a zoning variance.42

This concept of *quid pro quo* between nonprofit organizations and government on the basis of public good carries over into the reason for tax exemptions. Federal, state, and local law usually provide exemptions from various taxes (and where appropriate, deductibility of contributions for donors) for a wide variety of nonprofit organizations. Yet, despite the longevity of most of these exemptions, their underlying rationale is vague. Nonetheless, the rationale for exemption appears to be longstanding public policy and inherent tax theory.43

The importance of tax exemptions in encouraging the growth of the nonprofit sector in the United States is debatable. One position states that, “but for the tax law, the overwhelming

39. Id.
42. Note, *Towering Above Charities: Real Estate Development by Nonprofit Organizations, Zoning Variances, and the Reasonable Return Finding*, 8 CARDOZO L. REV. 397 (1986). Nonprofits in New York City, in seeking a variance to develop real estate they own, are essentially seeking a source of revenue. Nonprofit churches, for example, do not need the air rights development for their own physical space demands. The nonprofit acts like a commercial developer by allowing, through exemption of the reasonable return finding needed, a variance to build a building larger than permitted or that a similarly situated developer would not be permitted to build. The author of this Note views this as an abuse of the nonprofit privilege.
43. B. Hopkins, *supra* note 1, at 3.
majority of nonprofit organizations would not exist."44 Contrary to this is Professor Hansmann's position that tax exemption offers no scientific explanation for nonprofit sector growth.45 Nevertheless, tax exemption is largely an extension of comparable practice throughout the whole of history.46 On the state and local level, the real property tax exemption is the most attractive encouragement given to nonprofit organizations.47 Other taxes exempted are sales and use taxes, corporate income taxes, and local occupation license taxes.48 No general rule can be stated regarding exemptions from state and local taxation upon nonprofit organizations. Generally, "charitable organizations" receive total or partial tax exemption with "merely nonprofits" receiving a much more limited degree of exemption.49

IV. REQUISITES FOR GOVERNMENT INVOLVEMENT WITH NONPROFIT ORGANIZATIONS

Concomitant to the encouragement of the "public good" that nonprofit organizations provide is the need for policing the abuse that follows. The grant of corporate status to certain qualified nonprofit organizations is a privilege that can, has, and continues to be abused.50 Increasingly, there are articulated accusations of unchecked abuse in the nonprofit sector.51 Specific areas of abuse

45. Hansmann, supra note 17, at 881-83. Professor Hansmann's theoretical basis is that nonprofits exist because of economic factors and not simply because of tax breaks.
46. B. Hopkins, supra note 1, at 5.
48. Id.
49. H. Oleck, supra note 6, at 822. For example, the city of Covington, Kentucky provides a specific exemption to "entities operated on a not-for-profit basis according to state and federal law" from its occupational license fee. COVINGTON, KY. CODE OF ORDINANCES, § 110.02(B) (1984).
50. H. Oleck, supra note 6, at 223.
51. Hone, California's New Nonprofit Corporation Law—An Introduction and Conceptual Background, 13 U.S.F. L. REV. 733, 737 (1979). Numerous nonprofit organizations have considerable economic and political power. "For example, there are non-profit corporations which have over $100,000,000 a year in government contracts (The Aerospace Corporation 1968 Annual Report); receive over $120,000,000 a year to provide services to California motorists (The Automobile Club of California Annual Report); sell over $300 million a year in goods to members and the public (FEDCO, Inc. Annual Report 1978) and act as a trade association for 500 trading organizations in California with yearly sales in excess of $100,000,000 (California Trading Association)."
that the government should be concerned with include among other things: private inurement, advancement of members' financial interest, self dealing/interested transactions, dissolution, distribution of assets, and the mixture of nonprofit and for-profit activities.

For the most part, nonprofit and for-profit corporations are quite similar: both require a legal form, pay compensation, face essentially the same expenses, are able to receive a profit, make investments, and produce goods and services. The unique difference between the two is that nonprofit corporations may not distribute profits to members.\textsuperscript{52} The prohibition on private inurement is the "one unifying definitional principle"\textsuperscript{53} of nonprofit organizations. Hansmann agrees that the "prohibition of net earnings to controlling individuals" is the essential defining feature of a nonprofit organization.\textsuperscript{54} Hansmann notes that "current law in this area is often misguided, reflecting the prevailing confusion concerning the function of a nonprofit form."\textsuperscript{55}

Nonprofit corporation members may not directly acquire any of the organization's funds, yet members may still violate the spirit of nonprofit corporation statutes. Advancement of their own financial interests through their participation in the nonprofit is one method. Many nonprofit corporations provide services that directly or indirectly serve the financial interest of their members. Examples of this situation include local homeowners associations involved in general community planning and development, trade associations, and day care centers.\textsuperscript{56} The potential for abuse, although harder to detect, is still relevant.

Another area noteworthy of government involvement concerns self-dealing/interested transactions. A summary of self-dealing transactions that may amount to private inurement is as follows:\textsuperscript{57}

1. sale, exchange or leasing of property between an organization and an individual;
2. lending of money or extension of credit between an organization and an individual;

\textsuperscript{52} B. HOPKINS, \textit{supra} note 1, at 240.
\textsuperscript{53} Fishman, \textit{supra} note 8, at 619.
\textsuperscript{54} Hansmann, \textit{supra} note 19, at 553.
\textsuperscript{55} \textit{Id.}
\textsuperscript{56} \textit{Id.} at 553-59.
\textsuperscript{57} B. HOPKINS, \textit{supra} note 1, at 248.
3. furnishing goods, facilities, services between an organization and an individual;
4. payment of excess compensation, or expenses between an organization and an individual; and
5. income to the individual of the organization.

Because most states utilize the for-profit statutes as guides in self-dealing proscriptions, the evolving standard is too weak for nonprofits. Nonprofit corporations have a fiduciary duty to patrons and customers who are generally much less able to look after themselves than are shareholders in a business corporation—i.e., through derivative suits, voting power, and disclosure requirements—none of which are readily available to nonprofits.

Few or no limits are placed on a distribution of a corporation's assets upon dissolution. More particularly, in many instances, statutes explicitly recognize the right to have the organization's assets distributed to members upon dissolution, including net accumulated income. Hansmann categorizes this as an enormous loophole in nonprofit corporation statutes. Peculiar to Indiana law is the unique requirement that assets remaining after dissolution escheat to the state. This quite possibly is an overregulation of state law.

V. Effectiveness of Government Regulation

Recognizing that nonprofit corporations are prevalent in our society, that government encourages their existence, and that abuses often result from this encouragement, the question arises, how effective is government regulation of nonprofit corporations? Is the state of affairs today accurately depicted in the following 1970 statement by Professor Oleck?

The state of law and practice in the field of nonprofit organizations... can only be described as a mess. Considering the importance

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58. Hansmann, supra note 19, at 568.
59. Id.
60. Id. at 574. Kentucky requires assets of a voluntarily dissolved nonprofit corporation to be used to pay all debts and liabilities, to be returned to the donating entity if so required, and, if acquired subject to permitted use for a charitable, religious, eleemosynary, benevolent, educational or similar purposes, to be distributed to another nonprofit organization(s) of like purpose(s). Other assets remaining may be distributed according to the articles of incorporation or bylaws to members if provided as such. See KY. REV. STAT. ANN. § 273.303 (Michie/Bobbs-Merrill 1981).
61. Hansmann, supra note 19, at 574.
of these organizational forms and privileges in the U.S., and the
general lack of awareness of the size of the problem of their abuse
and governance, the prospects for decent non-profit laws, opera-
tions, and (above all) effective supervision, are ominously bad ... 
Present laws, practices and lack of skillful and ample supervision,
combined with normal human instincts towards self enrichment—
all continue to make a worrisome problem out of what should be a
joyous and very proud part of our society: nonprofit organizations.63

If credible, these assertions excite natural curiosity respecting
the degree and nature of government supervision. With the
exception of a few jurisdictions, the degree of supervision is
minimal.64

A. Statutory Drafting

Government regulation of nonprofit organizations at the state
level begins with statutory drafting. It has already been noted
that there is too much reliance on the for-profit business sta-
tutes.65 The essential elements of a nonprofit corporation statute
should include proper licensing schemes, enforcement provisions,
disclosure requirements, derivative suits for members/patrons,
membership and board of director provisions, and strict financial
accounting measures. Federal regulation has shaped nonprofit
corporation statutes and has, to an extent, removed the emphasis
for state efforts to enforce and reform nonprofit corporation law.
Often states have merely tracked internal revenue proscriptions
and yielded enforcement efforts to the IRS. Fishman notes that
"Nonprofit corporation statutes have been an afterthought."66

B. Special Statutory Attempts

States have used a diversity of schemes for categorizing non-
profit corporations. Some have followed the Model Nonprofit
Corporation Act.67 Two states, New York and California, have
both enacted nonprofit corporation statutes independent of their
business corporation statutes that include separate classification
systems.

63. Oleck, supra note 22, at 233.
64. Fessler, supra note 25, at 546.
65. See supra text accompanying notes 23 and 24.
66. Fishman, supra note 8, at 639.
67. Id. at 659.
New York provides for different degrees of regulation for enunciated types of nonprofit corporations. Type A corporations are the least regulated and generally include civic, fraternal, professional, or trade associations. Type B organizations are the most closely regulated and are similar to organizations classified under 501(c)(3) of the Internal Revenue Code. Type C organizations are intended to include purposes of a less traditional sort, i.e., a local development corporation with the exclusively charitable purpose of alleviating unemployment through stimulation of private investment in a given area. "Type D corporations are adapters or connectors which enable the Not-for-Profit Corporation Law to function as the foundation statute if the corporation's power of formation is covered by another statute."

California's nonprofit corporation law, effective in 1980, divides nonprofits into three categories: public benefit corporations, religious corporations, and mutual benefit corporations. Hansmann notes that California's law is a "wholesale replacement of pre-existing statutory provisions" and important because "it is the most comprehensive and carefully drafted of all the existing nonprofit corporation statute." Oleck objects to the California effort because the essence of nonprofit organizations, altruism and voluntarism, are lost in the California statute. Despite apparent flaws in New York and California's classification schemes, these attempts have been made in an effort to better regulate the nonprofit sector. As such, they serve as guideposts in the formulation of nonprofit corporation law.

C. State Enforcement Efforts

Beyond licensing, enforcement efforts by the states of the nonprofit sector have been collectively described as lacking. Most statutes and/or common law provide for enforcement by

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69. Fishman, *supra* note 8, at 661.
70. H. Oleck, *supra* note 6, at 235.
71. Fishman, *supra* note 8, at 662.
72. Id. at 663. See CAL. CORP. CODE § 5000-12000 (West Supp. 1988).
73. Hansmann, *supra* note 19, at 535.
the attorney general in each state. Mostly though, supervision by the respective attorney-generals' offices remains cursory or nonexistent in most states, since these offices have extremely limited resources and a multitude of responsibilities. The result is that most charitable organizations are essentially self-regulated. Most efforts at policing the nonprofit sector are targeted towards the charitable trust arena, concentrating largely on the most blatant abuses of fraud.

D. Enforcement by Patrons or Members

Government enforcement efforts against the abuses that occur in the nonprofit sector generally do not include the right to bring a derivative suit by members of the nonprofit corporation. Most nonprofit corporation statutes do not include this important legal mechanism for discouraging mismanagement on the part of nonprofit corporation directors and officers. It is almost a universal rule that patrons or members have no right to bring a derivative suit. The general rule is that, absent a statutory right, there is no private enforcement of a charitable trust, a nonprofit trust, or a nonprofit corporation. The nonexistence of this right places all of the burden of enforcement upon the secretary of state and the attorney general's office in the majority of states.

Generally, the nonprofit statutes, including the Model Act, with a few exceptions, are silent on the issue of a derivative suit. The doctrine is largely judge-made. As a result, the law pertaining to charitable nonprofits, and with it nonprofit corporation law in general, evolved into a hybrid of corporate and trust law principles. The degree of loyalty to which directors of nonprofit corporations should be held compared to for-profit corporations has been an area of disagreement by the courts. Some courts apply a trust standard of loyalty or another standard stricter than that applicable to a business corporation di-

76. Fishman, supra note 8, at 669, 673.
78. Hansmann, supra note 19, at 606.
79. Id. at 606.
80. Note, supra note 77, at 1001.
In a derivative suit in the for-profit sense, a shareholder sues not on his rights but on behalf of the corporation. The shareholder derivative suit has become a rather successful legal technique for discouraging mismanagement and fiduciary abuse of duties in the for-profit sector.

While the states have generally tracked for-profit statutes in enacting their nonprofit corporation statutes, this element of private enforcement curiously has been left out. Reasons given for not allowing standing to members to sue derivatively have centered on the premise that only the attorney general can sue to enforce a charitable trust. Also, courts have denied standing to members of non-charitable nonprofit corporations, without distinguishing between the charitable and non-charitable purposes of the two types of corporations. Other reasons given for not permitting standing to nonprofit members, donors or beneficiaries have been charges of excessive, vexatious, or harassing litigation. Therefore, essentially through judge-made doctrine and state legislative omission, the opportunity for members of nonprofit corporations to privately seek enforcement against potential abuse has not been made available.

Efforts at dismantling this prohibition on derivative suits by nonprofit corporation members, however, have been made by state legislators, courts, and commentators. Both New York and California have led the way in providing for nonprofit corporation derivative suits. Generally, these statutory provisions parallel their respective business corporation provisions on shareholder derivative suits. Within each, safeguards against vexatious litigation are incorporated.

Courts in some jurisdictions also have recognized the right of members to utilize the derivative suit mechanism on behalf of the nonprofit corporation. Granting standing in such cases has been reasoned upon the availability of the action in the for-profit business corporation laws and judicial decisions. Such courts are willing to grant standing until the state legislature acts other-

82. Note, supra note 77, at 1002.
83. Id. at 1004.
84. Id.
85. Hansmann, supra note 19, at 607.
86. Baker, supra note 19, at 829. Nine states have non-profit corporation statutes that permit members to sue derivatively as of 1985. These are California, Delaware, Florida, Idaho, New York, Oklahoma, Pennsylvania, South Carolina, and Wyoming.
Recently, Courts in the District of Columbia and Alabama have granted standing to consumers to bring suit against the managers of the organization for mismanagement of funds.88

Kentucky's Nonprofit Corporation Act contains no provisions for derivative suits by members of nonprofit corporations. Private corporation shareholders are accorded this right through KRS 271A.245.89 The attorney general in Kentucky is accorded the power to bring an action for involuntary dissolution of a nonprofit corporation. Grounds for dissolution include, *inter alia*, that the corporation is found "guilty of abuse or misuse of its corporate powers, privileges or franchises, or the corporation has become detrimental to the interest and welfare of the Commonwealth of Kentucky or its citizens. ..." No express statutory provisions for nonprofit member derivative suits exist in Kentucky, nor have the courts recognized such a cause of action.90

For most states, including Kentucky, reliance on the attorney general's office to independently monitor nonprofit corporation abuse, or effectively respond to valid complaints by nonprofit corporation members is unworkable. Oleck states that attorney generals practically shun investigations of nonprofit organizations.92 Generally, state attorney generals lack the financing, incentive, or capability to effectively protect nonprofit corporation members' rights.

State legislators need to open up this avenue for protection of nonprofit corporation members, donors, and beneficiaries. Safeguards against vexatious litigation and the possibility of strike suits can be effectively legislated and adhered to. Fishman argues for the expanded use of relators as preferable to any expanded government regulation in this area.93 The use of member derivative suits also works to satisfy this diversification measure. Concerning relators, the proceeding stems from the *quo warranto* proceeding. The relator expresses a third party interest through

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90. Id. at § 273.220.
91. Apparently, the Kentucky appellate courts have not addressed this issue.
the attorney general, who ultimately controls the action at all times. Cost of the suit is borne by the relator and not the state. Public interest law firms or public-spirited citizens are suggested as possible relators.\textsuperscript{94} Diversification of the enforcement function without the addition of bureaucratic governmental supervision is certainly noteworthy.

Reliance on the attorney general to effectively supervise nonprofit corporations is untenable. Because governmental bodies encourage nonprofit corporations to perform their public service functions, benefits are accrued directly by government through the non-provision of the many services these nonprofit corporations provide. With the astounding growth factor associated with the nonprofit sector, opportunities for abuse of the existing supervisory system are wide and diverse. To curb the almost imminent occurrence of abuse and to protect the public, state legislators need to fully consider the use of member derivative suits for nonprofit corporations as an important legal tool to assist in effective governmental supervision.

\textbf{E. Tax Exemption Regulation}

Enforcement by the Internal Revenue Service is another means of regulation of nonprofit organizations. Generally, once an organization qualifies under I.R.C. § 501(c)(3), tax-exempt status "may be maintained as long as the organization does not materially change its character, purposes, or methods of operation."\textsuperscript{95} In some instances, both for the ability to provide a tax deductible entity in which charitable contributions can be given and the nonprofit organization's own exemption from corporate income taxation, maintenance of tax exempt status is crucial to existence. This occurs mainly with private foundation charitable nonprofits. Sanctions against 501(c)(3) nonprofits exist in the form of "excise taxes," which in effect are really penalties for what Congress has characterized as wrongful conduct.\textsuperscript{96}

Problems exist, though, when tax exemption policy is heralded as a primary enforcement mechanism against poor fiduciary stewardship on the part of nonprofit organizations. Most exempt

\textsuperscript{94} Id. at 673-74.
\textsuperscript{95} B. HOPKINS, supra note 1, at 639.
\textsuperscript{96} Id. at 520; Hansmann, supra note 19, at 602.
nonprofits, including the bulk of operating nonprofits such as hospitals and schools, are not covered by these special rules that apply to private foundations.\textsuperscript{97} Generally, the private inurement proscription exists as the only means of regulation for the IRS against such nonprofit organizations. Utilization of the IRS as a comprehensive enforcement agency for nonprofit abuse is ill-advised. The IRS has a mission to collect revenues, yet nonprofits are not a revenue source to the federal government. If federal revenue agents strictly enforce the non-inurement doctrine, an increase in federal revenues will probably not occur because the salutary effect will be a redistribution of the nonprofit's resources from management to the patrons or to services which the nonprofit provides.\textsuperscript{98}

Without an opportunity to effectively create revenues, the federal government's interest in enforcement against most nonprofits is considerably diminished. Plus, any perceived amount of taxes due to corporate income tax liabilities of nonprofits turned for-profit is unlikely to be significant enough to warrant even modest IRS attention.

\textbf{F. Regulation Through Disclosure}

Generally, the Internal Revenue Service and most states require annual reporting by nonprofit organizations.\textsuperscript{99} The 1986 Exposure Draft of the Model Nonprofit Corporation Act likewise calls for an annual report to be submitted to the secretary of state.\textsuperscript{100} Elements of the annual report generally are cursory and provide only information on the correctness of incorporation name and address of the corporation and its registered agent designated for service of process. Sanctions under Kentucky law for failure to file the required annual report, or to keep it updated, amount only to a permissive opportunity by the attorney general to seek an involuntary dissolution of the nonprofit corporation.\textsuperscript{101}

\textsuperscript{97} Hansmann, \textit{supra} note 19, at 602.
\textsuperscript{98} Id. at 604; Seminar Presentations, \textit{supra} note 3.
\textsuperscript{99} Hansmann, \textit{supra} note 19, at 618.
\textsuperscript{100} MODEL NONPROFIT CORPORATION ACT § 16.22 (Exposure Draft 1986).
\textsuperscript{101} KY. REV. STAT. ANN. § 273.320(3)-(5) (Michie/Bobbs-Merrill 1981). In fact, the only penalties in Kentucky law able to be levied against nonprofit corporations through the nonprofit corporation statute relate to minimal fines for boards of incorporated cemeteries and their failure to file periodic reports. See id. at § 273.390(2). See also OHIO REV. CODE ANN. § 1702.59 (Baldwin 1988) that is similar to Kentucky's minimal requirements by requiring a "notice of continued existence."
Most nonprofit corporation statutes are silent on the provision for greater disclosure than what annual reports generally require. During the study on Alaska's review of its nonprofit corporation statute, this area was targeted for reform because "no command that information be supplied which might betray the presence of a problem" was required. California and New York provide for a provision requiring disclosure of financial statements from nonprofits to members upon request, as does the 1986 Model Nonprofit Corporation Act Exposure Draft. Essentially, "these provisions take their inspiration from the business corporation statutes and generally treat members as analogous to shareholders."

Charitable organizations, because of the history of charitable trust statutes, "typically require that charities register with the attorney general and file periodic financial reports." Hansmann argues for similar disclosure of all types of nonprofits and elimination of less rigorous standards for non-charitable nonprofit corporations. These disclosure requirements should extend not only to New York, California, and Model Act provisions upon request to members, but also to the entire public as well through a filing with the attorney general's office. The diversity of the nonprofit sector is problematical to this suggestion. Establishing a minimum size for disclosure, as Hansmann suggests, would be needed. Regulating and instituting uniformity of periodic financial disclosure would assist in limiting the opportunities for abuse in the nonprofit sector.

VI. CONCLUSION

Nonprofit corporations are regulated quite differently from state to state. The consistent thread between every state's law on nonprofit corporations is the prohibition of private inurement. Supervision and regulation of this doctrine varies with each state. The more populous states, i.e., New York and California, evi-

102. Fessler, supra note 25, at 546.
104. MODEL NONPROFIT CORPORATION ACT, supra note 100, § 16.20.
105. Hansmann, supra note 19, at 619.
106. Id. at 618.
107. Id. at 620.
ently have had to encounter problems moreso with nonprofits than in other states, i.e., Kentucky. This degree of regulation is reflected in each state's legislation and enforcement agenda.

In 1979 Professor Oleck characterized the state of law and practice in the nonprofit corporation field as "a mess" and he described the prospects for decent nonprofit laws and supervision as "ominously bad." With the exception of a few jurisdictions, the reality of his predictions seems fairly accurate. The potential for abuse in the nonprofit sector is high. Concentration on each state's nonprofit corporation statutes needs to be heightened. Providing the framework for more effective supervision and enforcement, i.e., through a provision for member derivative suits in nonprofit corporations, is a task that must be undertaken.

108. See text accompanying note 64 supra.
109. Id.
LIABILITY OF OFFICERS AND DIRECTORS: EXTENDING THE SAFE HARBOR TO NONPROFIT CORPORATE STATUTORY LAW

J. Steven Rawlings

I. INTRODUCTION

There is a significant concern in the business community regarding the ability of corporations to attract and retain qualified officers and directors in the face of the personal liability to which those individuals may be exposed in the performance of their duties.1 As in the business (for-profit) sector, potential liability of an officer or director is a substantial concern for those individuals serving corporations that operate on a not-for-profit basis (non-profits).2 A typical instance when liability may come into question is when a conflict of interest, which is an impermissible interested transaction, is alleged. This type of transaction may include self-dealing,3 as well as a wrongful taking of a corporate opportunity.4

1. Peat Marwick, Directors' And Officers' Liability: A Crisis In The Making (a report made available by the international accounting firm of Peat Marwick & Co. for the benefit of its clients).
2. Id.
4. See, e.g., Mile-O-Mo Fishing Club, Inc. v. Noble, 62 Ill. App. 2d 50, 210 N.E.2d 12 (1965) and Stern v. Lucy Webb Hayes Nat'l Training School for Deaconesses & Missionaries, 381 F. Supp. 1003 (D.D.C. 1974) (naming officers and directors personally as defendants in cases involving mismanagement or nonmanagement); Holt v. College of Osteopathic Physicians & Surgeons, 61 Cal. 2d 870, 394 P.2d 932, 40 Cal. Rptr. 244 (1964) (claim that a gift to the corporation was misused, or that the purposes of the corporation have been violated); Burnett v. Barnes, 546 S.W.2d 744 (Mo. Ct. App. 1977) (alleging officers and directors have exceeded their authority or powers); Macaluso v. Jenkins, 95 Ill. App. 3d 461, 420 N.E.2d 251 (1981) (alleging that the officers and directors had been operating the business in their personal capacity, and that the corporation is a sham); Adams v. Commissioner, 70 T.C. 373 (1978) (director liability founded on tax laws); Newman v. Forward Lands, Inc., 430 F. Supp. 1320 (E.D. Pa. 1977) (breach of contract); Northwest Suburban Congregation Beth Judea, Inc. v. Rosen, 103 Ill. App. 3d 1137, 432 N.E.2d 335 (1982) and Mullins v. Pine Manor College, 389 Mass. 47, 449 N.E.2d 331 (1983) (tort actions); Tillman v. Wheaton-Haven Recreation Ass'n, Inc., 517 F.2d 1141 (4th Cir. 1975) (abuse of civil rights).
Traditionally, the for-profit corporation sector has received greater protection and indemnification from state statutory laws in allowing officers and directors to engage in interested transactions, provided that certain requirements are met. The greater level of protection was a result of the different standards of law that were applied to the two distinct types of corporations, profit and nonprofit.

Because different standards have traditionally been applied to profit and nonprofit organizations, there is a growing concern that individuals are being discouraged from serving in the nonprofit setting. The concern of nonprofit organizations in attracting qualified individuals to serve is often compounded by the undercompensation, or lack of compensation, offered to those willing to serve. This concern is especially pertinent when the organization requires individuals to serve on a volunteer basis.\(^5\) Despite the lack of compensation offered, persons serving nonprofit organizations are very often as susceptible to damage suits and personal liability as are those persons who serve for-profit corporations. This undercompensation, coupled with potential personal liability, may have a deterrent effect when attempting to attract talented individuals to serve nonprofits. Concerned individuals fear that the resultant effect will be to discourage these persons from serving nonprofit organizations while encouraging them to flee to the for-profit corporation sector where they are offered more favorable protection and indemnification from personal liability under state statutory law.\(^6\)

Many trends and considerations have been evident in the development of the statutory law governing corporations which

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5. There may be a greater willingness to allow indemnification for individuals serving nonprofit organizations because they serve without compensation. Cross v. Midtown Club, Inc., 33 Conn. Supp. 150, 157, 365 A.2d 1227, 1231-32 (1976). An example of personal liability of volunteers can be found in Riverview Investments, Inc. v. Ottawa Community Improvement Corp., 769 F.2d 324 (6th Cir 1982), modified, 774 F.2d 162 (6th Cir. 1985). In this case, seven members of a community improvement council were held liable for an alleged conspiracy action. The jury determined that the members engaged in a conspiracy to restrain trade in violation of section 1 of the Sherman Act for voting to deny industrial revenue bonds that would have financed a retail shopping development. Even though the members of the Council were exercising their best judgment in disapproving the bond issue, they each were held liable in their personal capacities. Although a judgment n.o.v. was entered and a new trial granted, there are those who feel that decisions like this are jeopardizing volunteer service in many communities.

may affect a change in the law relating to nonprofits. Considerations as to the practicality of the management function, provisions for manageable means of avoiding and resolving conflict, and overriding notions of fairness led to the conclusion that a change was required in the law of nonprofits in order to bring them up to par with their for-profit counterparts. This Comment examines the effect of these considerations on the nonprofit sector and traces the rationale behind bringing nonprofit corporations on an even par with profit corporations. More specifically, this Comment will examine recent legislation that provides a "safe harbor" for nonprofit directors and officers from potential liability that had formerly been available only to those who served profit organizations. These safe harbors in state statutory law are protective statutes which supply the officer or director refuge from liability if certain requirements are met. These statutes are creating a clearer and more evenhanded treatment of nonprofit directors' and officers' standards.

II. REEVALUATING NONPROFIT CORPORATE LAW

Because of the growth and proliferation in the number of nonprofit organizations in recent years, and because nonprofit corporate law generally has not reflected the level of advancement and importance of business statutory law, there is an increasing trend to reevaluate and update the statutory law governing nonprofits. While almost all states have non-profit corporation statutes, they generally address only the organizational aspects of non-profit institutions. In response, a growing number of states are enacting statutes addressing general standards of conduct governing a director's duty of care, and are providing more precise language to guide directors.

8. The corporate duty of care requires the director to perform his duties in good faith, in a way that he believes to be in the best interests of the corporation, and with the care that reasonably would be expected from a person in a like position and under similar circumstances. Selheimer v. Manganese Corp. of America, 423 Pa. 563, 224 A.2d 634 (1966); CAL. CORP. CODE § 309(a) (West 1977); N.Y. BUS. CORP. LAW § 717 (McKinney 1986). Thirteen states that have specific provisions on interested directors in their not-for-profit statutes for interested transactions are ARIZ. REV. STAT. ANN. § 10-1044 (Supp. 1987); CAL. CORP. CODE § 5233 (West Supp. 1987); CONN. GEN. STAT. ANN. § 33-457 (West Supp. 1987); IND. CODE ANN. § 23-7 1.1-61 (West 1979); LA. REV. STAT. ANN. § 12:228 (West 1969.
Just as officers and directors of for-profit corporations have been calling for greater protections and indemnification from personal loss, individuals serving nonprofit corporations have been seeking similar protections. Traditionally, those persons who worked for nonprofit organizations enjoyed a general feeling of invulnerability. They assumed that because they were serving their community without pecuniary compensation, or for significantly less money than what was available in the business sector, they would be entitled to immunity from the liabilities which plagued their less public-spirited counterparts in the business world. Because these “pillars of the community” enjoyed much respect, partly because of their superior economic power, their blithe sense of security was based somewhat on reality.

However, several factors changed this situation, including the following: the wealthy became a favorite target of litigation; ownership of these institutions became more dispersed and the individuals who served them became less influential; assets of many nonprofit organizations became more immense and subject to waste and misuse; and the general population gained an awareness that litigation could be profitable.

To assess the problem of individual liability, a national accounting and consulting firm, Peat Marwick, conducted a comprehensive study on the growing exposure to liability facing officers and directors in the corporate setting, including the nonprofit sector. The study examined the increasing difficulty of officers and directors to protect themselves in light of spiraling insurance costs and the sharp rise in the number of liability suits. It reveals that a growing number of potential officers and highly qualified individuals are refusing to serve nonprofit organizations without the coverage of liability insurance. In a survey of over 2500 participants, ninety-two percent of the respondents felt that

\[\text{See supra note 1.}\]
the liability problem was either of crisis dimensions now or that the problem may soon grow into a crisis.\textsuperscript{16} Thus, the principal finding of the study points to the widespread conviction that a crisis situation is imminent, if not already in existence. Despite the pervasive feeling of an impending crisis, officers and directors of nonprofit organizations have felt the effect of the problem more slowly than those individuals serving business corporations.

Because of the crucial need to encourage persons to undertake service to nonprofit corporations, there is a strong feeling among many legislators, community-minded citizens, and concerned individuals that there should be no distinction between profit and nonprofit corporation law, and that the rules applied to each ought to be the same. The case of \textit{George Pepperdine Foundation v. Pepperdine}\textsuperscript{17} is a reflection of this attitude. The founder of the corporation, Mr. Pepperdine, was sued by the corporation for three million dollars which was allegedly wasted over an eleven year period by speculation and mismanagement. Taking into account that Mr. Pepperdine had originally contributed the money to found the nonprofit corporation, the court stated that:

Assuming that the alleged losses were due to the alleged egregious blunders of the board under the leadership of President Pepperdine, and to have been the result of his negligence and of the lack of zealous interest on the part of others, why should he be now required to restore to his corporation what he once gave from his bounty and which was lost solely by reasons of his ignorant or careless reckoning?\textsuperscript{18}

The \textit{Pepperdine} case has not only been criticized,\textsuperscript{19} it was overruled by \textit{Holt v. Osteopathic Physicians & Surgeons}.\textsuperscript{20} Despite the \textit{Holt} ruling, that distinctions should be made between profit and nonprofits, there remains a widespread belief among lawmakers that because individuals are devoting their time to non-

\begin{itemize}
\item \textsuperscript{16} \textit{Id.} at 3. A total of 2,532 persons participated in the survey, which included directors and officers of corporations, hospitals, municipalities, museums, and orchestras.
\item \textsuperscript{18} \textit{Id.} at 159, 271 P.2d at 604.
\item \textsuperscript{20} 61 Cal. 2d 750, 757, 394 P.2d 932, 937, 40 Cal. Rptr. 244, 249 (1964) (Minority trustees have the capacity to bring an action on behalf of the nonprofit corporation against the majority trustees to enjoin any breach of trust that is threatened.).
\end{itemize}
profit organizations voluntarily, there is no justification for requiring higher standards than those of highly compensated individuals serving business corporations.21

In response to the potential finding of liability of corporate officers and directors, there has been a recent history of liberalizing the protection and indemnification offered by state statutory law. This legislation can be traced, to a large extent, to Smith v. Van Gorkum,22 and to the difficulty of obtaining directors’ and officers’ liability insurance. In Van Gorkum, liability was imposed as a result of a breach of the duty of care by the directors. The case was settled for $23.5 million after the decision was entered, of which $10 million was paid by the directors’ insurance policy, and the balance paid by the tender offeror.23 This concern of potential liability and of high insurance costs has been carried over to the nonprofit sector, as many organizations do not have the resources to indemnify directors nor the financial capability to pay insurance premiums or self-insure.24

Notwithstanding the recent changes in state statutory law, corporate law, as it applies to nonprofit organizations, is thought to be at a remarkably immature stage of development by many leading legal scholars.25 Confusion abounds as to the lack of any coherent conception of the basic purposes for which nonprofit corporations may be formed.26 Much of this confusion is simply the result of the lack of legislative effort to update the law governing nonprofit organizations. This lack of effort may sometimes be traced to the early view that considered the activities of nonprofit organizations as private in nature and of little or no interest to the state.

22. 488 A.2d 858 (Del. 1985).
23. This decision led some jurisdictions to change their business corporation statutes to make insurance to officers and directors more available and affordable, and to permit advanced authorization of indemnification of legal expenses. See, e.g., DEL. CODE ANN. tit. 8, § 145(c) (1983) and N.Y. BUS. CORP. LAW § 722 (McKinney Supp. 1988). For a thorough discussion, see Kurtz, The Duties and Liabilities of Officers and Directors, Including a Review of Indemnification and Insurance, in NONPROFIT ORGANIZATIONS 283 (D. Kurtz & J. Small eds. 1986).
26. Id. See also Hansmann, The Role of Nonprofit Enterprise, 89 YALE L.J. 835 (1980).
Because of difficult financial environments, including decreased funding, and the lack of legislative involvement in the non-profit arena, many nonprofits have moved into areas of profit-making and risk-taking. These organizations, which have mixtures of profit-seeking purposes, nonprofit activities, and goals, blur the distinction between profit and nonprofit. An example of this occurrence can be seen in the undertaking of profit-seeking activities by modern colleges and universities. Many schools are currently involved with such activities as business partnerships, real estate ventures, and cooperative research projects with large corporations. Because the standards of law that have applied to nonprofit organizations historically have not achieved the level of development and sophistication of the standards of for-profit law, the question arises which standard should be applied to those organizations having a mixture of activities. As long as the standards between profit and nonprofit law differ, the determination of which standard should apply to these organizations will remain a confusing and difficult determination.

III. BACKGROUND OF GOVERNING STANDARDS FOR INTERESTED TRANSACTIONS

The typical situation in which liability is imposed in the corporate setting occurs when an impermissible contract is executed between an officer or director and their corporation. According to the common law rule, contracts between an interested director and the corporation were voidable at the election of the corporation or its stockholders. The rationale behind this early rule was that the director was a fiduciary of the corporation, and because of this fiduciary relationship, the duty of loyalty was the most fundamental responsibility to be imposed upon him. As the Scriptures read, "No man can serve two masters." The

27. Fishman, supra note 24, at 418.
29. A trustee is in a fiduciary relation to the beneficiary and as to matters within the scope of the relation he is under a duty not to profit at the expense of the beneficiary and not to enter into competition with him without his consent, unless authorized to do so by the terms of the trust or by a proper court. RESTATEMENT (SECOND) OF TRUSTS § 170 comment 1(a) (1959).
30. Matthew 6:24. In scrutinizing the duty of loyalty, factors include the director's objectivity in making decisions, whether independent advice is sought by the director, and whether he has obtained approval from the corporation to enhance the objectivity of his deliberations. A.L.I., PRINCIPLES OF CORPORATE GOVERNANCE: AMERICAN LAW INSTITUTE ANALYSIS AND RECOMMENDATIONS 16-17 (Tent. Draft No. 5).
courts, therefore, applied a high and strict standard of conduct for the trustee whenever his personal interest came into conflict with his duty to the beneficiaries.\textsuperscript{31} Thus impermissible interested transactions between directors and corporations were analogized to trust law rather than to corporate law. Contracts between a corporation and its directors were prohibited.\textsuperscript{32} The theory behind this directive is that given a self-interested situation, the director would favor his personal interest or gain over that of the corporation.\textsuperscript{33} Because of this strict voidability, there was no consideration given to the fairness of the transaction.\textsuperscript{34}

In the 1974 case of \textit{Stern v. Lucy Webb Hayes National Training School for Deaconesses \\& Missionaries},\textsuperscript{35} Judge Gerhard Gesell discussed the difficulty in determining what standard should apply to interested transactions by nonprofit officers and directors. Judge Gesell stated that:

\begin{quote}
[t]he applicable law is unsettled. The charitable corporation is a relatively new entity which does not fit neatly into the established common law categories of corporation and trust . . . However, the modern trend is to apply corporate rather than trust principles in determining the liability of the directors of charitable corporations, because their functions are virtually indistinguishable from those of their "pure" corporate counterparts.\textsuperscript{36}
\end{quote}

In its application, the early rule was clear and predictable. However, several considerations altered this line of thinking. First of all, the practicalities of the modern business function meant that qualified and able individuals would be precluded from serving as officers and directors of corporations.\textsuperscript{37} There was also the possibility that in some circumstances modern business corporations would be better served with transactions involving their directors than with transactions involving other

\begin{footnotes}
\item[31.] Fishman, \textit{supra} note 24, at 418-19.
\item[32.] Id. at 434.
\item[33.] Id. "[T]he danger in all cases is that the dictates of self-interest will exercise a predominant influence, and super[de] that of duty." \textit{Michord v. Girod}, 45 U.S. (4 How.) 503, 555 (1846).
\item[34.] Id.
\item[36.] Id. at 1013.
\item[37.] Fishman, \textit{supra} note 24, at 435. \textit{Goodwin v. Agassiz}, 283 Mass. 358, 363, 186 N.E. 659, 661 (1933) ("Fiduciary obligations of directors ought not to be made so onerous that men of experience and ability will be deterred from accepting such office.").
\end{footnotes}
individuals or corporations. Finally, the courts became increasingly reluctant to substitute their own judgment for that of the corporation under the aegis of the business judgment rule.

IV. MODERN GOVERNING STANDARDS FOR INTERESTED TRANSACTIONS

The modern rule governing transactions between the corporation and one of its officers or directors, or between a corporation and another organization in which an interest of that officer or director is involved, is exemplified by Delaware General Corporation Law statute section 144. An interested transaction is neither void nor voidable if one of three requirements are met. The transaction involving the conflict of interest should be

38. Id. See also G. Hornstein, Corporation Law and Practice § 439 (1959).
39. The business judgment rule has been defined as: If in the course of management, directors arrive at a decision, within the corporation's powers (intra vires) and their authority, for which there is a reasonable basis, and they act in good faith, as the result of their independent discretion and judgment, and uninfluenced by any consideration other than what they honestly believe to be the best interest of the corporation, a court will not interfere with internal management and substitute its judgment for that of the directors' to enjoin or set aside the transaction or to surcharge the directors for any resulting loss. Henn, Corporations § 242 (2d ed. 1970).
   (a) No contract or transaction between a corporation and 1 or more of its directors or officers, or between a corporation and any other corporation, partnership, association, or other organization in which 1 or more of its directors or officers, are directors or officers, or have a financial interest, shall be void or voidable solely for this reason, or solely because the director or officer is present at or participates in the meeting of the board or committee which authorizes the contract or transaction, or solely because his or their votes are counted for such purpose, if:
(1) The material facts as to his relationship or interest and as to the contract or transaction are disclosed or are known to the board of directors or the committee, and the board or committee in good faith authorizes the contract or transaction by the affirmative votes of a majority of the disinterested directors, even though the disinterested directors be less than a quorum; or
(2) The material facts as to his relationship or interest and as to the contract or transaction are disclosed or are known to the shareholders entitled to vote thereon, and the contract or transaction is specifically approved in good faith by vote of the shareholders; or
(3) The contract or transaction is fair as to the corporation as of the time it is authorized, approved or ratified, by the board of directors, a committee or the shareholders.
(b) Common or interested directors may be counted in determining the presence of a quorum at a meeting of the board of directors or of a committee which authorizes the contract or transaction.
(1) disclosed to the other members of the board of directors and approved by a majority of the disinterested directors; or (2) disclosed to the shareholders and approved by a majority of disinterested shareholders; or (3) fair to the corporation.\textsuperscript{41} The 1976 case of \textit{Fliegler v. Lawrence}\textsuperscript{42} explained section 144 as “merely remov[ing] an interested director cloud when its terms are met and provides against invalidation of an agreement ‘solely’ because such a director or officer is involved.”\textsuperscript{43} Thus, the \textit{Fliegler} court viewed section 144 as neither preempting the common law duty of director liability nor establishing a grant of broad immunity for directors. The court also gave consideration to the fairness of the transaction by applying a two-tiered analysis which coupled section 144 with a test of intrinsic fairness.\textsuperscript{44}

The trend has been to allow this line of thinking to apply equally to nonprofit corporate directors and officers. As a result, state statutory law concerning interested transactions by directors and officers of nonprofits has begun to closely parallel that of for-profit corporations. As in the statutory law governing profit corporations, strict prohibitions against interested transactions are giving way so that the transaction is neither void nor voidable if (1) the conflict is disclosed or known to the other board members and a disinterested majority have approved it; (2) the conflict is disclosed to the other board members and a disinterested majority have ratified it; or (3) the contract or transaction is fair to the corporation.\textsuperscript{45} A minority, but growing number, of states have enacted specific statutes that provide for validation of interested transactions by nonprofit directors.\textsuperscript{46} In other states,

\begin{itemize}
\item \textsuperscript{41.} Del. Code Ann. tit. 8, § 144 (1975).
\item \textsuperscript{42.} 361 A.2d 218 (Del. 1976).
\item \textsuperscript{43.} Id. at 222. For a recent Delaware case applying this analysis see Marciano v. Nakash, 585 A.2d 400 (Del. 1987).
\item \textsuperscript{44.} Id. In 1975 California revised its statute explicitly to include fairness by requiring that a contract or transaction be “just and reasonable” for it to be approved by the board of directors. Cal. Corp. Code § 310(a)(2) and (a)(3) (West 1977).
\item \textsuperscript{45.} Del. Code Ann. tit. 8, § 144 (1983).
\end{itemize}
the general corporate code incorporates these types of transactions by reference. 47

V. RECENT OHIO LEGISLATION

In recognizing the necessity of attracting and retaining qualified citizens to serve in the nonprofit setting, and in recognizing that volunteer service is vital to the well-being of communities everywhere, Ohio has taken significant steps to bring the protection of nonprofit directors and officers on an equal ebb with their business corporation counterparts through the passage of House Bill 533. 48 House Bill 533 is the Ohio legislature's latest effort to articulate the public policy sentiments that reflect the goal of providing broader indemnification of a trustee's standard of care and to limit a trustee's potential liability in damages. This Bill represents the lawmakers' attempt to prioritize the state's urgent concern of protecting nonprofit officers and volunteers, and to retard the threat to community service.

The most significant change brought about by House Bill 533 is the change to section 1702.30 of the Ohio Revised Code concerning a trustee's standard of care. Under this new section, liability for a trustee is essentially limited to the extreme situations of bad faith and gross negligence. 49 A trustee will not be

47. Delaware does not have a nonprofit corporation code. In other states, nonprofit corporations are incorporated in a general chapter of the corporate code. For a description of various approaches to state nonprofit statutes see H. OLECK, NONPROFIT CORPORATIONS, ORGANIZATIONS, AND ASSOCIATIONS 44-48 (4th ed. 1980).

48. House Bill 533 is designed to extend the provisions of its predecessor bill, House Bill 902 and further seeks to eliminate all possible ambiguity concerning nonprofit officer and trustee liability in Ohio. House Bill 902 came to be known as the "Goodyear Bill" because of its function of addressing the pending takeover of the Goodyear Tire and Rubber Company. That legislative thrust intended to clarify the application of the business judgment rule as it applies to Ohio's General Corporation law, to facilitate the indemnification of a corporate director's legal expenses when the director has been sued in connection with the discharge of his duties and, to provide directors with an additional measure of protection from personal monetary liability. House Bill 533 is an attempt to make the ground rules the same for trustees of nonprofit corporations.

House Bill No. 533 amended Code §§ 1701.79, 1702.01, 1702.04, 1702.05, 1702.11, 1702.12, 1702.13, 1702.21, 1702.30, and 1702.31 (Baldwin 1988).

House Bill 902 amended code §§ 1701.01, 1701.13, 1701.16, 1701.19, 1701.32, 1701.59, 1701.60, 1701.76, 1701.78, 1701.79, 1701.80, 1701.84, 1701.85, 1701.95, 4967.04, 4967.10; enacted § 1701.801 and repealed § 4967.05, 4967.06, 4967.07, 4967.08, 4967.09, 4967.11 (Baldwin 1986).

found liable for damages for any action the trustee undertakes or fails to undertake as a trustee unless the trustee's action or inaction is proven by clear and convincing evidence to arise out of a deliberate intent to cause injury to the corporation, or with a reckless disregard for the best interests of the corporation.\textsuperscript{50}

Thus, a trustee now has the benefit of a presumption that he or she is acting in good faith and in the best interests of the corporation.

Ohio Nonprofit Corporation Law section 1702 had been originally enacted in 1980 as part of Senate Bill 174\textsuperscript{51} to provide standards for nonprofit corporation law that would more closely parallel profit corporation law. An example of this change can be found in section 1702.301, an entirely new provision concerning "interested party transactions" enacted by Senate Bill 174.\textsuperscript{52} It was added in order to liberalize standards governing transactions between nonprofit directors and the organizations they serve by upholding certain transactions between an officer and his or her organization if specific requirements could be met.\textsuperscript{53} The newly

\textsuperscript{50} OHIO REV. CODE ANN. § 1702.30 (Baldwin 1988).
\textsuperscript{51} Senate Bill 174 amended Code §§ 1701.59, 1701.63, 1702.30 and 1702.33 and added § 1702.301 (Baldwin 1988).
\textsuperscript{52} OHIO REV. CODE ANN. 1702.301 (Baldwin 1988).
\textsuperscript{53} The newly adopted OHIO REV. CODE ANN. § 1702.301(a), (b), and (c) state:

(A) Unless otherwise provided in the articles or the regulations:
(1) No contract, action, or transaction is void or voidable with respect to a corporation because the contract, action, or transaction is between or affects the corporation and one or more of its trustees or officers, or is between or affects the corporation and any other person in which one or more of the corporation's trustees or officers are directors, trustees, or officers, or in which one or more of the corporation's trustees or officers have a financial or personal interest, or because one or more interested trustees or officers participate in or vote at the meeting of the trustees or a committee of the trustees that authorizes the contract, action, or transaction, if any of the following applies:

(a) The material facts as to his or their relationship or interest and as to the contract, action, or transaction are disclosed or are known to the trustees or the committee, and the trustees or committee, in good faith reasonably justified by the material facts, authorizes the contract, action, or transaction by the affirmative vote of a majority of the disinterested trustees, even though the disinterested trustees constitute less than a quorum of the trustees or the committee:
(b) The material facts as to his or their relationship or interest and as to the contract, action, or transaction are disclosed or are known to the members entitled to vote on the contract, action, or transaction, and the contract, action, or transaction is specifically approved at a meeting of the members held for the purpose of voting on the contract, action, or transaction, by the affirmative vote of a majority of the voting members of the corporation who are not interested in the
amended Ohio Rev. Code section 1702.301 states that a contract, action, or transaction between an officer and the corporation is not voidable as long as it satisfies any one of the following requirements: (1) The material facts of the officer's relationship or interest in the contract, action, or transaction are disclosed to the other officers and they have approved it; (2) the material facts of the relationship or interest in the contract, action, or transaction has been approved at a meeting held specifically for it by the disinterested members of the corporation, or (3) the contract, action, or transaction is fair to the corporation when approved by the trustees or the members.54

Thus, Ohio's interested transaction provision requires the trustee to disclose the nature of the interest and the facts surrounding the transaction.55 Section 1702.301 has also been amended by adding that "[a] trustee is not an interested trustee solely because the subject of a contract, action, or transaction may involve or effect a change in control of the corporation or his continuation in office as a trustee of the corporation."56 Subsection 3 of 1702.301 clearly articulates the rationale of the Ohio legislature. It explains the imperative need for nonprofit Ohio corporations to attract and retain qualified individuals to serve their corporations so "that those corporations remain incorporated in this state rather than reincorporate in other states that have laws providing a more favorable indemnification and liability posture for trustees or volunteers."57

House Bill 533 is also Ohio's latest effort to clarify the definition of "volunteer" and the standards required of volunteers in Ohio.58

54. Id.
55. OHIO REV. CODE § 1702.301 (Baldwin 1988). The practice of statutes, articles of incorporation, and bylaws has been to refer to the members of the boards of nonprofit corporations as "trustees." See, e.g., OHIO REV. CODE § 1702 (Baldwin 1988). While Ohio still uses the term "trustee," this practice seems to be on the wane in other states. The State of Tennessee recently enacted a statute which closely resembles Ohio Section 1702.301 by requiring disclosure of the material facts of the transaction and the nature of the director's or officer's interest. TENN. CODE ANN. § 45-50-302 (1986) (Director and officer conflict of interest).
56. Id.
57. OHIO REV. CODE § 1702.301(3) (Baldwin 1988).
58. The term "volunteers" as used in House Bill 533 is newly defined in Section 1702.01(N)(1).
It defines "volunteer" as a trustee, officer, or agent of a nonprofit corporation or another individual associated with a nonprofit corporation who performs services for, or on behalf of, that corporation, under the authority or auspices of that corporation and who is not compensated. Section 1702.01 clarifies that compensation does not include reimbursement of expenses, insurance premiums and modest perquisites, so that the payment of these items does not abrogate volunteer status.

House Bill 533 does not provide total immunity from volunteer liability. It does, however, clarify officer and trustee standards of care and limits their potential liability in damages by providing broader indemnification. More specifically, new subsection (E)(5)(a)(i) amends section 1702.12 to include volunteers within the class of persons entitled to be indemnified by their nonprofit corporation against liability and personal expense. House Bill 533 does not expand the limited immunity granted by section 2305.38 to volunteers performing supervisory or corporate services for their charitable nonprofit organization. If a volunteer performs a negligent nonsupervisory or noncorporate act, he or she will remain liable.

House Bill 533 is the result of the Ohio legislature's effort to provide more significant protection to trustees and volunteers and thereby encourage talented persons to serve Ohio's nonprofit organizations.

VI. CONCLUSION

Because nonprofit organizations often do not have as much to offer qualified individuals as their for-profit counterparts, and because of the crucial role of voluntary help in serving community organizations, there is much need for reform in the statutory laws of most states. Service by qualified individuals, even those who serve on a volunteer basis, is vital to the well-being of many communities, including small towns and rural areas as well as large municipalities. While many of these citizens do not expect recompense for their efforts, at the very least they deserve fair

59. Id.
60. Section 1702.01's predecessor is section 2305.38 which originated in Senate Bill 366 in 1986 and was amended by House Bill 327 in 1987.
and adequate protection from liability and from personal damage suits.

The law defining the standard of care of nonprofit corporate directors and officers is beginning to more closely parallel the standard of care governing profit corporation officers and directors. Statutory and judicial treatment of nonprofit corporations has traditionally been "less highly developed" than that of profit corporations. State legislatures are increasingly recognizing the need to attract qualified individuals for nonprofit organization service, and recognizing the importance of retaining these individuals for future service. The practical considerations of the management function, the need for providing manageable means for avoiding and resolving conflict, and the need for providing standards of fairness have all contributed to the development of appropriate parallel provisions in the general and nonprofit corporation laws. Ohio House Bill 533, which includes Ohio’s nonprofit interested party transaction provision, section 1702.301, is an example of the efforts now being injected into state statutory law to bring the standards of care governing volunteers and officers of nonprofit organizations on an even par with the standards of their corporate counterparts by providing a safe harbor for the individuals that choose to serve those organizations.

This Comment is not calling for a lower standard of care for officers and directors serving nonprofit organizations, nor is it suggesting a general lessening of their fiduciary responsibilities. This Comment is not suggesting that officers and directors of nonprofits should be free of liability when violating their duty of care. The suggestion is merely that officers and directors of nonprofit organizations should be subject to standards that parallel the standards their counterparts are subject to in the for-profit sector. Given well articulated standards, individuals serving nonprofits should be permitted to enter transactions with the organization they serve, under the conditions of disclosure to the corporation, acceptance by the board or members of the corporation, and fairness to the corporation.

Further legislative effort is now needed in most states to clarify the standards of nonprofit corporate law as it applies to director and officer liability. The growing influence and social importance of nonprofit organizations must be recognized and reflected in state statutory law. At the same time, the law must not discourage qualified individuals from serving in the nonprofit
setting, and it should offer to those willing to serve an equal amount of protection and indemnification as is provided to those who serve in the more profitable business corporation sector.
NOTES

Ronald J. Thompson v. Midwest Foundation Independent Physicians’ Association (ChoiceCare): The Conversion of Nonprofit Health Maintenance Organizations to For-Profit Status

Howard S. Levy

I. INTRODUCTION

The recent trend among nonprofit health maintenance organizations (HMOs) is to convert to for-profit status. In the early 1980s, nonprofit HMOs dominated the health care field due, in part, to the large amounts of federal aid available to start-up nonprofit plans. However, the amount of federal aid available began to decrease, causing HMOs to seek other sources of operating capital. As a result, new plans began to incorporate as for-profit organizations at an increasing rate. However, the already existing nonprofit HMOs were left somewhere between a rock and a hard place because they no longer enjoyed a steady flow of federal aid nor did they have access to financial reserves like the for-profit plans. Consequently, nonprofit HMOs began to convert to for-profit status as a means of pursuing necessary operating capital. In fact, sixty-three HMOs have converted to for-profit status since 1981, and two-thirds of the nation’s 663 HMOs are currently for-profit plans.

Nevertheless, the conversion of nonprofit HMOs to for-profit status has been plagued by uncertainty and turmoil. It should, therefore, come as no surprise that the legality of the conversion

3. Id.
4. Id.
5. Id.
process recently has come under attack. As more nonprofit HMO's convert, it is certain that courtrooms across the country will serve as the battleground for an increasing number of legal challenges. As such, it is necessary to address the issues presented by the conversion process as they presently exist, with the hope of finding answers and solutions to guide those nonprofit HMOs that are considering converting to for-profit status in the future.

This Note begins by presenting an overview of the conversion process, which entails an analysis of the more controversial conversions to date. However, virtually no legal precedent exists since only a handful of prior conversions have made it to the courts. As a result, the focus will be centered upon the methodology of the conversion process, specifically, how and why the process went awry. Then, an analysis of Thompson v. Midwest Foundation Independent Physicians' Association (ChoiceCare)\(^6\) will be presented. The advantages and disadvantages of the ChoiceCare conversion will be explained. The significance of this decision will be analyzed in light of prior conversions. Emphasis will be placed upon the problems of insider dealing, valuing the nonprofit HMO, and distribution of the nonprofit HMO's charitable assets. Lastly, possible solutions as to the conversion problem will be suggested.

II. OVERVIEW

A. Background

The uncertainty surrounding the conversion process is illustrated by the lack of a uniform system of standards and regulations to guide nonprofit HMOs seeking to convert to for-profit status. For example, in 1982, a telephone survey was conducted with Department of Insurance Officials from twenty-four states, all having two or more HMOs at the time, in order to determine how HMOs in those states would proceed in converting a nonprofit HMO to for-profit status.\(^7\) In response, most authorities believed that states would only require an evaluation of the

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HMO's financial stability and ability to pay subscribers' medical bills, and an amendment to the HMO's articles of incorporation.\textsuperscript{8} Several states (including Ohio) displayed a "wait and see" attitude, stating that they would formulate the necessary regulations when, and if, a conversion is requested.\textsuperscript{9} This lackadaisical viewpoint may be at the heart of the problems nonprofit HMOs have experienced in converting to for-profit status.

Although this attitude has not resulted in any standard procedures or regulations to guide the conversion process, most nonprofit HMOs convert to for-profit status in a similar manner. The nonprofit HMO is originally founded by physicians to provide enhanced medical care on a pre-paid fee basis. Upon conversion, the assets of the nonprofit HMO are usually sold to an independent group of investors, usually the nonprofit HMO's management. After the sale, the nonprofit HMO is considered a for-profit entity. As a for-profit organization, many states then require the buyer to repay the public for the value of the assets, usually by making contributions to charitable organizations.

This simplified explanation of the conversion process, however, does not reveal the problems in the system. For example, the investors/managers who purchase the nonprofit HMO usually have control over the price to be paid for its assets. This is because the investors buying the nonprofit HMO also manage and control the HMO. The buyers, as a result, are provided with an opportunity to use their insider position to profit. As management, they can set a low valuation. As investors, they buy the nonprofit HMO at the undervalued price, often with the motive of then selling stock in the for-profit HMO to the public at true fair market value. In many cases, the investors/managers limit the participation of the physicians/founders in the conversion process. The result is a transaction where the buyer and seller are the same, allowing manipulation of the nonprofit HMO's value and leading to instant wealth for the investors/managers. Who loses? Well, for one, the physician/founders, who lose control of their HMO and the ability to realize any substantial profits. Charitable organizations also suffer, because they lose the difference between what should have been paid for the nonprofit

\textsuperscript{8} Id. at 714 n.11.
\textsuperscript{9} Id. at 715 n.11
HMO's assets and what was actually paid by the investors/managers.

California, the state with the most experience in HMO conversions (twenty-three to date), has had several conversions illustrating the aforementioned scenario. California, as well as other states permitting nonprofit HMOs to convert to for-profit status, however, could cure their problems by following the example set by Minnesota. Minnesota's solution to the conversion process is simple—they do not permit nonprofit HMOs to convert to for-profit status. Although their solution may have eliminated the pitfalls of the conversion process, it is not immune from attack. For instance, in 1986, seven of the thirteen HMOs operating in Minnesota, including three of the largest plans in the state, lost money. Minnesota's experience teaches that HMOs must be permitted to operate as for-profit plans in order to maintain financial stability.

Thus, eliminating for-profit HMOs is not the solution. As such, it is necessary to analyze the facts and issues presented by prior conversions in order to ascertain the imperfections of the process.

B. The Problem of Valuation and Self-Dealing

There have been few cases addressing the problems of valuation and self-dealing. However, those that have addressed such problems illustrate the complexities and dangers that a nonprofit HMO must face when converting to for-profit status. In Maxicare Health Plans v. Robert Gumbiner, M.D., Dr. Gumbiner was the founder and chairman of the nonprofit HMO Family Health Program (FHP). Dr. Gumbiner and seventeen other investors, formed HMO Health Group as their vehicle to convert the nonprofit FHP to for-profit status. On September 20, 1985, the California Department of Corporations, which regulates HMO conversions, approved a $36 million bid by HMO Health Group, of which Gumbiner was a 50.5% owner, to buy FHP's assets. At that

10. Meyer, supra note 2, at 42.
15. Id.
point, FHP rival Maxicare Health Plan, a for-profit HMO, complicated the conversion by offering to purchase the assets of the nonprofit FHP for $50 million.16 This competing bid began a legal battle over the ultimate ownership and value of FHP.

Maxicare filed suit to force FHP to accept its higher cash offer.17 Maxicare believed that HMO Health Group's bid undervalued FHP's assets and its higher offer represented the true market value. Maxicare argued that FHP was obligated to accept the highest bid in order to convert.18 However, there was evidence to suggest that even Maxicare's bid was substantially below fair market value. Maxicare's chairman, Fred Wasserman, stated that their bid would be increased to "between $60 million and $80 million," provided that they would have complete access to FHP's books.19 Furthermore, it had been estimated that, if FHP had been sold to the public in the spring of 1985, it would have been valued at $216 million.20 Thus, it appeared that the bids of both HMO Health Group and Maxicare undervalued FHP's assets. Gumbiner stated that "[i]f Maxicare prevails, they would effectively establish a law that anybody wanting to convert would have to auction the assets, and then large companies would simply bid more than the fair market value to eliminate competition."21 In essence, Gumbiner believed that HMO Health Group's $36 million bid should be used as the true barometer of fair market value, regardless of the fact that there was another willing buyer offering to pay at least $14 million more.

The Los Angeles Superior Court ruled in favor of HMO Health Group, allowing it to convert FHP to for-profit status for $36 million.22 Judge Eli Chernow agreed with Gumbiner holding that, "[a]n HMO conversion, under the law established by the Legislature, doesn't require sale to the highest bidder."23 The court apparently based its holding on a hesitancy to allow the conversion process to turn into a bidding war. Such a scenario would

16. Id. at 1, col. 1.
17. Id.
18. Id.
19. Id.
20. Id. at 16, col. 3.
21. Id. at 16, col. 4.
23. Id.
encourage large, deep-pocketed HMOs, like Maxicare, to buy-up and eliminate the competition.\textsuperscript{24} However, Judge Chernow apparently failed to consider the motive behind HMO Health Group's bid.

The fault in Judge Chernow's holding became obvious less than one year later when stock in the for-profit FHP was offered to the public at a market value of approximately $150 million.\textsuperscript{25} This represented up to a four-fold increase over the price Gumbiner and his associates paid for FHP's assets.\textsuperscript{26} Moreover, Gumbiner and other insiders controlled almost seventy-six percent of the stock, representing a market value of $114 million.\textsuperscript{27} Thus, Gumbiner and his associates stood to make over $78 million on assets purchased months earlier for $36 million.

The windfall profit made by members of HMO Health Group was, arguably, the reason Gumbiner refused to engage in an "auction" for FHP's assets. If other bids had been considered, HMO Health Group's ability to purchase an undervalued asset would have been seriously impaired. This, in turn, would affect Gumbiner's and his associates' ability to profit on the stock offering. Judge Chernow's holding that an HMO conversion doesn't require sale to the highest bidder, although seemingly logical at the time, was flawed. Chernow ignored that fair market value should entail what a willing buyer is prepared to pay. The fact that Maxicare was willing to pay $50 million and the public placed FHP's value at $150 million signifies that HMO Health Group's bid did not represent fair market value. In fact, it might be best if a nonprofit HMO was required to be sold to the highest bidder and/or valuation. This would eliminate the ability of the management of nonprofit HMOs to make large profits from the conversion process.

Judge Chernow also failed to realize that he was permitting a transaction in which the buyer was also the seller. Gumbiner owned approximately fifty percent of HMO Health Group and, along with other HMO Health Group investors, controlled close

\textsuperscript{24} Id. at 2, col. 3.
\textsuperscript{26} Stock Sale Values at Four Times Buyout Price, see supra, note 25, at col. 2.
\textsuperscript{27} Id.
to seventy-six percent of the public stock offering of the for-profit FHP. HMO Health Group attempted to buy an asset in which they had a controlling interest at a price set by them. Although the physician/founders claimed that management's greed caused them to lose both control of their nonprofit HMO and any possible monetary gain that may have been derived, management was quick to argue that the physician/founders were just angry because they lacked the foresight to grab more stock. However, physician/founders are often not given a fair opportunity to purchase the stock, as investors/managers tend to allocate stock quantities to themselves, ignoring and misinforming the physician/founders as to the nature of the transaction.

This conversion was not FHP's first encounter with alleged self-dealing transactions. Earlier, in *People v. Gumbiner*, the California Attorney General filed suit against FHP, Gumbiner, and others, for restitution, damages, surcharges, removal of trustees, and enforcement of a charitable trust. A settlement agreement was reached between the parties prohibiting FHP from engaging in self-dealing transactions with its management. The agreement read as follows:

[N]o officer or director of Family Health Program, Inc. nor any corporation, partnership, or business entity of any kind in which any officer or director of Family Health Program, Inc., holds any financial interest, shall contract or have any business or financial dealings with Family Health Program, Inc., without prior notice to and express written approval of the Attorney General.

FHP and Gumbiner allegedly violated this agreement as a result of the conversion, as well as by engaging in other self-dealing transactions, without giving notice to or seeking the approval of the California Attorney General. However, since the California Department of Corporations obtained jurisdiction over HMO conversions in 1983, it was possible that the effect of the agreement was negated. Nevertheless, it is highly unlikely

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31. *Id.*
32. *Id.* at 7.
that the purpose of giving the Department of Corporations jurisdic-
tion was to allow nonprofit HMO principals to engage in self-dealing transactions.

The problems associated with the conversion of FHP from nonprofit to for-profit status has resurfaced in California in similar HMO conversions. These conversions further exemplify the potential trend of management becoming instantly wealthy by buying and selling undervalued nonprofit HMOs. For instance, officers and directors of Inland Health Plan, a Loma Linda, California-based HMO, converted it to for-profit status for $500,000. A year and a half later, they sold it to an Aetna Insurance subsidiary for $37.5 million. Again, management apparently made a quick windfall by acting as both buyer and seller, all at the expense of the physicians/founders, most of whom passed up an early chance to buy the stock for a nickel a share. The physicians claimed that management kept them ignorant about its true value. Likewise, management of the nonprofit HMO Foundation Health Plan (no relation to FHP, Inc.), converted it to for-profit status for $10.6 million. Although the physicians/founders subsidized the conversion by forfeiting their fee withholdings, most of the profits went to management when the value of the HMO skyrocketed to $50 million one year later. These conversions further illustrate the dangers inherent in the conversion process and the need to implement uniform standards and procedures.

C. The Charitable Asset Problem

As previously mentioned, when a nonprofit HMO converts to for-profit status, the buyer is often required to donate the assets being converted to a charitable organization. This "charitable asset" concept results from the HMO's original status as a nonprofit, tax-exempt entity. Many states have enacted legislation stating that the charitable assets should not be of benefit to

34. Meyer, supra note 2, at 42.
35. Id.
36. Id.
37. Id.
38. Id.
private individuals. Instead, the charitable assets must be distributed to the charitable organizations that are involved in activities that are "substantially similar" to those of the non-profit HMO. Those states that haven't adopted such legislation may nonetheless enforce the proper distribution of the charitable assets by following the Cy-pres Doctrine. This doctrine obligates a nonprofit HMO, upon conversion to for-profit status, to use its charitable assets in a manner that mirrors the original trust purpose (that is, distribution to the proper charitable organization).

In theory, the aforementioned concepts appear to be straightforward and problem-free. However, in reality, a conflict arises when the nonprofit assets are purchased at a price substantially below fair market value. This deprives charitable organizations of significant monies that they would have received had fair market value been paid for the nonprofit HMO's assets. For example, in Maxicare Health Plans v. Gumbiner, the California Attorney General filed a cross-complaint to enforce a charitable trust created by the conversion of nonprofit FHP to a for-profit HMO. In the cross-complaint, the Attorney General stated that Robert Gumbiner and his associates deprived charity of over $80 million as a result of converting FHP to for-profit status at less than fair market value.

More recently, Blue Cross of California (BCC) converted its TakeCare HMO from nonprofit to for-profit status. The conver-
sion was made necessary, in part, due to the poor financial condition of BCC. Critics were justifiably concerned whether BCC should be considered a charity. Questions were raised as to whether BCC even owned the HMO and was entitled to the sale proceeds, since the plan was required to be independent to meet federal and state laws. As a solution, it was suggested that BCC receive the proceeds provided that it earmark them for charitable purposes such as care for the indigent. However, Alister McAlister, a lobbyist for BCC, rejected such a solution and mandated that BCC receive the money or the conversion was off. It was also argued that BCC should receive the money regardless of any intended charitable purposes, as TakeCare's Articles of Incorporation specified that BCC is to receive any profits from a dissolution of the nonprofit HMO. BCC contended that it was entitled to the funds, since it paid TakeCare's start-up and management costs and accepted the insurance risk for its potential losses. Furthermore, BCC asserted that it was a charitable organization since it had long provided health coverage to the public at less than cost and had insured individuals that no one else would insure.

Due to the immediacy of BCC's financial woes, the California legislature passed a bill allowing BCC and TakeCare to bypass the normal California procedures in converting HMOs from nonprofit to for-profit status. The controversial bill precluded any legal challenge to these conversions by stating that any conversion or sale "shall be deemed to comply fully with all require-

48. Id. at 40. B.C.C. lost close to $120 million in the first three quarters of 1987, with cash reserves eroding from $72 million to $11 million. Poor management, flawed pricing and tough competition were blamed.
50. Id. at 39.
51. Meyer, supra note 47, at 40.
52. Id.
53. Id. Ironically, this is the same Alister McAlister who proposed A.B. 520 to the California Legislature as a solution to the problems encountered in the conversion process. Although the bill was never enacted, the main thrust of the legislation was to prevent the HMO from retaining its charitable assets, the exact opposite of McAlister's position regarding the TakeCare conversion.
54. Id.
55. Id.
ments of law relating to charitable trusts.\textsuperscript{57} This emergency procedure was flawed in that it promoted the evil that should be eliminated—that is, allowing an HMO to keep its charitable assets upon converting. Legislatures must resist the temptation to give floundering HMOs a financial boost at the expense of charitable organizations.

III. Ronald J. Thompson v. Midwest Foundation Independent Physicians' Association (ChoiceCare)

A. Facts

The defendant, Midwest Foundation Independent Physicians' Association (ChoiceCare) was formed on February 20, 1978, as a not-for-profit corporation to provide medical and health services to subscribers on a pre-paid fee basis.\textsuperscript{58} ChoiceCare is sponsored by the Academy of Medicine, which is a professional organization made up of physicians in the Cincinnati, Ohio area, with one of its goals being to improve the delivery of medical services to the community.\textsuperscript{59} At the time of ChoiceCare's formation, the physician-founders of ChoiceCare believed that the delivery of medical services in the future could be effectively accomplished through a health maintenance organization operated as a not-for-profit corporation.\textsuperscript{60} Other defendants included: ChoiceCare Corporation, a for-profit entity formed to purchase the assets of the nonprofit ChoiceCare; Dr. Stephen Hogg, President of the nonprofit ChoiceCare, and Chairman of the Board and Senior Executive Officer of the for-profit corporation; and Kerry Tarvin, Executive Director of the nonprofit ChoiceCare and Chief Executive Officer of the for-profit organization.\textsuperscript{61} The Plaintiffs in this class-action lawsuit included approximately 2,000 physicians in the Greater Cincinnati area who had entered into contracts to provide services for ChoiceCare.\textsuperscript{62}

\textsuperscript{57} Id. at 39.
\textsuperscript{58} Plaintiff's First Amended Class Action Complaint at 10, Thompson v. Midwest Foundation Independent Physicians' Association (ChoiceCare), (S.D. Ohio 1988)(No. C-1-86-744).
\textsuperscript{59} Id. at 14.
\textsuperscript{60} Id.
\textsuperscript{61} Id. at 10-11.
\textsuperscript{62} Plaintiffs' Trial Brief at 1, Thompson v. Midwest Foundation Independent Physicians' Association (ChoiceCare), (S.D. Ohio 1988)(No. C-1-86-744).
Approximately four or five years after its formation the non-profit ChoiceCare allegedly gained a financial hold over the plaintiffs as a result of anti-competitive rules and a large consumer base, the growth of which was funded by withheld, disallowed, and delayed payments to plaintiffs. The defendants, disregarding the nonprofit ChoiceCare's original goals, began a scheme to turn the company away from its nonprofit origins, allegedly for their own personal gain. The defendants realized that they could not increase their wealth if ChoiceCare continued to operate as a nonprofit HMO, so they began to set the stage to convert ChoiceCare to for-profit status.

In late 1984, ChoiceCare attempted to convert to for-profit status. A stock offering was made in the for-profit corporation, which was to acquire the assets of nonprofit ChoiceCare through a wholly-owned subsidiary. The Board of Directors of the for-profit corporation, including Hogg and Tarvin, authorized the issuance of 375,000 shares of stock in the for-profit ChoiceCare. Hogg purchased 45,000 at a cost of $1.00 per share. Tarvin bought 35,000 shares, also at a cost of $1.00 each. However, it was alleged that no plaintiffs were permitted an opportunity to purchase more than 500 shares.

The plaintiffs were subsequently advised by the defendants that the market value of the nonprofit ChoiceCare was approximately $500,000. However, in contrast, the defendants allegedly knew that prominent underwriting firms had valued the nonprofit ChoiceCare at between $40 and $50 million, and concealed this information from plaintiffs. In essence, Hogg and Tarvin, being on both sides of the transaction, attempted to convert the non-

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64. Id.
65. Id.
67. Id.
68. Id.
69. Id.
70. Id.
71. Id.
72. Id.
73. Id.
profit ChoiceCare to for-profit status for $500,000, knowing that the organizations true value was significantly greater. The plaintiffs effectively lost control of their nonprofit HMO as Hogg and Tarvin gave themselves a disproportionate amount of stock in the new, undervalued, for-profit ChoiceCare.74

After a four-month trial and a week of deliberation, the jury found that the defendants had engaged in price-fixing in violation of section 1 of the Sherman Act, securities fraud in violation of section 10(b) of the Securities Exchange Act of 1934 and rule 10(b)(5) of the Securities and Exchange Commission, racketeering in violation of 18 U.S.C. 1962 (A), (B), and (C), as well as monopolizing interstate trade or commerce.75 The U.S. District Court for the Southern District of Ohio upheld the verdict and trebled all damages to total approximately $102 million.76

B. Analysis

1. Advantages and Disadvantages of Converting

As part of the conversion process, nonprofit ChoiceCare submitted an application to the Ohio Department of Insurance to receive a certificate of authority to do business as a for-profit HMO.77 On May 18, 1987, the Ohio Department of Insurance, pursuant to its general investigatory powers,78 conducted a hearing to determine the merits of a for-profit ChoiceCare. The testimony presented by those in favor of the conversion process allows an understanding of why an increasing number of nonprofit HMOs, such as ChoiceCare, are finding it necessary to convert to for-profit status. The rationale of those opposed to the ChoiceCare conversion illustrates the fears that many physicians have of interrelating business and profit motives with the practice of medicine.

The testimony of those in favor of a for-profit ChoiceCare centered around one dominant theme—competition. The recent

74. Id.
77. See OHIO REV. CODE ANN. §§ 1742.01-.05 (Baldwin 1982).
78. See OHIO REV. CODE ANN. § 3901.011 (Baldwin 1982).
proliferation of health maintenance organizations, many of whom are for-profit organizations, has increased competition among HMOs. For instance, at the end of 1987, ten HMOs were operating in the Greater Cincinnati area alone. Although ChoiceCare was Cincinnati's largest HMO, with 100,000 employees, ChoiceCare was at a distinct disadvantage in operating as a nonprofit enterprise in a highly competitive environment.

As a for-profit entity, ChoiceCare would strengthen its ability to compete by having the ability to raise capital. Access to capital would allow a for-profit HMO to preserve a positive net worth, as well as to avoid risking reimbursement to physicians. A for-profit HMO may also use capital resources in the short-term to support lower premium structures. This allows an HMO to gain market share without further impairing payments to physicians. If ChoiceCare had access to capital, it would be able to more effectively compete, expand local advertising, develop new products, maximize economics of scale, and diversity.

A for-profit ChoiceCare would normally raise its capital through equity financing, that is, by selling stock in the HMO. Stock offerings could be used as incentives to retain and lure HMO management. William Kopit, an attorney in the Washington, D.C. firm of Epstein, Becker, Borsady, and Green, testified that:

Experienced HMO management is in very short supply at the present time. There are many more HMOs than there are experienced managers of HMOs, and as an incentive to keep experienced management ... and to insure that the management's incentive is precisely the same as the corporation's ... many HMOs are using the methodology of giving key management a percentage of equity stock in for-profit corporations. . . .

Kopit further testified that "[P]hysicians would be guaranteed the majority participation in the for-profit corporation that is that the majority of the stock would continue to be owned by

80. Id.
82. Id.
83. Id. at 93 (testimony of Allen Sarbo).
84. Id. at 130 (testimony of Charles A. MacDonell).
85. Id. at 73-74 (testimony of William Kopit).
The problems with Kopit's testimony are readily apparent. In Thompson, as suggested by Kopit, management (specifically, Hogg and Tarvin) were allotted a twenty-one percent stake in the for-profit corporation. However, unlike Kopit's testimony, inequity resulted because none of the participating physicians were permitted to own more than one percent of the corporation. Thus, Kopit's scenario is faulty in that greedy management may prevent physicians from controlling their own HMO, thus enabling them to make a huge profit for themselves.

Furthermore, a for-profit entity would have a distinct advantage in its ability to borrow money. A lender is hesitant to enter into borrowing relationships with nonprofit corporations, as no profits from operations exist to pay off the loan. Furthermore, a nonprofit ChoiceCare, being a tax-exempt organization, is limited in the amounts of unrelated business income it can earn. By comparison, for-profit competitors are unlimited in their ability to diversify their revenue base away from the fluctuations of HMO activities.

Testimony of those opposed to a for-profit ChoiceCare revealed a fear of abandoning the precepts of medicine in favor of achieving business objectives. The original concept of ChoiceCare was "to offer an alternative for those subscribers who wished to remain in traditional fee for service type of health care." ChoiceCare was not formed to compete or dominate the marketplace, as those in favor of a conversion would argue. If it converts to for-profit status, ChoiceCare's priorities might shift from providing quality health care to making money. Physicians would be forced to make decisions not in the best interests of their patients but, rather, to satisfy business objectives and provide profits for the company. ChoiceCare would no longer be an HMO run by physicians for physicians, with their patients benefiting, but a profit-orientated organization controlled by businessmen.

86. Id. at 75.
87. Id. at 6-8 (testimony of Greg P. Noll).
88. Id. at 130-131 (testimony of Charles A. MacDonell).
89. Id. at 131.
90. Id. at 83 (testimony of Peter C. Padore).
91. Id. at 57 (testimony of Dr. Ronald Fegelman).
92. Id.
93. Id. at 56. See generally, Hull, Physicians Organize to Stop HMOs From Altering Practice of Medicine, Wall St. J., June 23, 1986, § 2 at 23, col. 3; Some Doctors Assail Quality of Treatment Provided by HMOs, Wall St. J., Sept. 16, 1986, § 1 at 1, col. 1.
Furthermore, the motives of those advocating for-profit status should be questioned. Did Stephen Hogg and Kerry Tarvin really care about the competition? Or, as major shareholders, was their primary motive to buy an asset valued at $40 million for $500,000? Was this conversion, as well as others across the country, motivated by nothing more than sheer greed on the part of those who saw an opportunity to become wealthy? The verdict rendered by the jury in Thompson speaks a resounding “yes.”

2. The Impact of the Decision

As one of the first lawsuits to successfully challenge a nonprofit HMO converting to for-profit status, the verdict rendered in Thompson may encourage others to mount similar challenges to the conversion process. 94 Certainly, the legal precedent of the Thompson decision will cause the management of nonprofit HMOs converting to for-profit status to shy away from purposefully low asset valuations, self-dealing transactions, and depriving charitable organizations of monies owed them. Although challenging nonprofit conversions is still a rather novel idea, Thompson has paved the way for the development of new legal theories, case law, and statutes regarding nonprofit organizations.

Although Thompson may discourage nonprofit HMOs from improperly using the conversion process, there is no guarantee that future conversions will not entail managerial impropriety. In fact, the circumstances in Thompson were very similar in nature to those in Maxicare. 95 In both Thompson and Maxicare, management was on both sides of the transaction, attempting to purchase the nonprofit assets at a substantial discount to actual fair market value. In Thompson, it was management who allegedly predetermined the nonprofit HMO’s value at $500,000, and then found a firm to adopt it as true. 96 Meanwhile, ChoiceCare’s assets were simultaneously valued between $40 and $50 million. Furthermore, Stephen Hogg and Kerry Tarvin, both officers of the nonprofit ChoiceCare, controlled twenty-one percent of the for-profit cor-

poration. In Maxicare, Robert Gumbiner's HMO Health Group successfully persuaded the court to disregard the fact that Maxicare Health Plan was willing to pay $50 million for FHP's nonprofit assets. HMO Health group eventually bought the nonprofit FHP at $150 million. Robert Gumbiner and HMO Health Group controlled seventy-six percent of the for-profit entity, in addition to being chairman and the founder of the nonprofit plan. In both cases, the alleged self-dealing parties stood to make a great deal of money as a result of their ability to undervalue the nonprofit HMO's assets. Thompson shows that the issues presented when nonprofit HMOs convert to for-profit status are not only consistent, but bound to continue plaguing the conversion process.

Thompson also reiterated the trend of management to divert the nonprofit HMO's charitable assets to the for-profit HMO instead of making a donation to an independent charitable organization. For example, in Thompson, there were suggestions that the Cincinnati Academy of Medicine which was a sponsor of ChoiceCare, should be the beneficiary of the charitable trust. Thus, the charitable assets would go back to the nonprofit ChoiceCare's origins instead of to an independent charity. This encompassed the same problem previously encountered in the TakeCare conversion. In that conversion, the charitable assets would go back to the converting HMO (who management considered to be a charity). The problem presented in Thompson was that the Academy of Medicine sponsored ChoiceCare. In addition, undervaluing the nonprofit HMO results in fewer assets that are to be donated to charitable organizations. This issue surfaced in Thompson as well as in previous cases. In Thompson, charitable organizations would have been deprived of the difference between $500,000 for which ChoiceCare sought to convert and the $40 million valuation. Similarly, Maxicare involved a potential $80 million diversion from charitable organizations due to low conversion valuations. Thus, Thompson entailed many of the same charitable asset problems with which other conversions have struggled, and will continue to struggle.

97. Plaintiffs' Trial Exhibit #120 (Minutes-ChoiceCare Executive Committee Meeting), Ronald J. Thompson v. Midwest Foundation Independent Physicians' Association (ChoiceCare), No. C-1-86-744 (S.D. Ohio 1988).
Thompson illustrates that the problems encountered in prior conversions are not a matter of happenstance. Future conversions may also develop new problems that have yet to be addressed. Nevertheless, Thompson illustrates that the problems involved in conversion process-valuing the nonprofit HMO, self-dealing transactions, and determining how to distribute the charitable assets—need to be solved. However, the burden to prevent future legal battles over nonprofit HMO conversions rests primarily with state legislatures. It is the responsibility of the state legislators to enact laws to deter the management of nonprofit HMOs from illegally utilizing the conversion process for their own benefit.

IV. Solutions

State legislatures have failed to develop adequate regulations to govern the conversion process. The past abuses of the conversion process exemplify the need for state legislators to act swiftly and severely to eliminate the potential for further wrong doing. The California Legislature has been the first, and only, state legislature to address the problems of the conversion process. In 1985, California Assemblyman Alister McAlister introduced A.B. 520.98 Although A.B. 520 did not pass through the California Legislature,99 it provides an excellent model for other states to follow in adopting preventative legislation.

In drafting A.B. 520, the California Legislature recognized the need to protect the public from the pitfalls of nonprofit conversions. In fact, the legislature stated its intent in formulating A.B. 520 as follows:

There is a demonstrated need to ensure that the public be represented in a conversion of a nonprofit hospital service plan or health care service plan to for-profit status as to future proceedings determining the value of the assets and utilizing and dedicating a specified percentage of the converted value of the assets to current and proposed health care delivery systems.100

Thus, A.B. 520 represented a comprehensive effort by the

99. A.B. 520 died in the California Senate on November 30, 1986.
100. A.B. 520 at 2.
California Legislature to recognize and attack the misgivings of the conversion process.

First, in setting forth a solution to the dilemma of valuing the nonprofit entity, McAlister's bill pooled the resources of the California Attorney General, California Department of Justice, California Department of Corporation, and California Department of Insurance, in order to properly ascertain a true, unified value for the nonprofit HMO's assets. The purpose was apparently to eliminate any confusion over which bid and/or valuation pertaining to the nonprofit HMO's assets should be relied upon. In prior conversions, the outcome was predicated upon which valuation properly represented the value of the nonprofit HMO's assets. An analysis of A.B. 520 reveals an intent to prevent inconsistencies in valuing the nonprofit HMO by giving only the aforementioned authorities the power to determine one fair market value for a nonprofit HMO's assets.

Specifically, A.B. 520 sought to accomplish this goal by providing for a "separation of powers"-type arrangement among the authorities empowered with ascertaining what constitutes fair market value. The California Attorney General was granted the broad power to oversee the conversion process and to "provide the public with safeguards," \(^{101}\) including the "authority to obtain the fair market value of the assets involved in a conversion." \(^{102}\) However, A.B. 520 gave the California Department of Justice the specific authority to "approve or disapprove the consideration to be received for the conversion, including approval of value and type of consideration," \(^{103}\) as well as "complete access to all information of the Department of Insurance or Corporations relating to any conversion." \(^{104}\) In turn, the Department of Insurance and the Department of Corporations were to have the authority to conduct an audit of the nonprofit organization prior to approving its conversion to for-profit status. \(^{105}\)

In essence, the Department of Insurance and the Department of Corporations were to concurrently research, compile, and evaluate all the nonprofit HMO's financial data pertinent to the

\(^{101}\) Id.
\(^{102}\) Id. at 3.
\(^{103}\) Id.
\(^{104}\) Id. at 2
\(^{105}\) Id. at 4.
conversion. This independent audit and evaluation of the nonprofit HMO's assets would deter the management/investors of the nonprofit HMO from hiring a firm to value its own assets. Often, as in the case of Thompson, the management/investors may be prone to hire and rely upon a firm whose valuation techniques will most probably result in a low valuation, enhancing the management/investors' ability to make a profit. This is consistent with the provision of A.B. 520 stating that "[n]o plan may expend its assets to determine its value."106

The Department of Justice was then given power to further remedy any valuation problems by determining which valuation represented fair market value.107 As such, the Department of Justice was urged to consider "any information available, including bids to purchase the plan, expert opinion, and other methods of determining fair market value."108 Thus the Department of Justice would be equipped with an arsenal of information with which to properly determine fair market value, including the independent valuation by the Departments of Insurance and Corporations.

The California Attorney General was to guard and enforce the process, ensuring that any approval by the Department of Insurance of a conversion value was fair and just. This system of

106. Id. at 3.
107. Id.
108. Id. at 5. A.B. 520 defined expert opinion to include "fair market value determined by an investment banker of accounting firm which specializes or is qualified to render an expert opinion on valuation..." id. at 3. Furthermore, fair market valuations should include "applied methodologies of discounted present cash value, per member value, going concern, and multiple of gross revenue." id. at 3-4. For a more detailed discussion of valuing nonprofit HMOs see Sherlock, The Valuation of HMOs, The Sherlock Company, Jan. 1988 (setting forth ten steps to follow in valuing an HMO. Those steps are: 1) projection of HMO's most likely case financials, 2) modify projections to reflect relationships with affiliate or potential affiliate, 3) develop cash flow models, 4) develop total corporate value, 5) develop total value of the equity, 6) recompute with more optimistic more conservative operating assumptions, 7) recompute with more optimistic more conservative discount assumptions, 8) make subjective weights of likelihood of scenarios and discount rates, 9) multiply value times weight to establish expected value, and 10) compare to industry averages; Young, Ownership Conversions in Health Care Organizations: Who Should Benefit?, 10 JOURNAL OF HEALTH POLITICS, POLICY & LAW 765 (1986); Wallace, HMOs Converting to For-Profit Status Could Face More Rigorous Reviews, MODERN HEALTHCARE, Apr. 11, 1985 at 42, col. 3 (suggesting an adjustment to the HMO's book value, estimating the HMO's value based on its capacity to generate earnings over a five year period, and estimating the HMO's future cash flow over a five year period as solutions to the valuation problem).
checks and balances would allow the different authorities to work together in order to prevent the management of nonprofit HMOs from profiting at the expense of the founding physicians. Using the aforementioned guidelines, states are urged to join together to establish a uniform system of valuing nonprofit HMOs.

Second, A.B. 520 presented a straightforward approach to the problem of self-dealing transactions. Simply, A.B. 520 mandated that "[n]o officer or director of the plan shall receive any benefits from the conversion of any remuneration as an officer or director of the for profit entity, except actual and necessary expenses." Had the State of Ohio enacted legislation entailing this provision, Kerry Tarvin and Stephen Hogg might have thought twice before purchasing stock in the for-profit ChoiceCare. Without a doubt, states that enact legislation prohibiting self-dealing transactions will drastically reduce their chances of having to confront a Thompson-like scenario.

Third, A.B. 520 directly addressed the issue of how to properly distribute the charitable assets. A.B. 520 set forth a formula designating where the nonprofit assets should be distributed after a conversion to a for-profit entity. For example, ten percent of the charitable assets were designated to the California Nonprofit Public Benefit Corporation Conversion Uncompensated Health Care Fund. The purpose of this fund and others like it was to assist public and private hospitals and healthcare providers who did not receive compensation for their services. States enacting legislation should follow California's example and earmark the assets received from conversions to specific, designated charitable organizations.

A.B. 520 also hindered the ability of the nonprofit organization to be the beneficiary of their own charitable trust. A.B. 520 eliminated this scenario by stating that "[t]he moneys in the funds . . . shall not be distributed to a charitable organization . . . where an interlocking director relationship exists between the plan requesting to convert and the charitable organization . . . ." Thus, when the management of a nonprofit HMO is the same as that of the for-profit HMO, the management may not claim that

109. Id. at 4.
110. Id. at 5.
111. Id.
the nonprofit HMO is a charitable entity entitled to the proceeds of its own conversion.

V. CONCLUSION

Nonprofit health maintenance organizations have converted to for-profit status to maintain financial stability and remain competitive. However, many recent conversions have resulted in courtroom battles attacking the legality of the conversion process. Critics argue that these transactions entail HMO management acting as both buyer and seller. Thus, HMO management is given an opportunity to purchase the nonprofit HMO at an undervalued price. This detrimentally effects the physician/founders, who lose control of their HMO, and charitable organizations, who are deprived of charitable assets. Authorities must act swiftly to enact legislation similar to California Assembly Bill 520. The problems presented by the conversion process must be addressed. Nonprofit HMOs converting to for-profit status should not be permitted to turn the system into a legal battleground.
CLERGY MALPRACTICE CLAIMS: A NEW PROBLEM FOR RELIGIOUS ORGANIZATIONS

Kelly Beers Rouse

"and on this rock I will build my church . . . ."
Matthew 16:18

I. INTRODUCTION

For as long as people have been building churches, the churches have been charged with a multitude of tasks, and faced with a multitude of problems. Religious organizations today, in addition to fulfilling the spiritual needs of their members, are commonly involved in community service projects, local and worldwide outreach projects, religious education and training, and evangelism. Indeed, religious organizations can be very active and very visible nonprofit organizations. Religious organizations, however, are also facing an increasing amount of litigation. One of the most novel and controversial causes of action filed against a church in recent years is the claim of clergy malpractice. This Note will focus on this emerging area of the law.

II. BACKGROUND

At one time, the doctrine of charitable immunity was deeply engrained in the American legal system. The theories upon which the courts applied immunity arose out of the belief that a charitable organization's functions must not be hampered by extensive claims for damages. Generally, courts based charitable immunity decisions on one of four theories. The first theory, called the "trust fund" theory, was that the assets of a charitable organi-

3. Id.
zation were "trust funds" that could not be used to pay damages, because doing so would destroy the donor's intent. The second theory was that the doctrine of respondeat superior should not be applied to charitable organizations for public policy reasons, and because the organization received no monetary profit from the services of its employees. The third theory, called the "waiver" theory, was based on the presumption that one who accepted benefits from a charitable organization had, in effect, waived the right to collect damages from the organization for the torts of its agents. Finally, the "public policy" theory was based on the contention that it was better for the welfare of the general public that the injured individual, rather than the charitable organization, bear the burden of loss.

Criticism of the doctrine of charitable immunity, however, has been strong. The modern trend is to abolish charitable immunity entirely, or at least to drastically limit its application. The rationale behind this movement is that an individual, who is injured as a result of the actions of an employee of a charitable organization, may become the responsibility of the state unless he has some recourse against the organization. Also, the organization can protect itself from the threat of bankruptcy by being properly insured. Additionally, it is argued that organizations can obviate such injuries through careful selection and training of employees.

Although the doctrine of charitable immunity has been limited, religious organizations have traditionally been permitted to use immunity as a defense because of the free exercise and establishment clauses of the first amendment, incorporated and made applicable to the states through the fourteenth amendment.

4. Id.
5. Id.
6. Id.
7. Id. at 278-79.
8. Id. at § 109, at 279.
9. Id.
10. Id. at 280.
11. Id.
12. Id.
13. For a general discussion of the use of the free exercise and establishment clauses of the first amendment as a defense see Esbeck, Tort Claims Against Churches and Ecclesiastical Officers: The First Amendment Considerations, 89 W. Va. L. Rev. 1 (1986); Comment, Made Out of Whole Cloth? A Constitutional Analysis of the Clergy Malpractice
According to one writer, the Framers of the Constitution believed that the religion clauses were necessary for a variety of reasons.\textsuperscript{14} For instance, while Roger Williams felt that the clauses were needed in order to protect churches from the "worldly corruption" of the state,\textsuperscript{16} Thomas Jefferson wanted to protect the state "against ecclesiastical depredations and incursions."\textsuperscript{16} James Madison contended that religious and secular interests would both be best furthered by their separation.\textsuperscript{17}

In any event, the protections afforded by the religion clauses of the first amendment remain strong. Moreover, these protections are extended to "new" religions, as well as those that existed when the Bill of Rights was drafted.\textsuperscript{18} Additionally, there is no requirement that a religion meet an organizational or doctrinal test in order to qualify for first amendment protection.\textsuperscript{19} The first amendment protections apply to individuals who practice their religion without belonging to an organization, as well as to individuals who belong to organized religious groups.\textsuperscript{20}

Despite criticisms of the charitable immunity doctrine based on first amendment protections, religious organizations, particularly churches, are being subjected to an increasing amount of litigation.\textsuperscript{21} Publicity has focused upon the numerous tort actions filed against churches. These actions have been filed against churches on various grounds, including: alienation of affections;\textsuperscript{22} negligence;\textsuperscript{23} intentional infliction of emotional distress;\textsuperscript{24} and out-

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\textsuperscript{14} Comment, supra note 13, at 526. See also L. Tribe, \textit{American Constitutional Law} § 14-3, at 816 (1978).

\textsuperscript{15} Id.

\textsuperscript{16} Id.

\textsuperscript{17} Id.


\textsuperscript{23} Heath v. First Baptist Church, 341 So. 2d 265 (Fla. Dist. Ct. App.), \textit{cert. denied}, 348 So. 2d 946 (Fla. 1977).

rageous conduct. One of the most controversial and commented upon cases, Nally v. Grace Community Church of the Valley, alleged clergy malpractice, negligence, and intentional infliction of emotional distress, labeled outrageous conduct.

III. NALLY I AND NALLY II: THE COURT'S OPINIONS AND REASONING

Nally I has been touted as the first case alleging "clergy malpractice." The plaintiffs, Walter and Maria Nally, parents of a twenty-four year old man, brought a wrongful death action against Grace Community Church of the Valley, and some of its pastors, after their son, who had received counseling from the pastors, committed suicide. After the trial court granted the defendants' motions for summary judgment, the Nallys appealed.

In deciding whether the trial court properly granted the defendants' motions for summary judgment, the court of appeals first looked at the plaintiffs' complaint. Specifically, the plaintiffs alleged that Pastor MacArthur, while acting as an agent of Grace Community Church, had provided personal and spiritual counseling to their son, Kenneth Nally, that Pastor MacArthur negligently discouraged Kenneth Nally from obtaining psychological or psychiatric treatment even though he knew Kenneth had suicidal tendencies, and that Kenneth committed suicide because he did not receive psychological or psychiatric treatment. Additionally, the complaint contained a cause of action for intentional infliction of emotional distress (outrageous conduct) which alleged

27. Note, supra note 26, at 1296 n.1.
28. Nally I, 204 Cal. Rptr. at 304.
29. Id.
30. Id.
that the defendants, while acting as agents of the church, exacerbated Kenneth’s preexisting feelings of depression, guilt and anxiety. Finally, the complaint alleged that Grace Community Church and Pastor MacArthur failed to require adequate training for their counselors.

The court looked at evidence that the plaintiffs had introduced in opposition to the defendants’ motions for summary judgment. Plaintiffs introduced the declaration of Walter Nally, Kenneth’s father, in which Mr. Nally stated, *inter alia*, that one or two days before Kenneth’s suicide, Kenneth pointed to his arm, which had been injured in a prior suicide attempt, and said that the people at Grace Community Church told him it was “God’s punishment.” Plaintiffs also introduced an excerpt from a deposition transcript in which Pastor MacArthur testified “perhaps” he had contributed to Kenneth’s depression. Additionally, plaintiffs introduced the declaration of a psychiatrist, who after reviewing transcripts of the deposition, stated, that in his opinion, Kenneth suffered from severe mental illness and that the defendants increased his despair and anguish, thereby causing Kenneth to commit suicide.

Plaintiffs also introduced into evidence a tape by Pastor Thompson for a collection called “Principles of Biblical Counseling,” which contained statements conveying the idea that suicide is acceptable for “believers.” For example:

> And suicide for the believer is the Lord saying, ‘Okay, come on home. Can’t use you anymore on earth. If you’re not going to deal with those things in your life, come on home.’

Defendants’ depositions indicated that Pastors MacArthur, Rea

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31. *Id.* at 304-05.
32. *Id.* at 305.
33. *Id.*
34. *Id.*
35. *Id.*
36. *Id.* The court also noted that Pastor MacArthur admitted in his declaration that he was aware of Kenneth’s suicidal tendencies at the time he was counseling him; that Pastor Rea’s declaration indicated that during the period of time Pastor Rea was counseling Kenneth, Kenneth alluded to an “inability to cope”; and Pastor Thompson admitted in his declaration that during some of the sessions in which he provided counseling to Kenneth, he was aware that Kenneth had attempted suicide.
37. *Id.* at 306.
38. *Id.*
and Cory each used counseling techniques similar to Pastor Thompson’s techniques.39

The court concluded that the plaintiffs adequately pled a cause of action for wrongful death arising out of intentional infliction of emotional distress through the allegations that the defendants, as agents of the church, “knowing that Kenneth Nally was depressive and had suicidal tendencies, exacerbated his feelings of guilt, anxiety and depression with reckless disregard that their conduct would increase the likelihood that Kenneth Nally would commit suicide and that, as a result of this conduct, Kenneth Nally’s depression increased, causing him to commit suicide.”40

The court next discussed the issue of whether the pastors or the church were immune from liability for intentional infliction of emotional distress caused by the “nature of or content” of their counseling merely because their counseling may have had a spiritual aspect.41 The court was particularly influenced by the analysis contained in In re Edward C.42

In Edward C., the court affirmed an order removing children from their parents’ custody because the parents’ religiously motivated discipline of the children was both physically and emotionally detrimental to them. The court said further that mistreatment of a child is not privileged simply because it is imposed under the guise of freedom of religious expression.43 Although Edward C. was not a tort action for intentional infliction of emotional distress, the court recognized the case as affirming the principle that remedies should exist for individuals injured by extreme and outrageous conduct, even when that conduct involves the expression of religious belief.44 The court stated:

We hold that, while defendants’ religious beliefs are absolutely protected by the First Amendment, the free exercise clause of the First Amendment does not license intentional infliction of emotional distress in the name of religion and cannot shield defendants from liability for wrongful death for a suicide caused by such

39. Id.
40. Id. at 307.
41. Id.
44. Nally I, 204 Cal. Rptr. at 308.
conduct.\textsuperscript{45}

The court stated, in conclusion, that because there existed triable issues of fact as to whether Kenneth's suicide was caused by intentional infliction of emotional distress, there was no need to decide the issue of clergy malpractice.\textsuperscript{46} Justice Hanson dissented because, in his opinion, the plaintiffs failed to establish a cause of action for intentional infliction of emotional distress.\textsuperscript{47} Justice Hanson also expressed concern that to hold otherwise in this case, as the majority did, could have the effect of opening a Pandora's box

by subjecting all of the various religious faiths and their clergy . . . to wrongful death actions and expensive full-blown trials simply because they were unsuccessful in their sincere efforts through spiritual counseling to help or dissuade emotionally disturbed members of their congregations, who may be suicide prone, from carrying out such a predisposition.\textsuperscript{48}

On remand from the court of appeals, the Los Angeles Superior Court entered a nonsuit and the plaintiffs again appealed. This time, however, the court of appeals did examine the issue of clergy malpractice.\textsuperscript{49} The court held that:

[T]he non-therapist counselor who has held himself out as competent to treat serious emotional problems and voluntarily established a counseling relationship with an emotionally disturbed person has a duty to take appropriate precautions should that person exhibit suicidal tendencies.\textsuperscript{50}

The court noted that California courts have, for two decades, imposed a duty on psychiatrists (which presumably extends to all varieties of licensed psychotherapists) to prevent their patients from committing suicide.\textsuperscript{51} According to the court, logic and policy dictate that the duty imposed in those cases also applies to non-therapist counselors.\textsuperscript{52} If psychiatrists are considered to have a "special relationship" with their suicidal counse-

\begin{itemize}
\item \textsuperscript{45} Id. at 308-09.
\item \textsuperscript{46} Id. at 309.
\item \textsuperscript{47} Id. at 321.
\item \textsuperscript{48} Id.
\item \textsuperscript{50} Id. at \textsuperscript{49}, 240 Cal. Rptr. at 226.
\item \textsuperscript{51} Id. at \textsuperscript{49}, 240 Cal. Rptr. at 225.
\item \textsuperscript{52} Id. at \textsuperscript{49}, 240 Cal. Rptr. at 224.
\end{itemize}
lees, the court reasoned, then there are no grounds for finding that non-therapist counselors, "who hold themselves out as capable of dealing with mental and emotional illness severe enough to lead to suicide," have not assumed a special relationship with their suicidal counselees.\(^53\) The court stated further that whether the counselor is a psychiatrist or not, the counselee has the same type of dependent relationship with the counselor.\(^54\) Additionally, the court stated that in either case, the counselor has voluntarily undertaken that relationship by "holding himself out as especially competent to treat emotional problems."\(^55\)

Without this "special relationship," it would seem that the court would impose no duty. For example, the court emphasized that the duty does not extend to personal friends of emotionally disturbed people who give advice concerning problems.\(^56\) Nor does the duty extend to services such as "teen hotlines" which offer short term, "band-aid" counseling.\(^57\) The court also specified that the duty does not arise when a church member approaches a pastor after the church service for casual advice about a problem.\(^58\) The court contrasted these situations with facts in Nally, pointing out that in this case the church was advertising that its counselors were competent to treat serious as well as less serious problems.\(^59\) Furthermore, the court said, there is evidence to indicate that the counselors at Grace Community Church had an ongoing counseling relationship with Kenneth Nally that continued over a five-year period.\(^60\)

The court was careful to point out, however, that because of the differences in education, training and experience, the standard of care expected of a non-therapist counselor is not the same as the standard of care expected of a psychiatrist or other licensed psychotherapist.\(^61\) Thus, no duty arises when the counselee behaves in a manner that would lead a therapist to anticipate a suicide attempt, but would not lead a non-therapist

\(^{53}\) Id. at \(____\), 240 Cal. Rptr. at 225.
\(^{54}\) Id. at \(____\), 240 Cal. Rptr. at 225-26.
\(^{55}\) Id. at \(____\), 240 Cal. Rptr. at 226.
\(^{56}\) Id.
\(^{57}\) Id.
\(^{58}\) Id.
\(^{59}\) Id.
\(^{60}\) Id.
\(^{61}\) Id.
counselor to the same conclusion. According to the court:

[T]he minimal standard of care a non-therapist owes to a counselee he diagnoses as suicidal is to take steps to place him in the hands of those to whom society has given the authority and who by education and experience are in the best position to prevent the suicidal individual from succeeding in killing himself.

The court went on to say that this duty to refer does not impose a burden on the free exercise of religion by the pastoral counselors at Grace Community Church because there was no evidence that the Church or its counselors hold religious beliefs which would preclude them from fulfilling this duty.

Then, in an attempt to "avoid yet another round of 'judicial ping-pong' between the trial and appellate courts," the court anticipated and addressed the possibility that those respondents might introduce additional evidence indicating that, after all, the counselors at Grace Community Church do hold religious beliefs inconsistent with fulfilling their responsibility to refer suicidal counselees to those authorized and equipped to prevent suicide.

The court held that the first amendment would not be offended even if the duty to refer was imposed on religious counselors who hold religious beliefs that are inconsistent with referral.

In so holding, the court first found that California has a compelling state interest in preventing suicide.

Secondly, the court found that California's compelling state interest in preventing suicide is served by the imposition of liability on individuals who undertake counseling of mentally disturbed people, and whose negligence allows these mentally disturbed counselees to commit suicide. The court stated that:

62. Id. at ____, 240 Cal. Rptr. at 226-27.
63. Id. at ____, 240 Cal. Rptr. at 227.
64. Id. at ____, 240 Cal. Rptr. at 233. In fact, there was evidence, including Reverend MacArthur's testimony, that the church's doctrine and beliefs are consistent with referral to a nonreligious psychiatrist or psychotherapist. Since it was reasonable to conclude from the record before the trial court when it heard the nonsuit motion that the counselors had no religious beliefs inconsistent with such referrals, the court found that the trial court erred in granting a motion for nonsuit on "free exercise" grounds.
65. Id. at ____, 240 Cal. Rptr. at 234.
66. Id. at ____, 240 Cal. Rptr. at 237.
67. Id. at ____, 240 Cal. Rptr. at 234. The court pointed out that the State of California has a very strong commitment to preventing suicide evidenced by California Penal Code section 401 which makes it a crime for one person to participate in any way in another's suicide.
68. Id. at ____, 240 Cal. Rptr. at 235.
The lives of mentally disturbed people who happen to go to a pastoral counselor are just as precious as those who go to a psychiatrist or some other mental health practitioner. The only way the public can guarantee the former will have as good a chance of surviving as the latter is if pastoral counselors have the same legal duty to take care that their counselees not kill themselves.69

Thirdly, the court found that the imposition of this responsibility is "narrowly tailored" so as to achieve California's compelling state interest with a minimal restriction on the free exercise of religious freedom.70 According to the court, the legal duty and standard of care imposed in this opinion are narrowly tailored because they do not prohibit Grace Community Church or its counselors from holding or expressing religious views through the counseling of their parishioners or other individuals; nor do they prohibit the counselors from relying on religious doctrine in dealing with their counselees' problems.71

Finally, the court found that this duty does not discriminate against religion in general or against Grace Community Church specifically. The duty does not apply only to religious counselors and churches, but to psychiatrists and hospitals as well as other counselors who are not licensed psychotherapists.72

In a dissenting opinion, Associate Justice Cole argued that the Nally II majority had "no business making policy decisions of this nature."73 A major contention set forth in the dissent is that the majority made law in this case, rather than merely declaring the law as it exists.74 Cole believed that, in effect, the Nally II majority had trespassed into territory that had long been reserved for the legislature.75 Furthermore, Cole was unconvinced by the majority's determination that imposing a duty did not place a burden on the first amendment, nor did it meet the criteria necessary to justify such a burden.

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69. Id.
70. Id.
71. Id. at ____., 240 Cal. Rptr. at 236. The Nally II court also addressed the issue of intentional infliction of emotional distress (outrageous conduct) and found that nonsuit was not warranted as to this cause of action.
72. Id. at ____., 240 Cal. Rptr. at 237.
73. Id. at ____., 240 Cal. Rptr. at 243.
74. Id.
75. Id.
IV. ANALYSIS

Society has a very strong interest in the prevention of suicide. The California courts have taken the lead in protecting society's interest by imposing upon psychiatrists a duty to prevent suicide. The court in Nally I and Nally II allowed a cause of action for wrongful death arising out of intentional infliction of emotional distress against Grace Community Church and its pastors. The court also held that non-therapist counselors who hold themselves out as competent to treat serious emotional problems, and who voluntarily establish counseling relationships with emotionally disturbed persons, have a duty to refer counselees who exhibit suicidal tendencies to a psychiatrist or psychotherapist. These decisions represent an emerging trend in malpractice claims and an abrogation of the doctrine of charitable immunity in the religious sector. As the court in Nally II recognized, "the mere fact that a claim is novel does not defeat it."76

Nor does the fact that a claim implicates the first amendment automatically defeat it. The first amendment does not provide complete tort immunity for persons "vested with religious authority."77 Indeed, "just as members of the clergy may receive traffic tickets, they, and the institutions they serve, may be sued for torts they commit."78

Further, although courts may not constitutionally place burdens on religious beliefs, courts may, under certain circumstances, burden "expressions of belief" that adversely affect "significant societal interests."79 In order to do so, a four-part test must be satisfied.80 First, an important or compelling state interest must be furthered by the burden.81 Second, the burden must be essential to further the state interest.82 Third, the type of burden imposed must be the minimum required to achieve the state interest.83 Fourth, the measure must apply to everyone; it may

76. Id. at ___, 240 Cal. Rptr. at 242 (quoting W.P. KEETON, D. DOBBS, R. KEETON, AND D. OWEN, PROSSER AND KEETON ON THE LAW OF TORTS § 3, at 18 (5th ed. 1984)).
77. Note, supra note 26, at 1303.
78. Id.
80. Id.
81. Id.
82. Id.
83. Id.
not discriminate against religion. In *Nally II*, the four-part test has been met. As the court stated:

To sum up, we find California has a compelling state interest in preventing suicide which includes those mutually disordered people who have chosen to seek emotional counseling from pastoral counselors. We further find it promotes this compelling state interest to impose on all counselors, religious and secular alike, a standard of care which can in appropriate cases require them to refer in order that suicidal individuals reach those individuals and institutions society has authorized and equipped to administer medication and initiate involuntary commitments of people in danger of killing themselves. We further find imposition of this responsibility is a means "narrowly tailored" to achieve the compelling state interest in suicide prevention at the least possible cost to religious freedom. Finally, we find this duty is not discriminatory against religion in general or against the Grace Community Church in particular.

Although the courts' opinions in *Nally I* and *Nally II* are well reasoned, the dissenting opinions cannot be easily dismissed. Justice Cole's contention that the issue is one for the legislature, rather than the courts to decide, is particularly strong. The legislature, with its superior fact-finding capability, can determine the impact of proposed legislation before it becomes law. The courts, however, cannot. A decision to impose the duty to refer must be preceded by a careful balancing of the interests involved. The interests of the person or persons injured must be balanced with the interests of the religious organization, in light of the protection offered by the first amendment.

Allowing the question of "clergy malpractice" to be decided on a case by case basis could result in an uneven application of the law. The courts may favor well established, traditional religious groups over newer, less conventional ones. One writer noted that a study of some recent Supreme Court cases indicates that "the more one can point to history and tradition in support of one's practices, the more likely those practices are to be found unconstitutional." Thus, a court might hold in one case that a clergy member who represents a traditional, mainstream religion is

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84. *Id.*
85. *Id.* at ___, 240 Cal. Rptr. at 237.
86. *Id.* at 243.
87. *Id.*
protected by the first amendment, while holding in another case arising out of similar facts, that the leader of a newer, charismatic religion is not protected by the first amendment.

Additionally, without a statute promulgated by the legislature, members of the clergy will not know precisely what behavior is expected of them until after the matter is decided by a court. This dilemma remains even after the decision in *Nally II* since the court's opinion does not define what the duty to refer entails. For example, once the clergy member determines that a counselee has suicidal tendencies, must he merely provide the counselee with the name of a professional therapist, must he offer to make an appointment, or must he accompany the counselee to the therapist's office before he has fulfilled the duty to refer? If the counselee is unable to afford the services of a psychiatrist, does the clergy member have an added responsibility to assist the counselee in making the appropriate financial arrangements?

The court's opinion in *Nally II* also fails to set forth a precise standard to apply when reviewing such actions. Clergy members of various faiths receive different levels of education and training. The point at which one clergy member may be able to ascertain that a counselee might be contemplating suicide could be much earlier or much later than another clergy member working with the same counselee. Will the point at which this duty to refer arises vary according to the education and experience of the clergy member doing the counseling?

V. CONCLUSION

Although the events that gave rise to the cause of action in *Nally* took place in California, the decisions contained in *Nally I* and *Nally II* could very well have an impact in other jurisdictions. Suicide is a nation-wide problem. Likewise, in all areas of the country it is common for individuals to rely on the assistance of a minister, priest, rabbi or other spiritual counselor when these individuals are going through emotionally troubled periods in their lives.

89. On January 21, 1988, the Supreme Court of California granted respondents' petition for review in the *Nally* case. See 243 Cal. Rptr. 86, 747 P.2d 527 (1988). [Editor's note: On November 24, 1988, the California Supreme Court rendered it's opinion in the *Nally* case. Opinion not available at the time of printing.]
Both opinions leave many unanswered questions for courts faced with clergy malpractice claims in any jurisdiction. At this point, there are no easy answers to those unanswered questions. Allowing the courts to decide clergy malpractice claims on a case by case basis could give rise to a number of problems. A viable alternative is for the legislature in each state to carefully study the issue of clergy malpractice and determine the impact that a statute covering clergy malpractice would have in that particular state. If a state's legislature determines that a statute on clergy malpractice is necessary, the statute promulgated must establish clear guidelines for courts to follow, as well as putting members of the clergy on notice as to precisely what the state expects of them.

In the meantime, churches can take several steps to help avoid clergy malpractice claims. First, religious organizations must establish hiring policies that require employees to be adequately trained and educated. Second, religious organizations must encourage clergy members who do counseling to continually educate themselves in this area through classes, seminars, professional organizations such as local ministerial associations, and relevant publications. Finally, religious organizations that have extensive counseling programs and clergy members who do a great deal of counseling may benefit from the purchase of malpractice insurance.\textsuperscript{90} These measures must be undertaken in order to insure that church funds set aside for youth groups, neighborhood assistance programs, senior citizens' events, and religious education do not end up going toward the payment of clergy malpractice claims.

\footnote{\textsuperscript{90} Malpractice coverage has been available for clergy members since 1979. See Comment, supra note 13, at 508.}
BOOK REVIEWS


Reviewed by E. P. Krauss*

There can be little doubt that racism in our institutions and our attitudes poses a central contradiction of American history. If it is true that as a society we stand for human freedom and equality, then it is also true that our racism represents the legacy of slavery and continuing oppression. A century and a quarter after the Emancipation we are still a society divided along lines of race. Black Americans as a group consistently receive a proportionately smaller share of the benefits produced by American society than is enjoyed by white Americans. White Americans generally have better housing, education, health care and more wealth than black Americans. Moreover, few white Americans are willing to recognize that racism is a cause of these disparities. Rather, things simply are the way they are because of history, or nature, or the will of God, depending upon the individual's point of view.

In reality things are the way they are, in large measure, because the law in general, and the Supreme Court of the United States in particular, has been instrumental in perpetuating an American tradition of racism.1 Rarely has the Supreme Court unequivocally pronounced racism, as such, to be illegal. Some further nexus, as with "state action"2 or "interstate commerce"3 has typically been required. A shining exception to the Court's

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1. The infamous decisions in 19th century cases like Dred Scott, and Plessy v. Ferguson, are well known, but the pattern of judicial perpetuation of racism in the modern era of "civil rights" is more insidious. Scott v. Sanford, 60 U.S. (19 How.) 393 (1856); Plessy v. Ferguson, 163 U.S. 537 (1896). See generally D. BELL, RACE, RACISM & AMERICAN LAW (2d ed. 1980).


usual retreat from any unequivocal stand against racism was its decision two decades ago in *Jones v. Alfred H. Mayer Co.* 4 There the Court held that a private vendor's refusal to sell a house to a black prospective purchaser violated the Civil Rights Act of 1866, a statute passed by Congress to enforce the thirteenth amendment's declaration of universal freedom. 5 Eight years after *Jones*, in *Runyon v. McCrary*, 6 the Court extended the principle of *Jones* to so-called "purely private" discrimination in the making of contracts. Both of these decisions are based on twentieth century understandings of the history of the Reconstruction era. The future of these precedents has been placed in doubt by a recent order of the Supreme Court, 7 which will necessarily entail a re-examination of those decisions and of the interpretations of history on which they are based. Consequently, the publication of Eric Foner's *Reconstruction, America's Unfinished Revolution, 1863-1877*, the definitive history of this most confusing and controversial period in American history, could not have come at a more propitious time.

On July 19, 1982, Brenda Patterson, a black woman, was laid off from her job as a teller and file coordinator for the McLean Credit Union where she had worked for more than a decade. She subsequently brought a law suit charging her former employer with, among other things, violations of 42 U.S.C. § 1981, which provides: "All persons within the jurisdiction of the United States shall have the same right in every State and Territory to make and enforce contracts . . . as is enjoyed by white citizens . . . ." 8 At her trial, Patterson testified that she had been the victim of racial harassment by Robert Stevenson, McLean's president. Patterson related numerous incidents of unequal and degrading treatment she had received from Stevenson, who on several occasions revealed his prejudicial ideas about black workers. Patterson also claimed that because of her race she had been passed over for promotion and laid off before other employees

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5. Section 1 of the 13th amendment declares: "Neither slavery nor involuntary servitude except as a punishment for crime whereof the party shall have been duly convicted, shall exist within the United States, or any place subject to their jurisdiction."  
with less seniority. Susan Williamson, a white woman who had been hired after Patterson, was promoted from the position of "Account Junior" (the same as Patterson) to "Account Intermediate" in 1982, although, according to Patterson, Williamson's qualifications were no better than Patterson's. In support of her promotion and discharge discrimination claims, Patterson offered the testimony of Marie Roseboro, an expert in personnel administration, to show that Patterson was better qualified than Williamson. To establish a pattern and practice of past discrimination at McLean, Patterson offered the testimony of another former employee, Anita Reid Stovall, a black woman who had been a victim of Stevenson's racial harassment when she worked for the firm in 1972. The testimony of each of these witnesses was excluded from the evidence because, in the case of Roseboro, it was deemed to be an improper use of expert testimony, and, as to Stovall, its probative value on the issue of discriminatory intent was said to be "outweighed by its remoteness in time and its potential to confuse and mislead the jury." The district court held that the racial harassment claim was not cognizable under 42 U.S.C. § 1981 and submitted only the discriminatory promotion and discharge claims to the jury, which gave a verdict for the defendant. The court of appeals affirmed the district court, and Patterson obtained review in the Supreme Court, where oral argument was heard for the second time on October 12, 1988.

The posture in which Patterson v. McLean Credit Union arrived in the Supreme Court appeared to present a nice legal question requiring no more than the elaboration of fairly well established legal doctrine: Is racial harassment in employment a violation of the contract rights secured by § 1981? It should not be difficult to conceive legalistic arguments both for and against the proposition that racially motivated discrimination in the terms and conditions of employment violates the statutory right to make and enforce contracts free from such discrimination. The court of appeals thought there was an essential distinction to be drawn

10. Id. at 1147.
11. Id. at 1148.
13. The district court's evidentiary rulings exemplify the sorts of obstacles encountered by plaintiffs in civil rights cases, but they hardly constitute the "clear error" which typically justifies Supreme Court review of a judgment of the court of appeals.
between the terms and conditions of employment on the one hand, and the right to contract for employment on the other. However, it can just as easily be argued that the conditions of employment constitute an essential term of the contract of employment and not merely a peripheral "condition" in that contract. It is certainly disputable whether "the very existence and nature of the employment contract" can ever be considered in a vacuum without taking into account the particular terms and conditions of employment under the contract.

In light of the uncomplicated nature of the question presented, the legal community and civil rights advocates across the country were rocked by the Court's order of April 25, 1988, requesting that the parties brief and argue the question: "Whether or not the interpretation of 42 U.S.C. § 1981 adopted by this Court in Runyon v. McCrary should be reconsidered?" In Runyon the Supreme Court for the first time unequivocally held that 42 U.S.C. § 1981 was derived from the Civil Rights Act of 1866 and outlaws racial discrimination in making ordinary private contracts unconnected with state action. Ever since the Court's 7-2 decision in Runyon, the interpretation there given to § 1981 has been the well-established law of the land. The Court's eagerness to reconsider this interpretation in a case in which neither of the parties nor the Solicitor General had called it into question is astonishing. Four justices dissented from the Court's order in Patterson and joined in opinions written by Justices Blackmun and Stevens.

Justice Blackmun characterized the Court's move as "neither restrained, nor judicious, nor consistent with the accepted doctrine of stare decisis" After pointing out that Congress had specifically considered and rejected legislation which would have

14. Patterson, 805 F.2d at 1145.
15. Id.
19. The other dissenters were Justices Brennan and Marshall.
had the effect of overturning the Runyon interpretation of § 1981, Justice Blackmun concluded his angry dissent by stating:

I am at a loss to understand the motivation of five Members of this Court to reconsider an interpretation of a civil rights statute that so clearly reflects our society's earnest commitment to ending racial discrimination, and in which Congress so evidently has acquiesced. I can find no justification for the bare majority's apparent eagerness to consider re-writing well-established law.

Justice Stevens' opinion emphasized the impact the Court's order would have on those who rely on the law to protect them from invidious discrimination and on the integrity and esteem of the judiciary and the adversary system. He warned of the "delterious effect on the faith reposed by racial minorities in the continuing stability of a rule of law that guarantees them the 'same right' as 'white citizens,'" and expressed the fear that "some of the harm that will flow from today's order may never be completely undone." Justice Stevens concluded with a warning and a strong rebuke:

If the Court decides to cast itself adrift from the constraints imposed by the adversary process and to fashion its own agenda, the consequences for the Nation—and for the future of this Court as an institution—will be even more serious than any temporary encouragement of previously rejected forms of racial discrimination. The Court has inflicted a serious—and unwise—wound upon itself today.

The Majority, consisting of the Chief Justice and Justice White (who were the two dissenting justices in Runyon) together with the three most recent appointees to the Court, defended their action in a per curiam opinion responding to the Dissenters rather abstractly with string cites to other instances in which precedents had been overruled. The per curiam then unabashedly invoked the principle of equal justice in support of its order:

Both of the dissenting intimates that the statutory question in Runyon v. McCrary should not be subject to the same principles of stare decisis as other decisions because it benefited civil rights plaintiffs by expanding liability under the statute. We do not

21. Id. at 1422 (Blackmun, J., dissenting).
22. Id. at 1423 (Stevens, J., dissenting).
23. Id. (Stevens, J., dissenting).
24. Id.
believe that the Court may recognize any such exception to the abiding rules that it treat all litigants equally: that is, that the claim of any litigant for the application of a rule to its case should not be influenced by the Court's view of the worthiness of the litigant in terms of extralegal criteria. We think this is what Congress meant when it required each Justice or judge of the United States to swear to "administer justice without respect to persons, and do equal right to the poor and to the rich . . . " 25

The statutory interpretation summoned up for reconsideration in Patterson was contained in a single sentence: "It is now well established," the Runyon Majority stated, "that § 1 of the Civil Rights Act of 1866, 14 Stat. 27, 42 U.S.C. § 1981, prohibits racial discrimination in the making and enforcement of private contracts." 26 This assertion was based primarily on the authority of Jones v. Alfred H. Mayer Co. and on the assumption that the statute codified as § 1981, like § 1982 (the provision at issue in Jones), was derived from the Civil Rights Act of 1866. The Runyon Court stated:

Just as in Jones a Negro's § 1 right [under the Civil Rights Act of 1866] to purchase property on equal terms with whites was violated when a private person refused to sell to the prospective purchaser solely because he was a Negro, so also a Negro's § 1 right to "make and enforce contracts" is violated if a private offeror refuses to extend to a Negro, solely because he is a Negro, the same opportunity to enter into contracts as he extends to white offerees. 27

Since the Runyon Majority treated the question of statutory interpretation as a fait accompli, it is fair to conclude that the Patterson Majority's request for reconsideration of that interpretation is specifically an invitation to resurrect Justice White's Runyon dissent. Justice White had argued that the language and legislative history of § 1981 is directed only toward eliminating legal disabilities which impair an individual's capacity to make and enforce contracts. 28 In other words, Justice White imputes

25. Id. at 1421 (per curiam opinion) (citing 28 U.S.C. § 453) (emphasis original).
27. Id. at 170-71.
28. Justice White wrapped this assertion in multiple layers of artful argumentation built up from trivial bits of legislative history. Justice White's abdication of his judicial responsibility to interpret the federal law of race relations in an honest and straightforward manner is painfully obvious. See Runyon v. McCrary, 427 U.S. at 195-211 (White, J., dissenting).
to the Reconstruction Congress a philosophy of \textit{laissez faire}: get the government off of the freedmen's backs, and the work of reconstructing southern society will have been done.\textsuperscript{29} This may be the philosophy of certain members of the United States Civil Rights Commission in the 1980s, but historical support for such an interpretation of the decade following the Civil War is hardly clear.

Foner meticulously examines the often violently opposed forces that contributed to the politics, social struggle and the ultimate failure of Reconstruction. The freed slaves' demand for political rights and land pushed the Reconstruction agenda in one direction, while the free labor ideology of Radical Republicans, and moderates' desires to welcome the rebel states back into the Union pulled in others. The interests of southern planters, northern merchants, women's rights advocates, and many others all influenced the shape of Reconstruction. Federal power was, on

\textsuperscript{29} This imputation, which is necessarily implied by Justice White's stance on § 1981 in \textit{Runyon}, was explicitly made by Justice Harlan regarding § 1982 in \textit{Jones}. Justice Harlan's opinion, which was joined by Justice White, stated:

Many of the legislators who took part in the congressional debates inevitably must have shared the individualistic ethic of their time, which emphasized personal freedom and embodied a distaste for governmental interference which was soon to culminate in the era of \textit{laissez faire}. It seems to me that most of these men would have regarded it as a great intrusion on individual liberty for the Government to take from a man the power to refuse for personal reasons to enter into a purely private transaction involving the disposition of property, albeit those personal reasons might reflect racial bias. It should be remembered that racial prejudice was not uncommon in 1866, even outside the South. Although Massachusetts had recently enacted the Nation's first law prohibiting racial discrimination in public accommodations, Negroes could not ride within Philadelphia streetcars or attend public schools with white children in New York City. Only five States accorded equal voting rights to Negroes, and it appears that Negroes were allowed to serve on juries only in Massachusetts. Residential segregation was the prevailing pattern almost everywhere in the North. There were no state "fair housing" laws in 1866, and it appears that none had ever been proposed. In this historical context, I cannot conceive that a bill thought to prohibit purely private discrimination not only in the sale or rental of housing but in \textit{all} property transactions would not have received a great deal of criticism explicitly directed to this feature. The fact that the 1866 Act received \textit{no} criticism of this kind is for me strong additional evidence that it was not regarded as extending so far. Jones v. Alfred H. Mayer Co., 392 U.S. 409, 473-75 (Harlan, J., dissenting) (emphasis in original) (footnotes omitted).

It is shocking that in this day and age the interpretation of a law clearly targeted against racism is given a narrow interpretation in part because of the prevalence of racism at the time the law was first enacted.
On the one hand, being used in entirely new and revolutionary ways. The Civil Rights Act of 1866, which the Jones and Runyon decisions held to be the source of sections 1981-1982, was the first attempt by Congress to declare fundamental rights of citizenship. The Act "embodied a profound change in federal-state relations and reflected how ideas once considered Radical had been adopted by the [Republican] party's mainstream." On the other hand, Foner points out that the Act did not envisage a comprehensive federal regulatory regime. Rather, "it honored the traditional presumption that the primary responsibility for law enforcement lay with the states, while creating a latent federal presence, to be triggered by discriminatory state laws." As is often the case with legislation, its final form embodies compromises which can be embraced by opposed camps for disparate reasons. In such cases there is no real consensus, and the statements made in debates over such bills only confirm that the law that was passed most probably encompasses both more and less than its supporters and opponents would have preferred.

Foner is actually in agreement with the Dissenters in Jones and Runyon in concluding that "the Civil Rights Bill was primarily directed against public, not private, acts of injustice"; but that does not answer either the legal or the historical question that is posed by cases such as Jones, Runyon, or Patterson. Law in the aftermath of Reconstruction and the betrayal of 1877 chronicles the legitimation of a caste society built on the distinction of color. Although it is true that law presents history from the winners' point of view, it is also true that the whole history, and not just the winning side, is responsible for making the law what it is. In the wreckage of Reconstruction, Foner finds the promises

30. Justice White disputes this. He argues that § 1981 originated as § 16 of the Voting Rights Act of 1870, and that the similar language in § 1 of the Civil Rights Act of 1866 was repealed by the enactment of the Revised Statutes of 1874. This view ascribes a substantive intention to the preparation of the 1874 revision that simply was not there. More importantly, this argumentative strategy is an abdication of judicial responsibility to confront the great societal issues of the day in a fair and direct way once they have been properly presented to the Court in a justiciable form.


32. Id. at 245.

33. Id.

34. See Williams v. Mississippi, 170 U.S. 213 (1898); Plessy v. Ferguson, 163 U.S. 537 (1896); Louisville, N.O. & Tex. R.R. v. Mississippi, 133 U.S. 587 (1890); The Civil Rights Cases, 109 U.S. 3 (1883); Hall v. DeCuir, 95 U.S. 485 (1878).
of "America's unfinished revolution." The traditions and institutions that blacks developed during this period became sources of strength which contributed to the survival and progress of black Americans in a hostile socio-political environment. Similarly, the vision of a free and egalitarian society was articulated and preserved in the civil rights laws of the period. The justices of today's Court should learn this history well before rushing to judgment. Foner's outstanding scholarship has greatly facilitated this task.

More than a century of delay does not negate the ideals which the Reconstruction statutes represent. Perhaps the Republicans of 1866 lacked the will or the means to realize the transformation of society envisioned by the civil rights laws they produced. They may have gone only part of the required distance by passing a merely jurisdictional provision without any administrative apparatus to bring about a new social order; but, this does not excuse the courts of the present century from completing the tasks left to them by the legislatures of the last century.35 The view of civil rights taken by the majority of the Supreme Court in the Civil Rights Cases of 1883 does not for all time discharge that institution's responsibility to secure to all persons within the jurisdiction of the United States the same civil rights as are enjoyed by white citizens.36 Jones and Runyon rekindled a torch that was originally intended to light the way to freedom and equality for all Americans. For the Supreme Court to again extinguish that flame would be a national disgrace of immeasurable proportions.37

35. The form of the Civil Rights Act of 1866 is not dissimilar to the Sherman Antitrust Act of 1890. While at first the latter enactment was given a narrow construction, see United States v. E. C. Knight Co., 156 U.S. 1 (1895), before long the courts, acting pursuant to their grant of jurisdiction under the antitrust laws, developed a comprehensive law of industrial organization. An analogous approach to civil rights seems apt.

36. The dissents in both Runyon and Jones repeatedly invoked the authority of Chief Justice Bradley's 1883 opinion.

37. Should the Court venture down the path pointed to by its Patterson order for reargument, the burden will then shift to Congress to reverse that misguided course.
Unlike many other areas of income taxation, there is a dearth of literature discussing federal tax accounting law. At the same time there has been a significant increase in the amount of legislative activity involving tax accounting concepts because Congress has become increasingly aware of the potential revenue associated with these issues and the apparent lack of adverse political fallout provoked by changes in the area. For example, the Tax Reform Act of 1986 attempted to maintain the same level of tax receipts, in spite of its rate reductions, in no small part through a maze of tax accounting rules so complex that taxpayers are just beginning to understand them. This lack of understanding alone is often noted as the major reason why taxpayers objections to changes in the area have not been stronger.

Surrounded by this increased emphasis on tax accounting concepts, Stephen Gertzman has timely written an authoritative yet practical desktop reference treatise on eleven of the most important federal tax accounting topics. The author, a partner in the Atlanta and Washington, D.C. law firm of Sutherland, Asbill and Brennan, obviously maintains an active practice in the area of tax accounting in that his conclusions often discuss what might be the law, what should be the law, or what might ultimately prove to be the law.

Gertzman's book is notable for its concise text which is well referenced to footnote citations. These citations provide the basis for more rigorous research. His sophisticated analysis is often reinforced with clear and understandable explanations of the complexities inherent in the area. This format is particularly well-suited to the practitioner who is not involved in tax account-
ing issues on a day by day basis. The text is also well-suited to a classroom format in order to provide a sound basis for understanding the basic structure of tax accounting law. The text is quite readable. There is no esoteric jargon or needless excursions into theoretical issues that are of interest to the scholar but are not particularly relevant to the hands-on tax practitioner.

The book is divided into 12 chapters. Chapter one defines tax accounting and discusses the complexity of the topic, including the political, economic and fiscal considerations that resulted in the tax accounting laws that are in force today. Chapter two identifies and analyzes the requirements governing all methods of tax accounting. Chapters three, four and five cover the cash method, accrual methods, and the installment method respectively. Chapters six and seven cover methods of accounting for inventories. Chapters eight and nine cover changes in methods of accounting and techniques for obtaining the most beneficial methods of accounting. Chapter ten covers taxable periods. Chapter eleven covers the rules affecting so-called time value of money issues. Chapter twelve identifies and analyzes overriding principles affecting all tax accounting. The text also contains tables keyed to cases, rulings, etc. and a detailed index.

This book is a welcome addition to the literature that presently exists in this field. Concise yet sophisticated is its approach, practitioners will find it a good place to start in understanding and solving many of the complex issues that exist in an area that is destined to take on increasing importance in our system of taxation.
Reviewed by W. Robert Lotz*

Andrew R. Klein, a self professed "practitioner," has written an extensive guidebook for other "practitioners" on the subject of criminal sentencing alternatives. The book's basic premise is that long term incarceration can and should be avoided as the punishment of choice for many criminal defendants, but is too often imposed because of the inertia of defense attorneys, prosecutors, probation officers and judges, who fail to consider or understand the possibilities and applications of available "alternatives."

Alternatives discussed include probation, shock probation, intensive probation supervision, incarceration as a condition of probation, house arrest, curfews, split sentences, intermittent sentences, halfway programs, community work service, mandatory treatment, commitment to a facility, fines, costs, special fees, forfeitures, bonds, donations, family support, day fines, and special programs. Good legal references are provided to statutory and case law. Of even greater benefit to defense lawyers, like me, were references to relevant sociological correctional, and mental health studies. For those unfamiliar with "practical" applications, the book extensively outlines the real process by which most sentences are currently determined on a day to day basis "in the trenches" of our criminal courts.

The book forces practitioners to confront their ethical obligations to completely consider all correctional alternatives whenever they are involved in sentencing offenders and recognizes that much of their job is, in fact, glorified social work. A checklist is even provided which, if followed, eliminates any excuse for a less than diligent sentencing analysis in whatever case the reader is presented.

Unfortunately the book is somewhat dated for those who practice in the federal courts since it does not consider alternatives in light of the New Federal Sentencing Act. I would also have found one or two good examples of prosecution and defense sentencing briefs more helpful than some of the case examples given of alternative sentences. Since the book is intended to be nation wide in scope, the specifics of alternatives available in one's own jurisdiction will require further work by the reader. These are minor complaints.

As a springboard to use of imagination and creativity in sentencing the book succeeds very well, while giving sufficient research support to justify any alternative sentence you, as a practitioner, might choose to craft or consider. In today's correctional reality where jail and prison space is increasingly a precious and expensive resource, the book is timely and highly recommended, not just to practitioners, but to our lawmakers as well. It is as complete and organized an overview and useful appraisal of the subject as I have yet encountered.
In 1969, a young pregnant woman named Norma McCorvey met with two local attorneys to discuss her ability to get an abortion. This young woman would become the plaintiff in *Roe v. Wade*. By using an alias, her identity would not become known until a decade after the 1973 Supreme Court decision.

Norma McCorvey's 1969 meeting with attorneys Sarah Weddington and Linda Coffee began as a simple inquiry into McCorvey's situation, but quickly became an inoculative session leading to the challenge of the Texas abortion law. What began as a lawsuit to prevent the enforcement of Texas's abortion law led to a Supreme Court decision, unparalleled in its importance concerning the constitutionally focused right of privacy. The Court ruled that a woman's choice whether to terminate her pregnancy was protected by the right of privacy found in either the fourteenth or ninth amendments.

To present the human interest story of *Roe v. Wade* comes Marian Faux, an author deeply engaged in writing about basic personal matters of our time. Faux does not engage in legal exegesis, but rather, writes about the motivation and diligence of the people involved. As a result, this book is not especially targeted for attorneys, and Faux reveals this by explaining basic legal concepts such as discovery, summary judgement and writ of certiorari.

It is only fair to note that Faux, although claiming objectivity, writes from a solid position that the criminalization of abortion is wrong. It becomes obvious as you read her work that Faux has invested much emotional energy to this area, and as a result, it is an excellent book for those who support *Roe v. Wade* and its aftermath.

desire to know pioneers of this movement. Her emotional attachment, however, prevents the book from being an arena in which one can make an informed decision on whether legalized abortion is right or wrong. In fact, no such book may exist as it seems both sides of the abortion issue manipulate the facts, many times egregiously to their advantage.\(^3\)

The book, written in sequential form, reads like a story. Faux begins with the selection of Norma McCorvey as Jane Roe and then probes into the decision processes of the two attorneys in the case, Weddington and Coffee. Both attorneys are women, both graduated from the University of Texas Law School, and both were motivated for the advancement of women in society. This last concern was manifested in their belief that women should have the right to decide what to do with their bodies. They searched for a year before the selection of Norma McCorvey as their plaintiff.

With the selection of the plaintiff, Faux describes the decision process of the attorneys as they elect to sue in federal court. Faux informs the reader that the fifth circuit in which the suit was brought had a liberal slant, and reveals that Linda Coffee had been a law clerk for Judge Sarah Hughes, one of the judges on the special three member court. The district court ruled in favor of the plaintiff and found the Texas abortion law unconstitutional, but the court’s refusal to grant an injunction to stop the state from enforcing its abortion law caused Coffee and Weddington to appeal.

Because of the special three member court, Coffee and Weddington were able to directly appeal to the Supreme Court. The book does an excellent job of revealing the preparation and dedication of the attorneys involved, especially those on the plaintiff’s side. The story shifts its emphasis to SarahWeddington, the plaintiff attorney who argues before the Supreme Court. The national attention of the case allowed Weddington to receive assistance from a New York based abortion activist group, which committed to writing the brief. Upon discovering they had neglected what they promised to do, the book exposes that Weddington had to unexpectedly invest eleven weeks time in New York to prepare the brief. To complete the brief, Weddington’s

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husband had to fly in from Texas and spend five weeks away from his law practice to research and write a section of the brief.

Almost anti-climatic, the book describes the appearance before the Supreme Court and its decision which impacted every person in America. The author, in a poignant style, observes that the decision of Roe v. Wade, unlike most Supreme Court Decisions, greatly divided America.

If Faux told only the stories of those involved in Roe v. Wade and their beliefs, I could recommend this book. However, her overt lack of objectivity precludes my unqualified recommendation and negates the promise of the jacket cover that the book will “stand as the definitive account of the case for the foreseeable future.” Qualifying my recommendation, the book is appropriate for those whose minds are settled on either side of the question, but the book is not a fair presenter of facts to those who are undecided.

This is evidenced throughout the book, and especially in three instances. The first example, surreptitious and effective, was the author’s use of adjectives. In describing doctors who assisted patients in getting abortions, Faux used the adjective “brave,”\(^4\) but in referring to doctors obeying the law as it was then and refusing to give assistance, Faux describes them as recoiling in horror at such a suggestion and instead lecturing their patients.\(^5\) On the same page, Faux describes a woman as lucky if her doctor provided a name of someone whom she could procure an abortion, and unlucky if the physician declined to help.\(^6\)

The second instance is the author’s use of conclusory language which many times ended in unsupportable implications toward those who stand against abortion. In one section of the book, Faux leaves only one implication, those who cannot support abortion are inhumane.\(^7\) And in another, abortion reform in Texas was impossible, so said Faux, because Texans were chauvinistic and firmly entrenched in their own ways.\(^8\) And finally, the Catholic church was ineffective with judges because it could not

\(^5\) Id. at 9.
\(^6\) Id.
\(^7\) Id. at 51.
\(^8\) Id. at 103.
threaten, taunt or throw tantrums as it did with the legislature, asserts Faux. 9

Thirdly, Faux attempts to make the movement against legalized abortion only a catholic effort. This simply was not and is not the case. 10 In fact, the President of the National Right to Life organization, Dr. J. Willke, is a protestant. His book, Handbook on Abortion, was used extensively before Roe v. Wade by those who opposed abortion's legalization. 11 By limiting the opposition of abortion to the Catholic Church, Faux then proceeds to conclude that the church's campaign was only the work of the hierarchy and that the catholic laity was simply ambivalent. This entire line of reasoning by Faux was unsupported, almost as if she had heard it enough times and assumed it was without question true.

Although the lack of objectivity tarnished the book, Faux does succeed in allowing her readers to see behind-the-scenes in the process leading up to Roe v. Wade. For those simply interested in the human side, the book will be very informative. For others seeking an answer to the abortion question or to those seeking legal analysis, the book fails to contribute to your search.

9. Id. at 182.
11. J. C. Willke, supra note 3.