15/344

#77.600 1/5/77

Memorandum 77-4

Subject: Study 77.600 - Nonprofit Corporations (Background Materials Prepared by Professor Hone)

Attached to this memorandum are additional materials received from Professor Hone, draftsman for the Assembly Select Committee on Revision of the Nonprofit Corporations Code. The Commission requested that any materials produced by the Select Committee on Revision of the Nonprofit Corporations Code staff be provided Commission members for review.

The attached materials are very tentative, and we do not plan to discuss them at a meeting at this time. However, if and when the staff of the Assembly Select Committee produces a more or less finished draft of a nonprofit corporation statute, we plan to analyze the differences from the Commission's recommendation to help determine what changes, if any, the Commission may wish to make in its proposed legislation.

Respectfully submitted,

Nathaniel Sterling
Assistant Executive Secretary

KENNETH MADDY
VICE CHAIRMAN
JOHN MILLER
BILL MCVITTIE
ROBERT BEVERLY

California Legislature

Assembly Select Committee on Revision of the Nonprofit Corporations Code

MICHAEL C. HONE
DRAFTSMAN
IRA MARK ELLMAN
CONSULTANT
MARTHA C. GORMAN
ASSISTANT TO CHAIRMAN
GAIL GLASSBERG
COMMITTEE SECRETARY

SACRAMENTO OFFICE
ROOM 2148, STATE CAPITOL
SACRAMENTO, CALIFORNIA 95814
PHONE: (916) 445-7890

JOHN T. KNOX
CHAIRMAN

Reply to:

School of Law
University of San Francisco
San Francisco, California
94117

November 23, 1976

To: Members of the Bar Subcommittee on Nonprofit Corporations

The enclosed material is for our November 29, 1976 meeting. It consists of:

a. Memorandum entitled "Approach to and Selected Problems in Drafting a Nonstock Corporations Code." This is the basic paper which we will address at our meeting, and presents a number of questions for Committee resolution. These are fundamental questions the resolution of which will govern much of what we do later.

b. September memoranda, entitled "Introduction to Drafting a Nonprofit Corporations Code" and "A Sample of Particular Legislative Issues." This is included as background for those who were not present at the September meeting of the Corporations Committee.

c. Reprints of two recent articles concerning profit making in nonprofit corporations. This is for the information of Committee members.

We hope at this meeting to establish a firm basis upon which we can proceed expeditiously with this project. We look forward to your help and guidance.

Sincerely,

Michael C. Hone

Ira Mark Ellman

Enclosures
MCH, IME/geg

Approach To and Selected Problems in Drafting The Nonstock Corporations Code

Questions for Committee Resolution

On the basis of the attached memo, we would like to obtain decisions from the Committee on the following issues:

1. Should the code distinguish membership in charitable corporations from membership in non-charitable corporations?

   Recommendation: Yes.

2. Should the code distinguish between the duties of directors in charitable and non-charitable corporations?

   Recommendation: Yes.

3. Should the code require that charitable corporations state their public purpose in their articles?

   Recommendation: Yes.

4. Should some distinctions be drawn between various types of non-charitable corporations?

   Recommendation: See discussion on pages 10-13.

Our September memorandum should acquaint the Committee with some of the basic difficulties which we have to resolve in the course of this project. As explained in the Introduction to Drafting a Nonprofit Corporations Code, much of the problem results from the wide array of organizations which are formed under the present code. This memorandum lays out for the Committee a basic dichotomy which may be adopted for drafting a new code: the distinction between charitable and non-charitable nonstock corporations. We then suggest some basic policy questions regarding this distinction which have implications for the rest of the code. Finally, we outline some of the problems within each category which the Committee will confront during the project.

A. Observations

Under current law both charitable and non-charitable corporations may be formed under the General Nonprofit Corporation Law; and the law does draw some fundamental distinctions between the two kinds of nonprofits. Charitables are subject to the supervision of the Attorney General; non-charitables are not. Non-charitables may distribute their assets upon dissolution to the members; charitables must transfer those assets to another charitable organization under rules analogous to the cy pres doctrine. Finally, case law makes clear that the directors of charitable corporations are subject to some if not all of the fiduciary obligations ordinarily applied to charitable trustees, while this heightened duty of care is not applied to the directors of a non-charitable non-stock corporation. Surprisingly, however, the code makes no attempt to distinguish between charitables and non-charitables for the purpose of internal governance questions. In our view, this is one of, if not the, principal conceptual deficiency of the current law which our revision needs to address.

1. Non-charitables

Most non-charitable nonstocks can be conceived of as mutual benefit organizations, formed to serve the personal interests of its membership. This characterization is probably accurate for groups as divergent as Mastercharge, the AAA, or a babysitting cooperative. In such an organization, the membership is essentially proprietary. The members own the corporation as reflected by their right to a pro rata distribution of any surplus upon dissolution; the organization is created to serve their needs; and the policies of the directors may therefore be tested against the members' wishes. The activities of such an organization are defined principally by the desires of its members, who may even have made a capital contribution to it in the form of a high initiation fee, such as in a tennis club. As laid out more fully in the September memorandum, Introduction to Drafting a Non-profit Corporation Code, it is our general belief that the new nonstock code should generally follow the corporations code is setting forth the relationship between such members and the corporation. That is to say, basic rules of corporate democracy, similar to those found in the corporations code, are appropriate to ensure that the directors represent the members' wishes and that fundamental changes in the corporation be prohibited without the consent of the members. Similarly, the fiduciary obligations of the directors -- the standard of care -- may be similar if not identical to the standard applied to directors of a business corporation. As in a business corporation, it is principally the interests of the members that these fiduciary duties are designed to protect.

2. Charitables

Membership in a charitable corporation is entirely different, although often confused since those who contribute to charitable corporations are frequently called "members" as well. Yet, these persons have no personal interest in the charitable corporation by virtue of their contribution, which by definition is to support a public purpose and is not part of a private contractual exchange. They have no interests in the assets of the corporation, which is also dedicated to its public purpose, and would not be distributed to the members upon dissolution. Contributors may, of course, condition their contribution upon various restrictions giving rise to an enforceable trust obligation on the part of the directors who accept the contribution, but such an enforceable trust obligation arises entirely independently of the internal governance structure of the corporation. Finally, the primary obligation of the directors is to the charitable purpose of the corporation, which they are under high fiduciary obligations to serve, rather than to the wishes of the contributors, although, of course, they may feel a need to heed contributors' desires in order to compete successfully for contributions.

Indeed, the very term "charitable corporation" is an anomaly and most of the learning developed over the years that aids our understanding of the roles of directors and shareholders are largely irrelevant to it. The law of charitable trusts may be more helpful than corporate law in analyzing it.

Most charitable corporations have no members.* The self-perpetuating board of directors is thus independent of any formal internal control in its policy decisions, although of course the Attorney General, and, under certain circumstances, particular private parties, may judicially enforce fiduciary obligations. In this sense the directors resemble the charitable trustee, who has similar independence combined with high fiduciary obligations, usually enforced, if at all, by the Attorney General. For example, self-dealing is ordinarily proscribed entirely, at least without prior judicial approval, and the Attorney General may act where the director trustees

*As pointed out at the September meeting, current law allows nonprofits to be formed without members other than those serving on the board, which is thus self-perpetuating. While the corporation thus technically has "members" -- those serving on the board -- the effect is that it has none in the sense of larger constituency to whom the board is responsible.

allow the funds to lie idle, without fulfilling the charitable purpose. (See, e.g., Lynch v. Redfield Foundation, 9 Cal.App.3d 293 (1970).) Of course, the use of funds for an otherwise worthwhile endeavor outside the scope of the corporation's charitable purpose is also prohibited, although judicial action may enlarge or change the charitable purpose under the cy pres doctrine. But so long as the trustee-director acts within the terms of the entity's charitable purpose, there is no one to question whether it would have been wiser to fund research on heart disease rather than cancer, or whether the funds would have been better given to researchers at Berkeley rather than Stanford, or to aid the poor in Oakland rather than San Francisco.

That may well be as it should be. Certainly we would not want a governmental agency to review such decisions, and there is no private group whose interests require membership rights, at least where none have been held out to them. Donors may have rights arising from trust obligations that surround their gift, but these arise independently of the internal governance structure and do not relate to it. In any event, the law should not turn upon whether the charitable entity was a corporation or a trust. We thus conclude that there is certainly no problem created by the absence of members in a charitable corporation.

This discussion, however, does focus attention on one point in which charitable corporations should probably be different than other kinds of nonstocks: they should be required to state in their articles of incorporation what their charitable purpose is. It could be quite narrow or quite broad, but even where broad it will serve to guide the conduct of the trustee-director. Those who wish to form a charitable corporation with narrow purposes -- e.g., to fund research in Tay-Sachs disease only -- would want such a clause in any event, in order to keep the resources of the organization focused upon the object of their bounty. Those who desire to form a charitable corporation with breader objectives may have an analogous desire for such a clause, and in any event owe it to those contributing -- as well as to those with enforcement obligations, such as the Attorney General -- to make their intentions clear. We may further observe that the regulations issued under Section 501 of the Internal Revenue Code require identification of the charitable purpose in the entity's organic documents. More troublesome may be the question of how such a clause may be changed, or what enforcement possibilities it may give rise to. But we may reasonably conclude, however, that a charitable corporation, treated favorably under the law in a variety of ways, and governed by directors with unusual independence, ought at least to tell us what their charitable purposes are.

B. Conclusions and Recommendations

It is our view that since the concept of membership in charitable and non-charitable corporations is so entirely different, different provisions of the code should govern the relation of members of charitable and non-charitable corporations to the corporation, and further, for the sake of clarity and to prevent the creation of unreasonable expectations, different names should be applied in the code to membership in a charitable corporation as opposed to a non-charitable corporation. One could, of course, preserve the use of the term "member" for one of these two basic groups. For example, one could continue to call the members of non-charitable corporations "members", while referring to the membership of a charitable corporation as "subscribers." We believe, however, that it might be easier to continue the use of the term "member" for charitable corporations, while developing a new term to apply to the membership of the non-charitable entity. Regardless of the terms ultimately used, however, we believe the code should have two separate sets of provisions governing membership in each of the two principal kinds of nonstocks. This probably represents the principal departure from current law which we are now prepared to recommend.

Secondly, we conclude that the new code should preserve current law -- case law as well as statute -- insofar as it imposes a higher duty of care upon the directors of charitable corporations. Our principal contribution can be to clarify what has at times been a somewhat confused state of the law in this area. We will deal with this problem in connection with the chapter dealing with fiduciary duties.

Third, we recommend that charitable corporations be required to state their purpose in their articles, as discussed above.

C. Some Problems Which Lie Ahead

1. Membership rights for charitables

Having concluded that membership rights in non-charitables need protection, but that members of charitables have a lesser interest, we are still left with the problem of defining that interest. The problem is not without difficulty. As explained above, the memberless charitable corporation is rather easy to comprehend, because the directors may be treated for most purposes as charitable trustees. The addition of members to the governance system presents a puzzle which may be summarized by a single observation: those in control of a charitable owe their principal duties to its charitable purpose and are barred from using their position to advance their personal interest. Yet while this high fiduciary standard can, at least in theory, be enforced in the case of director-trustees, it is difficult, if not impossible, to conceive of a mechanism by which it could be enforced in the case of the members of a charitable corporation. Business corporation law assumes that shareholders vote their private interests in corporate elections, and absent unusual circumstances generally involving those owning a controlling interest, no greater duty is imposed. This presents no problem in the business corporation, or in the non-charitable nonstock corporation whose purpose is the advancement of member interests. But where a public purpose beyond member interests is the raison d'etre of the corporation, and the basis upon which it may receive contributions, the law cannot allow those with power within the corporation to exercise that power to further their personal goals. This is the established rule for director-trustees and their is no reason why it should not apply to members as well, to the extent that they are afforded rights to determine basic questions of corporate policy, whether in voting on fundamental changes or for directors.

There are basically two paths to resolution of this conflict: development of some plausible mechanism so that members are no less likely to act in their own self-interest than director-trustees or adoption of rules which limit member rights, thus eliminating the problem. These are issues we will have to confront later.

2. Memberless non-charitable corporations

This presents the converse problem to that discussed above. A non-charitable nonstock corporation might be formed with no members other than its directors for a variety of reasons. If it is truly non-charitable, however, in all cases the directors-members have the right to all corporate assets on dissolution.

1. It can be operated for the mutual benefit, whether economic, psychological or philosophical, of its directors or their affiliates. The mutual benefit may be economic as is the case of memberless trade associations or banks creating

cooperative facilities such as Mastercharge. In such a case the entity does not generate profits but serves to enhance the profits of organizations it serves. In the alternative, it may be a cooperative childcare facility formed and controlled by parents in need of childcare facilities, providing a social or educational benefit to the member-directors. In all such cases, the class of people for whose benefit the corporation has been formed is sufficiently small to allow all to participate as directors, in a fashion analogous to closely held corporations. Thus, apart from the size of its membership, such an organization appears to be no different from the archtypical non-charitable nonstock corporation.

2. It can be operated in fact or ostensibly to serve the private interests of some broader group of people, such as homeowners, condominium owners in a particular area, automobile drivers, etc., even though the small group of founders retain control. For example, current law would allow an organization such as AAA to organize itself so there were no members in the corporate law sense -- persons with internal governance rights -- other than, e.g., three board members. Those desiring maps road service, etc., would merely be customers. Such an organization is neither a charitable nor a mutual benefit organization, yet by its choice of the nonstock form purports to be organized for some purpose other than the private gain of those in control.

3. It might carry on some "quasi-charitable" purpose, in the sense that it offers no apparent economic benefit

to the controlling group and does provide a benefit to the public. For example, a wealthy patron of the arts might wish to create a corporate entity that will display his private collection free to the general public for some limited period, after which the art will revert to his personal control. Where no tax advantages are sought or obtained by virtue of a claim that the endeavor is charitable, we may comfortably conclude that this is not a charitable corporation.

Unique problems may arise when the nonstock form is used in the above ways. Type "1", for example, suggests that there may be some useful function to be served by provisions covering "closely held" nonstock corporations. It also suggests that there is no need to use the fiction that the directors are also "members." Type "2", on the other hand, appears in substance to be a business corporation employing the nonstock form. One may ask whether such a corporation might not mislead its customers by trading upon the label "nonprofit." It may be a profit-making corporation effectively distributing its profits to those in control through compensation, perquisites of office, or upon dissolution. If so, should special rules govern it? Should it be governed by the business corporation law? If not, what different policy considerations, if any, should apply to it other than those applicable to normal business corporations? Type "3" suggests that we may wish to consider whether all corporations organized for a public purpose ought to be subject to some or all of the rules governing charitable corporations.

We are interested in the Committee's thoughts as to whether special statutory treatment is required in these cases, and, if so, what it should be.

LRC Correlation Table for Chapter 2

This compilation may be used to look up a section of the Select Committee draft in order to find the comparable Law Revision Commission section. Note that this correlation references the LRC's tentative recommendation of July 26, 1976, and of course would not reflect any changes which the LRC may make after their consideration of comments.

Section 5210. LRC also follows current law and provision 5210 is thus substantially identical. Of course, here as in all other sections the LRC does not distinguish between "members" and "participants."

Section 5220. LRC Section 5220, 5221 and 5222 are the analogous provisions. They differ in that they drop the requirement for acknowledgement as being useless, and Section 5220 of their draft is phrased in the passive, thus avoiding the identification of those people who may form a corporation. LRC thus eliminates the concept of "incorporators."

Section 5221. The analogous LRC Section 5211 follows existing law, which means among other things that it is framed in terms of purpose rather than formation. It also preserves the existing superfluous language identifying various unincorporated associations which may be formed such as societies, libraries, etc. It also retains the vesting language of the current law without further elaboration or aid.

Section 5222. The LRC places this language in its Division Four; its version of subdivision (b) refers only to use of the term "charitable." LRC §14512(b).

Section 5230. See LRC §5250. The LRC makes no attempt to draw the distinctions suggested by our section, although they do require charitable corporations to so identify themselves.

Section 5231. The LRC locates this differently, in Article Five of their draft of Chapter Two, consisting of Sections 5250 through 5252. Their version departs fairly substantially from the Corporations Code draft, although not always on matters of real substance. Thus they have a separate provision on service of process in their Division Four and do not require initial designation in the articles. They do require that the articles contain the names and addresses of the initial directors, which our version, like the CC, does not require since it allows the incorporators to take whatever actions are necessary until directors are named. Nor does the LRC version contain any provision regarding different classes of membership.

Section 5232. The analogous LRC provisions are their Sections 5252 and 5251. They only require three specific items to be stated in the articles to be effective: a limit on duration, a limit on the activities or powers of the corporation, and the provision allowing creditors to vote in the election of directors. Note that this last provision is apparently applicable to nonprofit corporations by virtue of the incorporation by reference of current Corporations Code Section 306. The LRC deals with assessments of members and special qualifications for membership in the bylaws, and it also allows the corporation broad discretion to determine its voting rules in its bylaws.

Section 5233. It is unclear where the LRC has this section.

Section 5234. The LRC drops this provision, since they require the designation of directors in the articles.

Section 5240. LRC Section 5230 is the analogous provision, and it also departs from the Corporations Code draft in its organization, probably for the same reasons. They have a provision expressly allowing the corporation to deal in its memberships. It is phrased broadly to include "other securities," and replaces our subdivision (a)(4). They do not place here the provision on issuing certificates evidencing membership; but they do retain a provision we have deleted empowering the corporation to act as a trustee.

Section 5241. This section is analogous to the LRC Section 5233, although they have no counterparts to our subdivisions (b) and (d).

Section 5242. This section correlates with LRC provision 5234; their section is different and is apparently derived from Section 26 of the model code. It lists a variety of things under the exception clause beyond the two that we list and phrases them somewhat differently.

Section 5243. The basic LRC ultra vires section is 5231, but it is framed with language that is quite different from the Corporations Code version which we adopt. The LRC version is framed in the affirmative -- that is, it sets forth the situations in which the limitation may be asserted rather than those in which it may not. In substance, their version probably comes out the same in the end, although their difference in phrasing would appear to create unnecessary uncertainty.

Section 5244. Their version, Section 5232, is quite different. It would appear to apply to any nonprofit corporation holding assets in charitable trust regardless of whether the issue in question arises as a breach of that trust or not.

Section 5250. The analogous LRC provision is Section 5260 which is somewhat different from our section; again, of course, they do not distinguish between members and participants.

Section 5251. There is no analogous provision in the LRC to subdivision (a) or (b); Section 5261 is analogous to subdivision (c) although it does not list the various matters which may be put in the bylaws but states merely that they may contain any provision not in conflict with the law or the articles. The LRC then goes on to have a series of sections relating to bylaws on particular subjects which authorize various provisions that may be contained in them. Section 5262 is on members, 5263 of their version is on members as well, 5264 is on voting rights, 5265 is on meetings, and 5266 is on directors, officers and committees.

Section 5252. The analogous LRC provision is Section 5267, which is the same in substance.

Finally, the LRC has a provision -- §5268 -- which states that unless there is specific authorization to the contrary in the code, a provision authorized to be included in the bylaws will be effective only if adopted in the bylaws or the articles. This is a new section which would change existing law and which the LRC thinks is necessary in order to insure that these various matters are adopted with the formality required of bylaws. The LRC feels that the section would not abrogate the judicially developed rule of de facto bylaws, although it would appear certain that it would create some confusion in this regard.

Profit in Not-for-Profit Corporations: The Example of Health Care

AMITAI ETZIONI
PAMELA DOTY

In the course of the recent nursing home investigations, the thesis has repeatedly been advanced that a major source of the abuses uncovered is the provision of care by proprietaries (i.e., for-profit corporations). While in most human services sectors proprietary institutions account for only a small percentage of those providing services (e.g., only 13 percent of hospitals[1] and an even smaller percentage of schools), about 77 percent of the nursing homes in the United States are proprietary.[2] In response to the scandals, a solution more and more frequently proposed is to phase out the proprietaries and require all nursing homes to be run on a "voluntary" (not-for-profit) basis.[3] Similarly, when abuses have come to light in other service areas—e.g., in proprietary correspondence schools, for-profit abortion-referral services, and the minority of

[1] American Hospital Association, *Hospital Statistics* (Chicago, 1972), pp. 20–21.

[2] *Nursing Home Care in the United States: Failure in Public Policy, Introductory Report* (Washington, D.C., November 1974), p. 22.

[3] This suggestion has been made by New York Assemblyman Andrew J. Stein, chairman of the New York State Temporary State Commission on Living Costs and the Economy, which investigated nursing homes; an assembly of the Golden Ring Council of Senior Citizens Clubs; and a series of expert witnesses testifying before the New York State Assembly's Health Committee. See *The New York Times*, February 27, March 19, and April 12, 1975.

AMITAI ETZIONI is professor of sociology in Columbia University and director of the Center for Policy Research. His books include *The Active Society: A Comparative Analysis of Complex Organizations* (recently revised); and *Social Problems*. PAMELA DOTY is a research associate at the Center for Policy Research and a doctoral candidate in sociology at Columbia University.

hospitals which are profit making—there has been a call to place these human services under the exclusive domain of the not-for-profit corporations.[4]

A closer look at current regulation of the financial dealings of not-for-profit corporations suggests, however, that a decision to bar for-profit corporations in the human services would not suffice to eliminate profit-making abuses. The reason is that omissions, ambiguities, and loopholes in the laws and regulations governing not-for-profit corporations presently make it possible for the trustees and staff of not-for-profit corporations to engage in a variety of financial practices which bring them personal profits over and above fees, salaries, and fringe benefits due them for work performed. The practices in question are not those generally termed "fraud," i.e., kickbacks, double billing, charging for services never performed, etc., which are clearly illegal whether they are practiced in for-profit or not-for-profit corporations. Rather we refer to forms of profit making which are at odds with the underlying rationale of not-for-profit corporations, not as currently written in existing laws and regulations but as widely held and understood as legitimate expectations by members of society. Examples of these abuses of not-for-profit status constitute the body of this article.

We cannot stress sufficiently that the central thesis of this presentation is not that we have established the *frequency* with which abuses occur in not-for-profit corporations, a subject which would require monumental investigative efforts, but that we have identified the major *types* of abuses which occur, *and* outlined the ways to *curb* them. Note, though, that the cases of abuse reported below are not hypothetical and the incidents are sufficient in number to lead one to estimte that whatever the frequency of such abuses, they are not so rare or trivial that they can be safely ignored.

Profit Making in a Not-for-Profit Corporation: A Definition

What kinds of reforms are needed? To answer this we need first to clarify what constitutes profit making in a not-for-profit corporation and why it is considered illegitimate. The definition we propose draws on the conception of what not-for-profit corporations are expected to be by the public at large and community leaders—i.e., by the normative consensus prevalent in society. In essence, we propose a definition which, if adopted in state and federal statutes would prod not-for-profit corporations to operate according to the public-minded, responsible, and conflict-free interest standards that the society's mores ascribe to and expect of them.[5]

[4] See, for example, testimony by Albert Shankar, president of the American Federation of Teachers, urging Congress to exclude profit-making day-care centers under legislation to provide new federal support to preschool programs. *The New York Times*, June 6, 1975.

[5] A recent discussion of these mores was highlighted during changes in the tax laws governing foundations. The foundations relied on these mores to argue for their right to tax-exempt status and related privileges. See, for instance, Alan Piper, "Assessment of the Law and Its Effects on Foundations," *Foundations and the Tax Reform Act of 1969* (New York,

The essence of the not-for-profit organizational structure is that the pecuniary interests of the trustees and staff be decoupled from the rises and falls in the output and income of the corporation. This, in turn, allows them to concentrate on the public or client needs, without concern that this will affect their income. A conflict of interest between trustees and staff on the one hand and the public and clients on the other is basically avoided by paying the trustees and staff salaries, wages, or fees *not* dependent on the client's payments, and by disallowing compensation for ownership and capital investment.[6] This is the reason these corporations have no stockholders and pay no dividends, and their trustees receive only nominal compensation or none at all.

Our central thesis is that existing laws and regulations governing not-for-profit corporations are insufficient to safeguard the underlying legitimate purpose of these corporations. For instance, the HEW guidelines for not-for-profit corporations, elaborated over sixty-five pages, define a not-for-profit corporation as one "which is not organized primarily for profit and which uses all income exceeding costs to maintain, improve, and/or expand its operations."[7] The term "primarily" leaves open the door to profit making (if it is not "primary") and the question, how much is "not primarily"—10, 20, or 40 percent?

That this ambiguity is not a hypothetical one is illustrated in *Anateas Lineal Inc. 1948 v. U.S.*,[8] where a federal district court ruled that a commercial pathology laboratory was a not-for-profit corporation for federal tax purposes, because aside from its highly lucrative pathology services to various hospitals, it provided training to high school and medical students.

The New Mexico statute says, " 'nonprofit corporation' means a corporation formed for a purpose not involving pecuniary gain to its shareholders or members, paying no dividends or other pecuniary remuneration, directly or indirectly to its shareholders or members as such, and having no capital stock."[9] The Georgia code states " 'nonprofit corporation' means a corporation no part of the income or profit of which is distributable to its members, directors or officers."[10] As we see it, the intentions of those who formed the corporation is not a sufficient criterion, as even if their purposes were pure of any profit considerations, later they—or those who succeed them—may change their minds. However, the main difficulty is with the concept of no distribution of income. As the staff is being paid and not working as volunteers, it is necessary to determine

1970), esp. p. 43; Eli Ginsburg et al., *The Pluralistic Economy* (New York, 1965); and Waldemar A. Nielsen, *The Big Foundations* (New York, 1972), p. 369ff.

[6] It does not follow that in *profit-making* corporations, any and all increase in the amount or quality of service is viewed by owners or employees as "loss." To the extent that it increases revenues it may *increase* profit. However, at each point the owners and employees must estimate to what extent such improvement in services is in line with *their* interests or in conflict. This consideration, in principle, does not exist in not-for-profit corporations.

[7] *A Guide for Non-Profit Institutions* (Washington, D.C., August 1974), p. 15.

[8] 366 F. Supp. 118 (W. D. Ark. 1973).

[9] N. M. stat, Ann. #51-14-22 (1953).

[10] Georgia Code, Ann. #22-2102 (a) (1970).

where their income is a reasonable compensation for work or services rendered, and where it exceeds this level and becomes but a veiled form of profit making. The cited codes do not cover this issue, nor does the often cited IRS code: "no part of the net earnings of which inures to the benefit of any private shareholder or individual."[11] The notion of a *net* as definition of profit, as derived from the difference of expenditures and revenue, is borrowed from profit-making corporations. In a not-for-profit corporation, illicit gains are made by the staff and trustees, we shall see, when expenditures are smaller, equal to, or larger than revenues—i.e., even when there is no "net" at all. Our definition attempts to get at this matter by defining explicitly what distributions *are* allowed: a not-for-profit corporation will provide to persons associated with it (such as trustees, managers, staff, and employees) no benefits apart from reasonable and customary fees, salaries, and fringe benefits. To put it differently: while the existing definitions cited above are "exclusive" or "negative" in the sense that they characterize what may not be done, ours is "inclusive" or "positive" in the sense that it defines which allotments are proper. Of course the two definitions may be combined.

Barriers to Perception of the Problem

That the statutory language pertaining to not-for-profit corporations has for so long remained imprecise seems to stem in part from the strength of the philanthropic tradition in America and the trust long placed in the unselfish motivations of those associated with not-for-profit corporations. By and large the public and government have been content to allow a large measure of self-regulation to not-for-profit institutions, first because these institutions are typically staffed by members of respected professions who claim allegiance to a service ethic which requires placing the interest of the client above all other considerations, and second, because those who serve on the boards of trustees of not-for-profit institutions are generally among the community's leading citizens. It has been often argued in the past that pressure from professional peers, as well as the respectability assured by a board of directors should be sufficient to curb unethical practices that might develop. As one author put it:

> The image of a nonprofit carries with it a halo of probity in a capitalist society; one imagines the gentle administrator of a church-owned nursing home who spends his time in good works for the benefit of his patients, rather than in calculating new ways to beat the government.[12]

Finally, it is probable that, until recently, when a large infusion of government funds began to rival and then surpass charitable contributions as a major source of support for not-for-profit corporations, there were fewer opportunities to exploit the law's laxities. Now that a high proportion of the income of not-for-profit corporations, such as voluntary hospitals, "private" colleges, and not-for-profit nursing homes, is derived from taxpayers' funds, the question of proper use of the funds has gained in scope and significance.

In addition, the general tenor of the society seems to be one of growing ethical laxity and weakening of core values, which questions a reliance on the motivation of the staff and the reputation of the trustees, and increases the need for reliance on law, regulation, and enforcement. It is not that these regulatory mechanisms can suffice without ethical backing; but especially in periods in which the ethical base has to be shored up, the fewer temptations that are left by the regulatory mechanism, the less burden the ethical base has to carry.

The incidents or "cases" or actual occurrence of profit making in not-for-profit corporations cited below were not uncovered by us; rather we have culled them from a variety of sources including congressional and state investigatory testimony and staff reports, as well as published and unpublished accounts by others. Our contribution is to bring together the various abuses reported here and there as "cases," analyze them as being of four main types, and suggest ways to deal with them. Although the examples cited come from the health field, we suggest that the underlying issues are the same for all not-for-profit corporations, be they educational, social, charitable, or otherwise.

Four Avenues for Profit Making in Not-for-Profit Corporations

Staff Income Tied to Entrepreneurship Rather than to Work

In many voluntary hospitals several medical specialists, pathologists, and radiologists in particular receive all or part of their remuneration in the form of a share of their department's gross or net income. A 1959 survey of 2434 American hospitals found that approximately 70 percent of radiologists; 45 percent of pathologists; 49 percent of physicians specializing in EKG, BMR, and related readings; 22 percent of specialists in physical medicine; 19 percent of internists; and 14 percent of anaesthesiologists earned their income exclusively from such a "percentage of the take."[13] A 1969 study found that 46 percent of pathologists and 60 percent of radiologists practicing at the hospitals surveyed were paid a percentage of their department's income.[14] A 1972 survey, based on a comparable universe of hospitals ($N = 1798$) found 52 percent of pathologists and 62 percent of radiologists receiving their remuneration in the form of a percentage of departmental income.[15]

For many years, acceptance by a pathologist of a salaried position in a hospital was grounds for expulsion from the College of American Pathologists, although exemptions were allowed for government-run and university hospitals. Fol-

[11] Section 501 (c) (3), 1954 Internal Revenue Service Code.
[12] Mary Adelaide Mendelson, *Tender Loving Greed* (New York, 1974), p. 195.

[13] Milton I. Roemer and Jay W. Friedman, *Doctors in Hospitals* (Baltimore, 1971), p. 65.
[14] C. M. Begole, P. J. Phillip, and M. Williams, "Hospital Specialist Compensations Plans," *Hospitals*, 46 (April 16, 1972), 81.
[15] Robert M. Blakely, "Hospital Physicians: How They Are Paid and How Much," *Modern Hospital*, 121 (August 1973), 74.

lowing a Justice Department suit charging "monopolistic practices," a consent decree was issued in 1967 whereby the College of American Pathologists agreed to delete this rule. Nevertheless, some hospital administrators contend that strong pressure is still exerted informally to maintain percent of revenue as the dominant mode of reimbursement.[16] As a result, according to one observer, a heart surgeon and medical consultant, a situation has developed where pathologists of equal qualifications will work for $28,000 to $40,000 salaries in university hospitals, while those working in general hospitals under percent-of-revenue schemes can earn $200,000 and more.[17]

A recent General Accounting Office study of compensation arrangements for pathology and radiology specialists at seventeen hospitals in Washington, D.C., and Missouri found that the nine pathologists with percentage-of-gross arrangements earned an average of $80,000 over annual periods ending between April and December 1972. In contrast, the four pathologists earning salaries averaged $26,000.[18]

Why do we hold that these arrangements, known in the for-profit corporations as "profit sharing," are incompatible with the basic concept of not-for-profit corporations? Because as long as the income of the staff rises as more services are rendered, the motivation to provide the service may not be the needs of the client or public, but the desire of the provider to increase his or her income. Overutilization tends to result, causing both unnecessary financial burdens on the client and taxpayer, and unnecessary health risks which medical interventions entail.

When the income of the staff is tied to provision of *fewer* services, the opposite effect—underutilization—may result; i.e., clients will receive less care than they require, which again calls for separating the income of the provider from the needs of the client. Thus, in some not-for-profit Health Maintenance Organizations (HMO's) physicians receive a bonus, above their salary, calculated as a percentage of the organizations' net surplus. The fewer services rendered, the higher the surplus, all other things being equal.[19]

Writing in the *New England Journal of Medicine*, Dr. Robert W. Geist noted that HMO incentive bonuses are conceptually quite similar to fee-splitting or rebate arrangements between physicians and other providers to whom they may refer patients or from whom they may order services.[20] The principal difference between such arrangements among providers—which have traditionally been held unethical by the profession and often illegal by government—and HMO incentive bonuses is that the former give physicians a financial reward for prescribing additional services while the latter reward them for withholding services.

The American Medical Association House of Delegates recently adopted a report by its Judicial Council stating, "compensation geared not to the quality of services but to the extent that physicians can keep the medical, surgical or hospitalization rate of a particular group of subscribers below a predetermined level is not in the best interests of the public or the medical profession."[21] The council warned that this mode of payment "introduces a financial incentive that may interfere with the physician's obligation to place his patient's welfare first. In cases of doubt, deliberate or otherwise, the incentive may tip the scale against the patient's welfare . . ."[22]

Nevertheless, the AMA has not taken the position that it considers such arrangements unethical and hence does not prohibit its members from participating in them. Government agencies are very favorable to HMO's because they are said to be more economical than other arrangements. Our point is not to ask here if cost-saving or patient services should take precedence; some balancing of health needs and costs is clearly necessary. Our point is that where the staff has a financial stake in the services rendered or *not* rendered, this should not be hidden under the umbrella of a not-for-profit corporation. Let the patient choose to be served by a profit-making corporation or in a not-for-profit one; but the patient looking for one free of this form of conflict of interest should not end up being subject to it. It is not a matter of informing people that profit making takes place in not-for-profit corporations, "so they know what they are getting into," an approach which would make them better informed but also leave them without a clear choice; the point is that by keeping the not-for-profit corporations clear of profit, the public's choice will be protected.

Attempts have been made to try to deal with the matter through "disclosure" rather than by regulations. An April 30, 1975, General Accounting Office report to the Congress stated:

> In view of concern over high medical costs and the monopoly position of pathologists and radiologists at many hospitals, the public should be informed of methods used to determine patient charges for X-Ray and laboratory services and the extent that specialists can determine their own income.[23]

The GAO recommends that consideration be given to amending the Social Security Act Amendments to require hospitals to disclose their contractual arrangements with affiliated physicians in order to be eligible for participation in publicly funded programs.[24] Presently (1) such disclosure is neither required

16 "Now they use the velvet glove approach," Richard M. Loughery, administrator, Washington Medical Center is quoted as saying in *The Washington Post*, November 1, 1972.

17 Dr. John Gillespie, heart surgeon, ibid.

18 See the Comptroller General of the United States, "A Proposal for Disclosure of Contractual and Financial Arrangements between Hospitals and Members of Their Governing Boards and Hospitals and Their Medical Specialists," *Report to the Congress* (Washington, D.C., April 30, 1975), p. 23.

19 Harry Schwartz, *The Case for American Medicine* (New York, 1972), p. 177.

20 Robert W. Geist, "Incentive Bonuses in Prepayment Plans," *New England Journal of Medicine*, 291, no. 24 (December 12, 1974), 1307.

21 "HMO Bonus Policy Assailed," *American Medical News*, 17, no. 13 (December 9, 1974).

22 Ibid.

23 Comptroller General, *Report*, p. 17.

24 Ibid., p. 28.

nor commonly practiced, and (2) if introduced would not provide the patients with a clear choice, because then profit making would be practiced both in for-profit and not-for-profit hospitals. It seems to us that limiting profit-sharing schemes to profit-making hospitals and other health service facilities is a more proper solution.

University of Pittsburgh Health Law Professor Nathan Hershey has suggested that perhaps getting a percentage of gross or net income arrangements are a case of "necessary evil" if we are to have the services of specialists who wish to maintain the practitioner's professional autonomy. Exploitative arrangements can, however, be prevented, he argues, by providing the hospital's attorney with a projection of the volume likely to be generated within the various hospital departments and having the attorney set a percentage of return to be not different from what the physicians would have received from a salary plus fringe benefits. If, in addition, there were greater restrictions on the tests or services classified as routine by the hospital's medical staff for all, or some categories, of patients, thereby requiring specific orders from the patient's own physician for performance of many tests and services, an increased potential for control over unnecessary tests and services, which increase specialists' income based on departmental revenue, could be achieved.

As we see it, the idea of the autonomous professional is just as readily upheld by fee-for-service compensation as by gaining a percentage of a department's income. While we agree that fee-for-service can also be abused, and hence would prefer that physicians be salaried, we suggest that its potential for profit-making abuse can be more readily controlled than that of percentage-of-income arrangements for several reasons. First, as a practical matter negotiating reasonable percentage-of-income arrangements is particularly difficult. For one thing, the volume of services a hospital specialty department has may change considerably over time, due to overall growth of the hospital, changes in the population of the area, and many other "irrelevant" reasons. Thus, gradually, a formula that originally provided a reasonable income to the specialists may become more and more lucrative, perhaps even outlandishly so. At this point, it will be quite difficult for the hospital to attempt to negotiate a lower percentage cut for the specialists. Second, it is very difficult to determine when a service is and when it is not "necessary" and hence, we hold that it is best not to generate motivation to oversupply or undersupply a service. This would curb the need to evaluate them. Nor can service initiation be limited to the patient's own physician (often an internist) and not be allowed to a specialist; nor is it reasonable to expect internists to curb their specialized, often more prestigious colleagues.

Regulatory implications

Since, in our view, "profit sharing" as on the part of physicians associated with not-for-profit health facilities is in conflict with the very concept of a "not-for-profit" corporation, we suggest *a revision of the law covering not-for-profit corporations to explicitly exclude any form of compensation of the staff other than salary or fee for service.* Physicians like to maintain the legal posture that they are not working for the hospital but are only "using" its facilities. We propose that, though a one time or occasional use (such as that of a consultant) may be deemed use by an outsider, persons who utilize a hospital regularly and continuously, as most physicians do, should be considered staff for the purposes of this regulation and be prohibited from contracting to provide their own (or others') services on a for-profit basis as well as from operating hospital departments as private profit-making concessions.

Self-Dealing

Self-dealing refers to business transactions in which the same persons (or their kin) appear on both sides of the transaction, once as the staff or trustee of a not-for-profit corporation, once as a profit-making provider of goods or service to the other side (the not-for-profit corporation).

In 1972 a number of practices of this sort were reported in Washington, D.C.'s largest not-for-profit hospital, the Washington Medical Center. A member of the administrative staff in charge of data processing had decided that the existing facilities at the hospital for billing, keeping track of patient records, and accounting through the hospital's computer were inadequate. His solution was to hire an outside for-profit firm to furnish these services, and he selected one he had started himself—with the help of a $50,000 deposit from the hospital. The hospital administrator received stock in the new company free of charge; five other top administrators of the hospital bought stock at $1.00 a share.[25] Following public disclosure of these relationships, most of the administrators disposed of their stock. In 1974, however, when the General Accounting Office included the Washington Medical Center in a review of self-dealing transactions in nineteen hospitals, it found that four hospital officials and several relatives of another official owned stock in the same computer firm; a physician employed by the hospital provided consultant services to the firm; and the firm's president was a hospital consultant and a member of the hospital's action committee.[26] The GAO also found that it was not until mid-1973 that the Washington Medical Center requested competitive bids for computer services. According to the hospital administrator the other bids were not comparable with the present firm's services for a number of reasons; thus the hospital decided to continue retaining the firm's services for twelve to eighteen months, during which time a "more specific request for bids would be developed."[27] The GAO report concluded that the overlapping interests of the hospital officers with the firm were likely to continue to give the firm an advantage over potential competitors.

In addition, at this same hospital, the official in charge of managing the in-

[25] *The Washington Post*, October 31, 1972.
[26] Comptroller General, *Report*, pp. 7–9.
[27] Ibid.

stitution's finances placed hospital funds in an interest-free account at a bank where he was vice-president. The hospital's account balance is reported to have generally hovered around $1 million, sometimes going as high as $1.8 million; a conservative estimate placed the hospital's annual loss of interest because of this account at $50,000.[28] That hospital *staff* gained something from these transactions is suggested by the fact that the hospital's administrator admitted this bank had lent him money at a low interest rate.[29]

More recently, Medicare officials disclosed that millions of dollars in federal and private funds entrusted to Blue Cross and Blue Shield are being channeled through banks with officers who serve on the boards of trustees of these not-for-profit health organizations. Officials of the Social Security Administration identified eleven accounts out of twenty such Medicare accounts investigated as containing excess balances during the first quarter of 1975, indicating that the banks had federal money to invest beyond that needed to pay each bank for its checking account service. The excess balances ranged from $8,597 to $163,717.[30]

According to a 1971 New York State Health Department working paper, "self-dealing" transactions, of the type apparently practiced at the Washington, D.C., not-for-profit hospital and by some Blue Cross and Blue Shield officials, are a growing trend. In particular, doctors, administrators, or trustees of not-for-profit health facilities are increasingly setting up their own for-profit corporations, ranging from physician provider groups, laboratory service, food service, and linen and laundry service to equipment leasing, housekeeping and maintenance, rehabilitation therapy, and health personnel service.[31] In addition, doctors frequently own pharmacies (thus giving them an incentive to overprescribe), a practice that was investigated several years ago by the Senate Monopoly and Anti-Trust Committees, and which the AMA debated but avoiding condemning.[32]

The results of a recent California Auditor General's Office investigation of inexplicably high costs charged to Medicaid by a number of not-for-profit prepaid health plans can serve as a warning signal. In eight of thirteen not-for-profit prepaid health plans reviewed, officers or directors were found to have formed profit-making partnerships or associations which sold various supplies to the not-for-profit prepaid health plan, thereby enabling these individuals to make personal profits from what was ostensibly a not-for-profit operation. The report went on to note that the complex administrative structure created by these interlocking firms made it difficult for the state to determine what percentage of its payments actually went for patient services and what

[28] *The Washington Post*, October 31, 1972.
[29] Ibid., October 30, 1972.
[30] *The New York Times*, August 5, 1975.
[31] New York State Department of Health, "An Outline of Changing Trends in Ownership and Operation of Health Facilities and Services" (New York, April 19, 1971).
[32] *Modern Hospital*, 117 (March 1969), 86, 160.

percentage went into executive salaries and other components of administrative overhead.[33]

In California, the practice of self-dealing has recently come into question in connection with the new wave of Health Maintenance Organizations. Currently most HMO's are not-for-profit corporations. There are at present, however, few legal obstacles barring not-for-profit HMO's from becoming chiefly shells for a myriad of for-profit corporations. According to California Assemblyman John T. Knox, "The notion that prepaid health plans are operated by non-profit corporations is nothing but fiction, a fiction that has worked directly contrary to the original goal of the prepaid health plan as a means of reducing the cost of health-care delivery."[34] In testimony before the Senate Permanent Investigations Subcommittee, Dr. Lester Breslow, dean of the School of Public Health at the University of California at Los Angeles and former health director of the state, said that many Health Maintenance Organizations, though ostensibly not for profit, siphoned most of their state and federal funds into subsidiary profit-making corporations.[35] Dr. Bruce R. Frome testified concerning California's second largest prepaid health plan, Marvin Health Services, Inc., which he had helped to found. He acknowledged that most of the state and federal money received by the not-for-profit Marvin Health Services was turned over to a profit-making subsidiary called American Health Maintenance Organization, Inc., which was owned by doctors and other health professionals associated with Marvin Health Services. Marvin Health Services, located in the Watts section of Los Angeles, had received $7 million, of which $4.2 million went to administrative costs and profits.[36]

The most comprehensive study of "self-dealing" in not-for-profit health facilities to date is a General Accounting Office survey of "overlapping business interests" of key hospital employees and members of hospital governing and advisory boards. Nineteen hospitals were studied: five not-for-profit and one profit-making hospital in the Washington, D.C., metropolitan area and thirteen not-for-profit hospitals in the cities or metropolitan areas of Kansas City, St. Louis, and Springfield, Mo. At the Missouri hospitals, only overlapping interests involving governing or advisory board members, not those involving employees, were investigated. At seventeen of the nineteen hospitals "overlapping interests" were found.[37] Of these,

> 14 had at least 1 board member associated with a bank or investment or legal

[33] Testimony from California Auditor General's office represented by Gerald Hawes and Robert Christophel before the United States Senate Special Committee on Aging concerning "Medicaid—Home Health Care Regulations" (Washington, D.C., October 29, 1975), pp. 9–10.
[34] *Medical Care Review*, 32, no. 4 (April 1975), 373–374.
[35] Ibid.
[36] Ibid.
[37] Comptroller General, *Report*, p. 3.

firm serving the hospital. Board members at 3 hospitals had associations with insurance companies; 14 hospitals had board members associated with various other firms doing business with the hospital.[38]

At one St. Louis not-for-profit hospital, ten of the fifteen board members had overlapping interests with twelve different companies, primarily banks in which the hospital had accounts or which managed its pension funds or investments. In addition, however, the hospital did $934,000 worth of business in 1972 with utilities, conglomerates, or manufacturing firms with which its trustees were associated.[39] Again, noting the unfair competitive advantage that could result from "overlapping interests" between board members or staff and firms doing business with a hospital, the GAO recommended public disclosure of all such relationships.

Regulatory implications

In total, it seems that to avoid conflict of interest between the staff and trustees on the one hand and the client and public on the other hand, it is necessary to deal not only with transactions within the not-for-profit corporation but also with dealings between it and other corporations. Thus we suggest that business transactions between an institution where an individual is a staff member or official and a company in which he or she has a financial interest should be disallowed.

At present, most statutes regarding not-for-profit corporations either contain no provisions regulating self-dealing or rather permissive ones. For example, section 715 of the New York Not-for-Profit Corporation Law is nearly identical to New York business corporation law in providing that:

> No contract or other transaction between a corporation and one or more of its directors or officers, or between a corporation and any other corporation, firm, association, or other entity in which one or more of its directors or officers are directors or officers, or have a substantial financial interest, shall be either void or voidable for this reason alone or by reason alone that such director or directors or officer or officers are present at the meeting of the board, or of a committee thereof, which authorizes such contract or transaction, or that his or their votes are counted for such purpose.

The director or officer is, however, expected to disclose his interest in good faith to the full board which then takes a vote (not including the interested director) to decide whether or not to authorize the transaction. If there was no such disclosure or the vote of the interested party was necessary to authorize the transaction when the vote was taken, then

> the corporation may avoid the contract or transaction unless the party or parties thereto shall establish affirmatively that the contract or transaction was fair and reasonable as to the corporation at the time it was authorized by the board, a committee, or the members.

[38] Ibid., p. 7.
[39] Ibid., pp. 13–14.

A notable exception is Section 4941(d) of the 1954 Internal Revenue Codex which sets forth a set of limits and levies a special tax on self-dealers in the context of foundations. Prohibited acts of self-dealing are defined as follows:

> (1) In General.—For purposes of this section, the term "self-dealing" means any direct or indirect (A) sale or exchange, or leasing, of property between a private foundation and a disqualified person; (B) lending of money or the extension of credit between a private foundation and a disqualified person; (C) furnishing of goods, services, or facilities between a private foundation and a disqualified person; (D) payment of compensation (or payment or reimbursement of expenses) by a private foundation to a disqualified person; (E) transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation; . . .

We hold that the same prohibitions should be applied to all not-for-profit corporations. It might be asked if a trustee who owns a few shares of Johnson and Johnson, Ford Motor, and Procter and Gamble would be disqualified from serving on a hospital board if the hospital buys paper towels, a car, and soap from the respective companies. One may say that such purchases by the hospital are so small compared to the total volume of transactions of the said corporations that trustees could not expect any benefits to accrue to them because the hospital buys from "their" corporations rather than other ones and hence view that such ownership is not a violation. However, the courts may have been too lax when they allowed self-dealing when the director had up to 10 percent (or even more) interest in the other corporation.[40]

The argument that unless one allows trustees not to divest themselves of ownership and management roles in related business there will be an insufficient number of trustees outweighing the danger of some self-dealing, is doubly mistaken. First, it overestimates that role of the trustees. They no longer are a main source of "raising funds" for private hospitals, colleges, etc., which rely heavily on public funds (Medicare, Medicaid) and insurance (Blue Cross). Second, the trustees need not be businessmen and can be community leaders, union representatives, and others with little business investment.[41]

Another legal means for curbing self-dealing transactions in not-for-profit institutions is by holding trustees accountable on the basis of their fiduciary obligation to the institution. Directors and officers of not-for-profit corporations are considered as having duties vis-à-vis the corporation encompassing good faith, loyalty, and the exercise of sound business judgment, as well as the responsibility to use corporate assets in a manner consistent with the purposes set forth in the corporation charter. A recent court decision suggests that these fiduciary duties can serve to provide a legal foundation for penalizing, or at

[40] Harold Marsh, Jr., "Are Directors Trustees?" 22 Bus. Law. 35 at 65 (1966), cites this standard as common in business corporation law.
[41] Ibid. at 36.

least censuring, trustees who engage in or allow self-dealing transactions. In July 1974, U. S. District Judge Gerhard A. Gesell ruled that five trustees of Sibley Hospital had failed to supervise properly the not-for-profit hospital's funds and investments over several years.[42] While Judge Gesell did not characterize the acts of the trustees as conspiracy or illegal use of the funds for their own benefit, he did rule that they had breached their fiduciary duty to exercise proper supervision. Although not taking any action against the trustees (who were also members of the boards of the banking and financial institutions handling the hospital's funds), Judge Gesell outlined specific steps to be taken in the future by the hospital and its trustees on a regular basis, including full listing to the boards of directors of the hospital's dealings with any institution. In addition Judge Gesell recommended that the hospital restrict board membership to representatives of financial institutions that have no substantial business relationship with the hospital.[43]

This suggests that (1) the concept of good faith does *imply* proper curbs on the trustees, but (2) it is too vague to provide a sufficient guideline to either trustees or courts, and hence (3) additional, more specific curbs are necessary—ones which explicitly rule out self-dealing.

In addition, we hold that while public competitive biddings are not a cure-all, because such biddings have been known to be rigged and there are occasions when they are not practical, this procedure does offer fewer opportunities for abuse than do sole service contracts. It would seem that in exchange for the privileges which their special tax status bestows on the not-for-profit corporations, they should be required to make their purchases through competitive bidders except when this is not practical (e.g., when there is only one supplier within an extensive geographical radius).

Such a "rule" has been on the books of New York City since 1909. Rule 9 of the Terms and Conditions Governing Payments to Charitable Institutions states that no member of a hospital board can be a member of a company that is paid for providing services or merchandise to these institutions. The rule, though, is not on the books elsewhere and the mechanisms for its implementation are not clear. Thus when the New York City comptroller asked the trustees of New York City hospitals to disclose any such affiliations, most failed to respond, leaving on him the onus of making the case.[44] We would add, then, the requirement that persons accepting a public office, such as that of trustees or director of a not-for-profit corporation, should be required to disclose all such affiliations and how they dispose of them.

In addition, the lack of enforcement of Rule 9 was attributed to the fact that the city felt that it could not cut off the funds to the hospitals because some trustees violated a rule.[45] We suggest that the penalty for violation of such rules

[42] *The Washington Post*, July 31, 1974.
[43] Ibid.
[44] *The New York Times*, December 26, 1975.
[45] Ibid.

should be exacted from the individual trustee, not from the not-for-profit corporation; also, that the penalties will have to be sufficiently large to more than outweigh the benefits which accrue to violators. The antitrust law notion of triple damages may apply here.

In sum, we recommend that (1) persons having potential "conflicts of interest" be required to sever the relationship in question before being permitted to serve on the board or as an official or staff member of a not-for-profit entity; (2) penalties be exacted from any member or trustee of a not-for-profit institution engaged in any such conflict of interest transactions; (3) in order to prevent exploitation of the authority to award contracts on the part of the not-for-profit entity's officials—in particular, favoritism toward friends and relatives—the law should require competitive bidding for all business transactions over a given size, unless special circumstances can be demonstrated to the regulatory agencies *before* the transaction.

Real Estate Transactions

The sale or lease of land or facilities to a not-for-profit corporation by an officer or staff member offers a number of profit-making opportunities, which differ from the self-dealing reported above chiefly in the magnitude of the abuse and in the form of the transaction. Since some areas, especially nursing homes, are believed to account for a major proportion of all the damage done, they deserve separate attention and treatment. Instead of profiting from purchases of goods or services from a corporation in which the officer has an interest, here real estate manipulations make it possible to reap profits from the property the officer owns (or once owned) and which is now used by the not-for-profit corporation. One way is for the owner of a property (land, building, nursing home, or hospital) to set up a not-for-profit corporation of which relatives, friends, or long-standing business associates—and often the owner himself—become the trustees. The not-for-profit corporation then buys or leases the properties from the owner at highly inflated prices much above the market terms of purchase.

A 1970 Senate Finance Committee report pointed to the profit-motivated conversion from proprietary to "not-for-profit" ownership as a growing problem. One instance among several that the report cited involved a 160 bed hospital that had been operating for eighteen months. It had been set up as a proprietary hospital for investment purposes by the hospital administrator and a group of businessmen who then converted it to a not-for-profit institution. Purportedly, the not-for-profit organization taking over the hospital was set up by three disinterested citizens concerned with the welfare of the community. The owners furnished the not-for-profit group with an appraisal of the hospital's worth to be $5 million (although the Internal Revenue Service later contended in litigation that the hospital had a fair market value of $2.9 million), and this was the price paid. The sales agreement provided for the continued employment of the proprietary hospital administrator, and since his share of the purchase price as a former stockholder was to be paid out of future hospital earnings, he was also accorded a great deal of autonomy in controlling operations. After the sale was consummated two other former stockholders became members of the board of directors.[46]

Mary Adelaide Mendelson has described the conversion from "for-profit" to "not-for-profit" status of a Cleveland nursing home. In 1971 the owner of this nursing home sold it to a not-for-profit organization, a Baptist church, which was to expand it to encompass a family training, day care, and health services center. The church became responsible for the former owner's debts, plus its own mortgage with a bank and a second mortgage with the former owner. Thus,

> The nursing home, which had been built with little or no down payment, and was purchased with no down payment at all, now served as collateral for debts totalling $2,695,000. The mortgage obligations had doubled, and the home now enjoyed the advantages of nonprofit status. As for [the owner] he had turned a debt of $1.1 million owed by him into a debt of $1 million owed *to* him.[47]

Mendelson went on to note that because the home's mortgage would require, for the next twenty years, monthly payments of $22,000 while the Medicaid reimbursement rates for most of the patients' care was fixed, the only way that the payments could be met was to cut the cost of care. The result, state inspectors' reports indicate, was poor quality care. Staff was cut and the following year the State Medical Review Team noted the effects of the staffing shortage: poorly groomed patients, dehydrated patients, and a pervasive odor of urine. Subsequently, state personnel had to be sent in to investigate why fifteen patients, an abnormally high number, had died in the home in a single month.[48]

Leasing arrangements can be another source of profit. Recently, a well-known dealer in nursing home construction attempted to have a small liberal arts college, of which he was chairman, buy from him four nursing homes which he owned, and then lease them back to him. The motive seemed to be a desire to boost artificially the value of the real estate in order to increase the reimbursement for rent that he would be entitled to receive under Medicaid.[49]

Another example entails a husband and wife team in White Plains, N.Y., who constructed a sixty-six bed nursing home under the ownership of a real estate company of which they were the sole stockholders. The home's construction cost was approximately $779,800 of which $700,000 had been financed by an FHA guaranteed mortgage. Shortly before the home opened, the owner entered into a lease agreement with his real estate company—that is, with himself—to

[46] United States Senate Finance Committee, *Medicare, Medicaid: Problems, Issues and Alternatives* (Washington, D.C., 1970), pp. 141–142.

[47] Mendelson, *Tender Loving Greed*, p. 200. For an example of circumventing a law which limits kidney dialysis centers to not-for-profit corporations in New York City, see *Barron's*, October 20, 1975.

[48] Mendelson, *Tender Loving Greed*, p. 201.

[49] *The New York Times*, February 27, 1975.

lease the facility and run it as a proprietary home. A few years later, he converted the home into a not-for-profit corporation. He then applied to the state for permission to sell his leasehold to the newly organized not-for-profit corporation of which he and his wife were members of the board of directors. Although at first state officials were apparently reluctant to approve the transaction, they eventually granted the home not-for-profit status. Next, the owners arranged for the not-for-profit corporation to lease five-year-old equipment, estimated to be worth $198,000, at an annual cost of $24,000 over a fifteen year period—$360,000 all told. Thus at the end of the lease term, the real estate company was expected to have realized a profit of $195,000 and still own the property free and clear. The not-for-profit corpoartion would then be permitted to exercise an option to buy the property, which had originally cost $780,000, for $900,000.

> The total profit to the [owners] would then be $1,095,000—not bad at all, considering that the most the [owners] themselves would have put up, with the FHA-insured mortgage, is $80,000. Payments on the mortgage for $700,000 which provided the balance of the original cost, would have been covered by the payments under the lease. That, of course, is in addition to their profit on the equipment. The term "nonprofit" clearly does not include the [owners'] share of the deal.[50]

An analysis by a state health department official showed that the money needed to meet these lease payments was slated to come out of patient care; specifically, the home's projected operating budget indicated a major portion would be provided by skimping on patients' meals. Indeed, a 1970 state audit later revealed that 24 percent of this not-for-profit home's expenditures went into the pockets of its owner-operator-trustees.[51]

Regulatory implications

Here the correctives are basically the same as those suggested above for self-dealing: no transactions should be allowed between owners and their relatives and the officers of a not-for-profit corporation when these persons are one and the same or related.

Legal provisions should be adopted similar to those regulating the relationship between persons donating funds to establish a foundation and the foundation which results. Thus, former owners and their relatives should not be permitted to serve on the board of trustees of the newly created not-for-profit institution.

In the case of providers of health services such as nursing homes and hospitals, it is also necessary to rewrite substantially the regulations covering reimbursement rates for Medicaid in those states where provisions for reimbursement increases presently in effect encourage frequent sales and changes in

[50] Mendelson, *Tender Loving Greed*, p. 205.

[51] Ibid.

leasing arrangements as well as concealment of personal relationships among the parties involved in these transactions. The New York Temporary State Commission on Living Costs and the Economy recommended, and the New York State Legislature enacted into law, a bill specifying that the Medicaid reimbursement formula no longer be tied to changes in ownership or lease.[52] Though this change was made primarily to combat real estate manipulations of for-profit homes, the reform is also likely to discourage the profit-motivated conversion of nursing homes from "for-profit" to "not-for-profit."

Finally, we note that some state statutes (e.g., California, Georgia) permit under certain circumstances what amounts to the conversion of not-for-profit properties to for-profit status. This is accomplished by allowing individuals associated with a not-for-profit corporation to pocket a share of its assets upon the corporation's dissolution. Thus, the California statute reads:

> A nonprofit corporation may be formed by three or more persons for any lawful purposes which do not contemplate the distribution of gains, profits or dividends to the members thereof. . . . Carrying on a business at a profit as an incident to the main purposes of the corporation and the distribution of assets to members on dissolution are not forbidden to nonprofit corporations but no corporation formed or existing under this part shall distribute to any of its members except upon dissolution or winding up.[53]

To prevent the possibility of persons creating not-for-profit corporations in order to claim their assets upon dissolution, such statutes should be altered to require (as some federal and state statutes already do) that the assets of a dissolved not-for-profit corporation be donated to another not-for-profit institution or organization, and not distributed to the members.

Unreasonable and Uncustomary Fees, Salaries, and Fringe Benefits

The easiest way to violate the essence of a corporation's not-for-profit status is to provide its staff or officers with unreasonable and uncustomarily high fees, salaries, or fringe benefits. In principle, income is not a violation of the not-for-profit concept, and as it is rather difficult to establish what is proper and what is exaggerated compensation, this area is rather difficult to regulate. Thus, attention must focus on those situations in which the income provided is manifest.

One such example is a hospital paying for the poetry and drama lessons of the physicians' children.[54] No reasonable person would define such fringe benefits as typical, common, or legitimate. That a not-for-profit hospital can provide

[52] For the recommendations see The Temporary State Commission on Living Costs and the Economy, Report to the Governor and the Legislature on *Nursing Homes and Health Related Facilities in New York State* (Albany, N Y., April 1975), pp. 13–14; for accounts of the debate over and passage of the bill see *The New York Times*, July 10 and August 8, 1975.

[53] West Ann. Corp. Code § 9200 (1949).

[54] *The New York Times*, March 15, 1975.

such benefits is ironic: this case involves New York City voluntary hospitals that have contracted with the city's municipal hospitals to be paid for providing the municipalities with such services as physician and nursing assistance and laboratory work. These affiliation contracts were entered into by the city because it could not attract the needed qualified personnel for its own hospitals. By paying the voluntaries, however, they are perpetuating the problem, since the voluntaries use the contract money to pay for the education of doctors' children and for poetry and drama lessons, terming these fringe benefits.[55] Thus, the city is paying the voluntaries because it cannot attract good personnel, and the voluntaries use this money to attract the personnel via benefits the city cannot match.

The ambiguities of the law and regulations concerning not-for-profit status of a corporation are illustrated by the trial and appellate decisions in *American Automobile Association* v. *Bureau of Revenue*.[56] The AAA claimed tax-exempt status as a not-for-profit corporation despite many discounts and other benefits it distributes to its members. The court held that "Profit does not necessarily mean a direct return by way of dividend, interest, capital allocation or salaries. A saving of expense which would otherwise necessarily be incurred is also a profit to the person benefited."[57] However, the New Mexico Court of Appeals rejected this analysis because there were no income or dividends, the corporation was chartered without capital stock, and the corporation's *purpose* was not profit so that *any* benefit conferred upon its members was "wholly irrelevant." As we see it, a third position seems worthy of consideration: some benefits to members are not, *prima facie*, evidence of profit, as of course salary is not. However, unreasonable and uncustomary benefits are, because they are but a different form of what in effect amounts to sharing of profit.

An example of out-of-line salary seems to be provided by a prepaid health plan contractor who employed a physician as plan administrator at an annual salary of $120,000 plus expenses. The contract with the physician read:

> Employer recognizes employee is involved in other medically related ventures such as inhalation therapy contracts and other non-medically related business ventures. These ventures shall at all times remain under the strict control and ownership of the employee.[58]

That one can establish what reasonable and customary salaries are is illustrated by court cases which have on a number of occasions disallowed salaries and fringe benefits in part because they failed to satisfy criteria of reasonableness. While the only cases we have come across deal with profit-making corporations, we see no reason why the same procedures may not be applied to not-for-profit ventures. In the case of *Miller Box, Inc.* v. *U.S.*,[59] a taxpayer (a

[55] Ibid.

[56] 525 P. 2d 929, 86 N. M. 569 (1974), *rev'd.* 533 P. 2d 103.

[57] 525 P. at 932.

[58] Testimony, Gerald Hawes and Robert Christophel, "Medicaid—Home Health."

[59] 488 F. 2d 695 (5th Cir. 1974).

corporation owner) sued the Internal Revenue Service to recover an alleged over-collection of taxes. The IRS had disallowed the taxpayer's claim under the section 162 deduction for "a reasonable allowance for salaries or other compensation for personal services actually rendered. . . ."[60] The plaintiff had paid his brother more than $1 million plus $24,000 for two years' work as manager of two corporations. As grounds for rejecting this payment as unreasonable the court noted (1) that the brother's immediate prior salary as a farm worker was $200 per week, (2) the corporate work was not complicated, and (3) comparable positions generally paid $50,000 and at most $100,000. The court further stated:

> It is the duty of the directors of the corporation . . . to bargain with an employee for "fair and advantageous terms" to obtain the service of such individuals.[61]

Thus, a standard for reasonable salaries and fringe benefits keyed in part to the nature of the duties involved, in part to salaries in comparable positions, and in part to employee qualifications is not unenforceable.

Regulatory implications

Whenever fees, salaries, and fringe benefits in not-for-profit corporations significantly exceed those in comparable institutions, the not-for-profit status of the corporation is being circumvented. How this practice can be effectively prevented is less clear. However, in those cases where such institutions draw on public funds, the government regulatory apparatus should examine fees, salaries, and fringe benefits as compared to similar institutions, and refuse to certify or recertify for participation in government programs those institutions providing income grossly above the norm.

Guidelines would need to be established for determining when fees, salary levels, and fringe benefits have begun to exceed the reasonable and customary. Flexibility within the limits of reasonableness could be permitted in establishing a range within which differences in qualifications among individuals could be accommodated.

As the experience of private insurers as well as Medicare and Medicaid suggest, determining reasonable and customary charges solely by reference to the particular professional or occupational group in question tends to place the setting of allowable fee or salary levels at the mercy of collective action by a significant segment of the group (which will benefit by high charges). Thus, it would be advisable to compare what members of a profession claim are their reasonable and customary fees or salaries with what is paid to persons of other professions doing work involving similar skills and level of training. Thus, a nursing home administrator with no professional degree or education beyond a high school

[60] 26 USCA § 162.
[61] 488 F. 2d at 707.

diploma should not be able to justify earning more than the average hospital administrator by referring to other nursing home administrators. Nor would chiropractors be permitted to charge fees exceeding those received by surgeons.

Shoring Up the Integrity of the Not-for-Profit Sector

This article points to four types of abuses which violate the underlying concept of the not-for-profit corporation, the source of its legitimacy, and suggested ways these abuses may be curbed. This is not to imply that we are "down on not-for-profits" or that they are "no different" from profit-making proprietaries. On the contrary, we consider them an essential, important part of the three sectors of America: the government, the private sector, and the not-for-profit sector.

Actually, some have argued that the not-for-profit sector, or—as it is often referred to—the voluntary one, is the "best" sector of the three, while others hold that the private sector is more efficient and the government sector more egalitarian.[62] This is hardly the place to settle this age-old argument of which sector is "the best," nor is it necessary. Hardly any one questions the fact that America is a pluralistic society, one in which a range of choices is offered precisely by there being services provided by different sectors. At least, since Tocqueville it has been widely recognized that in this pluralistic spectrum, the voluntary, not-for-profit sector is a main source of protection of individual freedom and initiative, of public interest service, of concern for quality of service and quality of life. Undermine the voluntary sector and America's choices are reduced to reliance on the government and the profit makers. There can thus be no question about preserving the integrity, and thus the legitimacy, of the voluntary, not-for-profit sector.*

[62] For additional discussion see Amitai Etzioni, *Social Problems* (New York, 1976), chap. 5. For some relevant studies see Richard K. Earner, "Nonprofit vs. profit: What data do you see?: corporate executive" and Richard L. Johnson, "Data show for-profit hospitals don't provide comparable service: consultant," *Modern Hospital*, 122 (April 1974), 116–118; Sharon Winn, "Analysis of Selected Characteristics of a Matched Sample of Nonprofit and Proprietary Nursing Homes in the State of Washington," *Medical Care*, 12, no. 3 (March 1974), 221–228; and *Fornia*, Blue Cross Reports Research Series No. 9 (Chicago, March 1973).

* This work was conducted under the auspices of the Center for Policy Research. Position papers prepared and issued by the Center for Policy Research reflect the views of those who have authored them, not those of the Center. The Center facilitates the drafting, reformulation, and dissemination of position papers but takes no positions of its own.

The authors are indebted to Dr. Dorothy Patton, research associate at the Center for Policy Research, for valuable legal research which she conducted and to Professor Nathan Hershey, University of Pittsburgh, for valuable comments on an earlier draft.

Big Man On Campuses: ETS' President Bill Turnbull, a tweedy, rather deliberately homespun ETS career man, has run the company since 1970. Under Turnbull, ETS has drawn the fire of critics ranging from Ralph Nader to New York magazine, but so far has had little trouble establishing that, whatever its faults, ETS does what it sets out to do.

The Pleasures Of Nonprofitability

Nonprofit in theory, Princeton's Educational Testing Service in fact shapes up as a tough, aggressive and even dynamic growth business.

IF PRINCETON, N.J.'s Educational Testing Service were a public company and not a self-contained tax-exempt nonprofit organization, it would probably have long since emerged as one of the darlings of Wall Street. The knowledge industry has generally manifested more promise than performance, but ETS has demonstrated all the performance any promoter could wish. Over the past 30 years, it has easily racked up a record as one of the hottest little growth companies in U.S. business.

ETS' business is no longer limited to the well-known Scholastic Aptitude Tests required for admission to many private secondary schools, colleges and universities. ETS has helped to devise programs to certify that you're qualified in gynecology, pharmacy or auto mechanics, to license you as a barber, beautician or real estate agent, and in some parts of the country to permit you to hold a job on the police force, the fire department or as a social worker. Testing, in fact, has been taking on almost Orwellian proportions in recent years. Close to 6.5 million Americans took ETS' 17 educational placement tests last year. Another 260,000 took its 50-odd occupational certifying or licensing exams.

ETS started out in 1947 with a mere $1.4 million in seed capital—much of that in plant and equipment—and a first-year sales volume of under $1 million. Nearly 30 years later, its sales were still doubling every six or seven years, and in fiscal 1976, ended last June, it boasted assets of $37.8 million, sales of $62.9 million and a comfortable nonprofit of just under $1 million after deducting all its expenses. At the same time, without benefit of any additional infusion of capital, ETS' original $1.4-million stake has grown to nearly $25 million.

In The Beginning

The company (which is how its executives tend to refer to it) was created in 1947 as a repository for the testing operations of three big educational foundations: the Carnegie Foundation for the Advancement of Teaching, the American Council for Education and the College Entrance Examination Board—this last a group of 2,500 colleges, universities and secondary schools that use ETS scores in making admissions decisions.

ETS' president is William W. Turnbull, 56. He sees ETS' impressive growth as something of an accident of history. Like the canmakers who found they were really in packaging, ETS fairly soon discovered that its business was not really testing, but measurement—the measurement of everything from the effectiveness of *Sesame Street* to the adaptability of programs by Britain's Open University to the U.S. educational system.

As Bill Turnbull sees it, ETS simply happened to be on the spot in the late Fifties when the postwar baby boom broke on U.S. colleges and universities like a torrent. "There was not enough space in colleges and universities to accommodate all the kids who wanted to go, and at the same time there was a tremendous need for help in making admissions decisions. As a result, more and more colleges required entrance examinations in the screening process." The various ETS testing programs—the SAT, the 15 subject achievement tests—afforded admissions officers quick, easy, objective assistance in making their choices.

Distributing, administering, collecting and scoring millions of such tests obviously involved a mountain of paperwork and ETS had to create a modern, efficient, technologically oriented management organization to handle the job. It had to automate and it did, funneling its cash flow into data processing and automatic test-scoring equipment on a large scale. (ETS' latest optical scanner now processes 18,000 answer sheets an hour.) "We had to automate or not do the job," says ETS' financial vice president, David Brodsky, who came to the company in 1955 when the testing boom was just getting under way. "That's really where our capital has gone—into plant and data processing equipment."

Since then the collegiate demand has ebbed, but ETS' growth has nonetheless continued to be brisk. Between 1970 and 1976 the ETS' SAT volume dropped nearly 12%; ETS' total sales nonetheless shot up another 80%. If collegiate demand was off, the growth in the consumer movement had created a rising demand for accountability—in government, in business, in trade, in the professions. This opened up vast new markets for ETS, which had the testing instruments to measure performance.

ETS was ready for them. As far back as the 1950s, ETS had come up with a test for certifying medical specialists, and since then it has come up with a number of programs for licensing and certifying members of more than 50 other occupations—insurance agents, real estate brokers, actuaries, merchant marine officers, electrical contractors, moving men, city planners, nurses, opticians, Foreign Service officers and architects.

Over the years ETS has grown so fast and so profitably that its competitors have sometimes complained that, thanks to its income tax exemption, ETS is well-nigh impossible to compete with. Even so, ETS has plenty of competitors. Though no other firm duplicates ETS' range of services, individual firms duplicate every one of them—universities, think tanks, consulting organizations, publishing houses. Even the SAT has its counterpart in the American College Testing Programs' ACT tests, used largely in western states. Competitive awareness, says Turnbull, keeps ETS prices low, its quality high.

ETS controls its costs through the same sort of budgetary controls any profit-making business uses. And, although it has no stockholders to reward, it needs profit for much the same reason any private business does—to finance its growth. Says Financial Vice President Brodsky: "We have a rolling five-year projection of what our capital needs are, what we anticipate receiving from outside and what level of activity we have to support. If it turns out we are making more than we feel we need for capital needs, we reduce our prices."

Investment And Rewards

In the late Fifties and early Sixties, when rising volume and automation were broadening ETS' testing margins considerably, ETS cut its rates again and again, and even then was able to generate capital aplenty to feed its expansion. ETS' SAT fees today are in fact only 30% higher than they were 30 years ago, a period during which the consumer price index just about tripled.

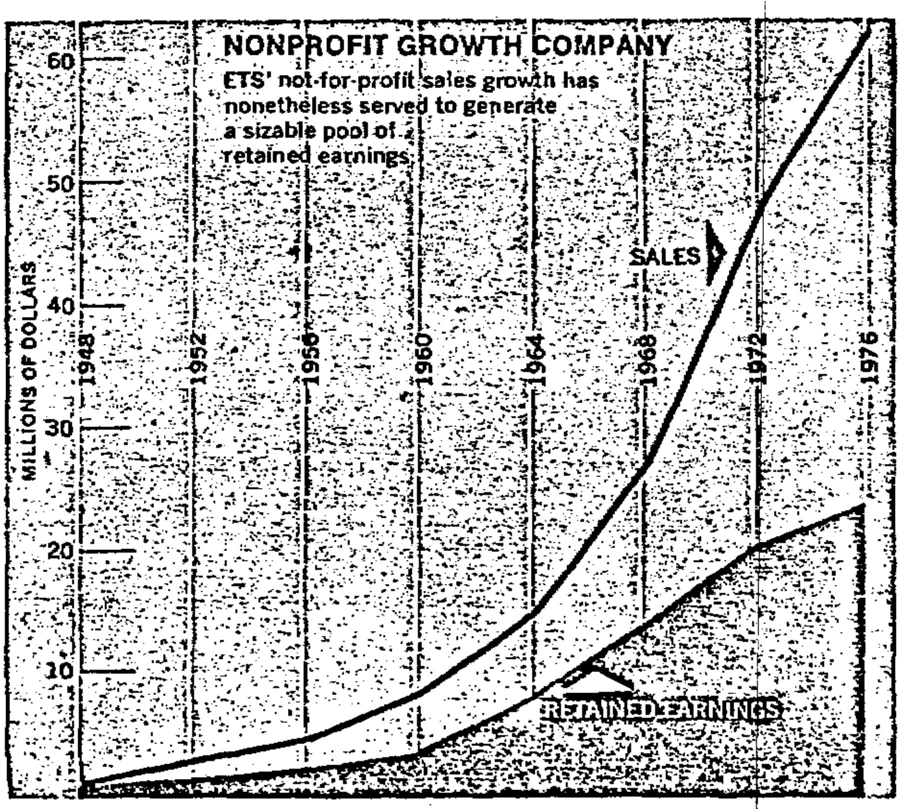
Which is not to say that ETS and its executives do not enjoy the same privileges and emoluments as do those of other successful corporations. ETS operates out of a spacious 380-acre estate in the country near Princeton, N.J. It maintains a conference center with accommodations for 200, a data processing center, a complex of modern offices, complete with recreational facilities. And it pays its employees well. Divide ETS' total labor costs by the number of its permanent employees, and you get a $17,000-a-year average, which is not bad, considering the range includes everyone from maintenance people to executives.

ETS is inherently a labor-intensive business, and so is especially exposed to the pressures of wage inflation. As ETS' growth rate has slackened and the benefits of volume and automation leveled off, the cost pressures have inevitably increased. So far, ETS has kept is labor costs down by shifting the burden from its temporary to its permanent staff. Since 1970, says Brodsky, though ETS' work load has risen 20% to 25%, the permanent staff has risen only 5%, while the temporary staff has declined 31%. But there are limits to how far this can go.

Just as it watches its labor costs, so does ETS look for growth opportunities. "We look around," says Brodsky, "and come to the conclusion that there is a need for a certain kind of service, so we develop that and see what kind of interest there may be." In the Fifties and Sixties, for example, ETS developed the College Level Examination Program to ease the transfer of students from two- to four-year colleges and to award academic credit for off-campus educational experiences. The program met strong resistance from both two- and four-year colleges, but the need existed, and ETS succeeded. Last year ETS administered 94,000 CLEP tests.

ETS has also been supplementing the research and development contracts it has undertaken for outside foundations and governments with projects financed out of its own funds. It specializes in areas like infant behavior, personality, creativity and cognitive learning. "I think our physical growth is largely behind us," Brodsky says. "So the balance will shift toward research and development and away from the equipment needed to drive the machine." ETS' research contracts now make up 10% of revenues.

There's no denying the education markets look especially uncertain these days. A college education is becoming so costly that the colleges and universities could conceivably price themselves and ETS out of a portion of the market. At the same time, higher education is no longer as highly valued as it once was. "We're in a mature growth phase," Brodsky says. Therefore, ETS' trustees have been urging Brodsky to build up ETS' reserves against a rainy day. "We have a small invested reserve—about $3 million," he says, "and as a contingency fund, that's not much. The market



abolished buggy whips, and it could abolish us. But if we no longer serve a useful social purpose, why not go out of business? Realistically, there's an instinct in the organization to perpetuation and even growth."

"My own feeling," says President Turnbull, "is that we've gone about as far as we're going to go with measurement of traditional verbal and mathematical skills. The main impetus to growth now is likely to come from the emphasis on competent performance in a lot of different nonacademic fields. Our main contribution in the next ten years or so may be in attempting to put in the hands of college people more information about the noncognitive characteristics of young people—a better statement of their interests and desires. If we succeed, I think the individual's life chances are going to be improved."

Brave New World? Maybe so, but in a society that believes in equality of opportunity, why should such things be left to sheer chance? ■

Ticket Of Admission

FAR AND AWAY the most important product the Educational Testing Service has is its phenomenally successful Scholastic Aptitude Test. The SAT is probably the single most important factor in determining which college a student gets admitted to or whether he even gets admitted at all. "University and college admissions officers," ETS says piously, "are cautioned against relying solely on SAT scores in making their decisions." That's like adjuring smokers that cigarettes can be injurious to your health. And some *have* given it up—especially these days when some colleges have trouble attracting students, no matter what their scores. Even so, the SAT still ranks as the ticket of admission to higher education in the U.S.

Last year, 1.4 million students took the SAT—45% of all the high school seniors in the U.S. The SAT is a standardized 2½-hour multiple-choice examination. It is given six times a year at some 4,000 testing centers, mainly high schools, throughout the U.S. The test is divided into two sections designed to measure a student's mathematical and verbal skills, and the result is two scores expressed on a scale ranging from 200 to 800.

The tests are designed to "predict academic performance," and, according to ETS and most admissions officers, that is just what they do. This is why they are widely—almost universally—used in the U.S. Says ETS' President William Turnbull: "The predictive quality of the exams comes from the fact that what a person has done in the past is indicative of what he will do in the future."

The SAT is put together, updated and continuously revised by a full-time 200-man staff, whose makeup is designed to reflect a wide range of regional, educational, racial and ethnic backgrounds. The tests are rigorously scanned to see that the questions do not bear any trace of cultural, ethnic, sexual or whatever other bias happens to be unfashionable at the moment, and ETS carefully throws in a few reading comprehension passages by minority writers—like Eldridge Cleaver—to make minorities, who make up almost 15% of the test-takers, feel they haven't been left out of things.

ETS vigorously denies that the SAT reflects the sort of cultural bias that has so often been charged against intelligence tests. The purpose of the SAT is not to measure "intelligence" but to determine how well someone will perform in certain academic contexts. And if that means that someone who lacks certain skills is at a disadvantage, that's what the test is supposed to reveal. "In my opinion," says Turnbull, "it is not as easy for a person with an inferior education to do well on the SAT as it is for someone with all the advantages."

More women (51%) now take the tests than men, but, though women go into the test with higher grade averages, men score higher than women except on the Standard Written English test. A third of the seniors who take the test earn scores of between 200 and 400, another 55% between 400 and 600. Last year only 8% scored higher than 600 on the verbal section of the test, *vs.* 16% on the mathematics section. The average scores on the SAT are declining and have done so for the past 12 years, a matter that has worried educators considerably. Turnbull thinks that the scores have declined because society no longer puts the emphasis on the written word that it used to.

With the SATs as with its other tests, ETS contracts to provide a service for the sponsor, the College Entrance Examination Board. ETS develops the tests, collects the $7.25 the Board sets, deducts its own expenses and a fee, and returns the excess to the Board. How much that is is anybody's guess. The SATs alone yielded a good 17% of ETS' revenues last year, roughly $10 million, and the College Board's programs altogether contributed close to 41%.

For all their success in the market, the tests have provoked a good deal of criticism almost from the time the first one was devised back in 1926. Critics complain that the tests are not really aptitude tests, that the questions are uncongenial to subtle and imaginative minds, that the SATs do not really establish a student's aptitude for doing anything other than taking the tests. But is this necessarily bad? The ability to discipline one's thinking to the requirements of the test may reflect the very qualities that the test is supposed to reveal. After all, in the kingdom of the blind, the one-eyed man is unlikely ever to be king if the blind have put out the lights.

The objections to the SATs are formidable, but so are the reasons for retaining them. On the one hand, most admissions offices do not have the staff to do an adequate job of screening applicants. On the other, the reliability of the high school grading system has deteriorated almost everywhere, so that the SAT does provide some sort of standardized and objective measure of student performance—which was, after all, why it was devised in the first place.

Bill Turnbull views the whole controversy philosophically: "As testing has become more important in the lives of a lot of people," he says, "public scrutiny of testing has increased. The crescendo of interest is a corollary of the importance of testing rather than a threat to it."

California Legislature

Assembly Select Committee on Revision of the Nonprofit Corporations Code

SACRAMENTO OFFICE
ROOM 2148, STATE CAPITOL
SACRAMENTO, CALIFORNIA 95814
PHONE: (916) 445-7890

JOHN T. KNOX
CHAIRMAN

Reply to:

School of Law
University of San Francisco
San Francisco, California
94117

December 9, 1976

To: Members of the Bar Subcommittee on Nonprofit Corporations

We enclose a draft of Chapter 2 for consideration at the December meeting. Chapter 1, which will contain definitions, will be compiled later.

For your convenience we also enclose copies of the sections of the current nonprofit law that we refer to in our discussion.

Sincerely,

Michael C. Hone

Michael C. Hone

Ira M Ellman

Ira Mark Ellman

Enclosures
cc: Members of the Assembly Select Committee on Revision of the Nonprofit Corporations Code

Attached is a draft of Chapter 2, "Organization and Bylaws", for the Committee's consideration. It is the counterpart of Chapter 2 in the new corporations code.

In accordance with the Committee's tentative decision at the last meeting, we have developed different terms to indicate membership in charitable and non-charitable corporations. In order to minimize the burdens on existing organizations, we suggest preserving the term "member" for charitable corporations. For non-charitable corporations we have coined the term "participant" to designate those people with statutory protected rights in corporate elections and to share in the proceeds upon dissolution. As the analogue to "membership" we employ the terms "participantship" or "participation."

This draft reflects this wording change, although there are relatively few sections in Chapter 2 for which the distinction is important.

The most important section of this chapter for policy purposes is Section 5230, which would confront the major policy questions we discussed but did not resolve at the last meeting. We present three alternative drafts of this section in order to provide the Committee with a more concrete focus for discussion. The discussion following that section highlights the issues involved.

TABLE OF CONTENTS
WORKING DRAFT
NONPROFIT CORPORATION CODE

Chapter Two
Organization and Bylaws

Chapter Two
Organization and Bylaws
Article 1: Purposes

Section 5210. Subject to any other provision of law of this state applying to the particular class of nonstock corporation or line of activity, a nonstock corporation may be formed under this division for any lawful purpose other than the distribution of gains, profits or dividends to its members or participants.

DISCUSSION: This language is similar to §9200 of the current code. (All references to the "current code" or the "current law" are to the now prevailing General Nonprofit Corporation Law, §9000-9802 of the Corporations Code, as well as to the related provisions which follow these sections in Division 2 of the Corporations Code. None of these provisions were amended by the Corporations Code revision. References to "CC" are to the new, revised Corporations Code; where it is necessary to refer to the old corporations code which will be replaced by this new revision in January, we shall call it, simply, the old corporations code.) There are no analogous provisions in the CC. The current California law is very liberal in regard to the allowable purposes for which a nonstock corporation may be organized. See Groman v. Sinai Temple, 20 Cal.App.3d 614, 99 Cal.Rptr. 603, which holds both that a nonstock corporation may have as one of its principal purposes the carrying on of a business for profit, so long as the profits thus accumulated are not distributed by way of dividends to the members, and that the providing of services at a discount is not a prohibited distribution. As indicated by the discussion papers presented at the September meeting, we see no policy purpose to be served by limiting the activities of nonstock corporations.

This selection of course does not preclude a nonstock corporation from conferring benefits upon its members or participants in the form of reduced prices for certain services, from paying reasonable compensation to its employees and officers, or from making distributions to members upon the winding up and dissolution of a non-charitable nonstock corporation. All of these results are consistent with current law.

The introductory clause of the section - "Subject to..." - is meant to preserve the provisions of any other law regulating a particular kind of activity, such as the law governing cooperatives.

Questions for Committee

1. Should current law, which does not limit the purpose or activities of nonstock corporations, be continued?

Recommendation: Yes, although we may wish to keep this question in mind during the revision process to consider exceptions to it.

2. Is such a section necessary?

Recommendation: Yes. One may logically conclude that a special section allowing formation of a nonstock corporation for all lawful purposes is superfluous, since that result is implied where the law places no limitation upon the purpose for which it may be formed, especially given the language of proposed Section 5231 of this chapter, on the contents of articles. Nonetheless, because of the peculiar tradition of nonstock corporations, in which restrictions upon the purposes for which they were formed were common, retention of a section such as this does aid in making clear that there are no such restrictions in California law.

Article 2: Formation

Section 5220. (a) One or more natural persons, partnerships, associations or corporations, domestic or foreign, may form a corporation under this division by executing and filing articles of incorporation.

(b) Each incorporator and each director named in the articles shall sign and acknowledge the articles.

(c) The corporate existence begins upon the filing of the articles and continues perpetually, unless otherwise expressly provided by law or in the articles.

(d) A charitable nonstock corporation shall furnish an additional copy of its articles to the Secretary of State who shall forward that copy to the Attorney General.

DISCUSSION. This draft is identical to Section 200 of CC, except for subsection (d).

Note that subsection (c) changes existing law in allowing a corporation to limit the duration of its existence in its articles, and subsection (b) deletes the provision contain in current Section 9304(a) allowing "any other person desiring to associate with" the first directors to sign the articles of incorporation.

Subsection (d) is included at the request of the Attorney General's office, which indicated to the Law Revision Commission that such a practice would aid them in their enforcement duties.

Question

Should the provision allowing third persons to sign the articles be deleted?

Section 5221. (a) An existing unincorporated association or organization may be incorporated under this section, but this section does not preclude the formation of a corporation under any other provisions of law, including Section 5220 of this division, that would otherwise apply.

(b) Where an existing unincorporated association or organization chooses to incorporate pursuant to this section, the articles of incorporation shall

(1) set forth the name of the existing unincorporated association or organization, and

(2) be accompanied by a verified statement of the presiding officer, or a majority of the governing board, then in office, of the association or organization, stating that the membership of the association or organization has duly authorized the filing of the articles and the application of this section. The affidavit may further state that the membership has agreed to waive subdivision (f) of this section, but such waiver shall be effective only if agreed to by the unanimous vote of all members of the association.

(c) The person or persons submitting the verified statement required in subdivision (b)(2) shall sign, acknowledge, execute and file the articles.

(d) The corporate existence begins upon the filing of the articles and continues perpetually, unless otherwise expressly provided by law or in the articles.

(e) The members of the association or organization incorporated pursuant to this section shall become participants of the corporation so created, and all property held by the association or organization shall belong to and vest in the corporation so created upon filing of the articles of incorporation, subject to all pre-incorporation encumbrances and claims as if incorporation had not taken place.

(f) Neither the initial articles nor the initial bylaws of the corporation shall distribute voting rights or rights in the property of the corporation, in a manner which reduces the rights of any participant below those enjoyed as a member in the predecessor association, nor shall the obligations of any member be increased. Any subsequent changes in the articles or bylaws shall be governed by the applicable provisions of this division.

Defined term: verified.

DISCUSSION: This provision has no analogue in the CC.

The basic question for the Committee is whether there is a need for such provisions. Most are continued from current law, which scatters them throughout the code (§§9202, 9300(f), 9304(b), 9604). One could obviously incorporate an unincorporated association without such a section, by merely forming a new corporation to which is transferred the property of the old association upon its dissolution. The articles of the new corporation could even provide for automatic participation for the members of the defunct association.

To the extent a section such as this might be thought necessary to establish that the incorporation of an association is an allowable "purpose" (see current law §9202), it is obviously now superfluous with the broad purpose language provided in §5210. The only reason for retaining such a section, then, is to provide a simpler method of incorporation. This section probably does accomplish that purpose, although the difference may be marginal -- and may not be worth the potential problems, as explained below.

Some problems of the current law are cured by this section. First, it should be noted that the section is framed as an alternative method of formation available to the association, thus allowing the association to proceed, if it wishes, under §5220 instead, avoiding the application of this section where it does not prove convenient for the particular association. Where the association chooses to proceed under this section, however, the required affidavit must explicitly state that the membership has approved its application. The principal results of the choice of this section are the provisions contained in subsections (e) and (f).

Subsection (e) is different from current law in a number of ways. First, it provides for automatic vesting of property, which would seem to be a principal convenience that could be achieved by such a section. The current law in this area is uncertain, although the meager authority which exists is consistent with this section. See <u>Security First National</u>

Bank v. Cooper, 62 Cal.App.2d 653, 670 (1944); CEB, California Nonprofit Corporations, §2.6.

Where documents are fraudulently filed, asserting approval of the association which has not in fact been obtained, case law indicates that the new corporation can continue to exist, but that equity will require it to reconvey the property to the predecessor association which it purported to supplant. Barber v. Irving, 226 Cal.App.2d 560, 30 Cal.Rptr. 192 (1964). Without evaluating the merits of this rule, we recommend that this problem be left with the courts, and this section does not address it.

The language used in (e) -- preserving all pre-incorporation claims upon the property -- is taken from §403 of the new New York law. There may remain, however, difficulties under the recording acts which need be addressed here.

Second, subdivision (e) provides for automatic transfer of membership, but drops the language of the current law providing that individual members may "file their dissent in writing" to avoid this result. There is no need for a special provision allowing for the resignation of membership; §5415, in the chapter on members, covers the right to resign in general language that would apply here. Moreover, the special provision regarding "dissent" is troublesome, since it appears to create a right without elaboration of its nature. Nor are there cases construing this language.

This draft takes a different approach. It assumes that the fact of incorporation, alone, cannot possibly prejudice the rights of individual members in some way entitling them to special protection against the will of a majority which wishes to incorporate. Instead, they require protection, if at all, from changes in the internal structure of the organization, which may occur incidentally to its incorporation and which reduces their rights in it. Subsection (f) addresses this concern by simply prohibiting such changes as part of the process of incorporation, although they may of course be made later under the same rules that apply to any other nonstock corporation -- with appropriate safeguards for the minority. The only exception to the mandate of subdivision (f) is where the members are unanimous, as provided in subdivision (b)(2). This is to allow the convenience of this section to an organization where it has been demonstrated that there is no internal controversy at all regarding the proposed changes, so that there is no group of members requiring the protection of subdivision (f).

As noted above, this section is not without potential problems. First of all, subdivision (f), while solving the difficulty that might otherwise arise with potential dissenters, may set a standard for the new bylaws and articles which is too uncertain to allow counsel to assure a client association that it is in conformity. The automatic vesting of property may produce recording act problems, as noted above. Nor does the section answer the question of the means by which the association "duly authorizes" its incorporation. "Duly authorized" can mean here, as it does in current law, a method of authorization that is proper under the law governing the association. This will ordinarily be a majority vote as set out in the association's bylaws.

On the other hand, few problems will probably arise in the majority of cases in which there is no internal controversy concerning the incorporation. Unanimous consent could be obtained, thus waiving (f), or the identical rules could be adopted for the corporation as the association. And in such cases this section would be of some convenience.

Question

Does this section, on balance, fulfill some useful function which calls for its continuation?

Section 5222. (a) The Secretary of State shall not file articles setting forth a name in which "bank", "trust", "trustee" or related words appear, unless the certificate of approval of the Superintendent of Banks is attached thereto.

(b) The Secretary of State shall not file articles setting forth a name in which "charitable", "charity", "church", "foundation", "nonprofit" or related words appear, unless the corporation is a charitable corporation.

(c) The Secretary of State shall not file articles which set forth a name which is likely to mislead the public or which is the same as, or resembles so closely as to tend to deceive, the name of a domestic corporation, the name of a foreign corporation which is authorized to transact intrastate business or has registered its name pursuant to [Section 2101], a name which a foreign corporation has assumed under [subdivision (b) of [Section 2106], a name which will become the record name of a domestic or foreign corporation upon the effective date of a filed corporate instrument where there is a delayed effective date pursuant to [subdivision (c) of Section 110] or a name which is under reservation for another corporation, except that a corporation may adopt a name that is substantially the same as an existing domestic corporation or foreign corporation which is authorized to transact intrastate business or has registered its name pursuant to [Section 2101], upon proof of consent by such domestic or foreign corporation and a finding by the Secretary of State that under the circumstances the public is not likely to be misled.

The use by a corporation of a name in violation of this section may be enjoined notwithstanding the filing of its articles by the Secretary of State.

(d) Any applicant may, upon payment of the fee prescribed therefor in the Government Code, obtained from the Secretary of State a certificate of reservation of any name not prohibited by subdivision (b), and upon the issuance of the certificate the name stated therein shall be reserved for a period of 60 days. The Secretary of State shall not, however, issue certificates reserving the same name for two or more consecutive 60-day periods to the same applicant or for the use or benefit of the same person, partnership, firm or corporation; nor shall consecutive reservations be made by or for the use or benefit of the same person, partnership, firm or corporation of names so similar as to fall within the prohibitions of subdivision (b).

DISCUSSION: This language is identical to that which appears in the CC §201, except for the addition of subsection (b), the purpose of which is apparent.

Section numbers in brackets will have to be adjusted to mesh with the nonstock corporation code.

Article 3: Articles of Incorporation

Section 5230. (a) The articles of incorporation shall set forth one, but not more than one, of the following:

(1) "This corporation is organized for the following public purpose [insert language describing purpose here]. It is not organized for the private gain of any person."

(2) "The purpose of this corporation is to engage in any lawful act or activity for which a nonstock corporation may be organized under the General Nonstock Corporation Law."

(3) "This corporation is organized for the following religious purpose [insert purpose here]. It is not organized for the private gain of any person."

(b) A corporation including the statements described in subdivision (a)(1) or (a)(3) shall be subject to the provisions of this code applying to charitable corporations.

(c) The articles shall not set forth any further or additional statement with respect to the purposes or powers of the corporation, except by way of limitation or except as expressly required by any law of this state other than this division or any federal or other statute or regulation (including the Internal Revenue Code and regulations thereunder as a condition of acquiring or maintaining a particular status for tax purposes).

Article 3: Articles of Incorporation

Section 5230. (a) The articles of incorporation shall set forth one, but not more than one, of the following:

(1) "This corporation is organized for the following public purpose [insert language describing purpose here]. It is not organized for the private gain of any person."

(2) "This corporation is organized for the mutual benefit of [insert here language indicated by subdivision (c)], and such persons may become participants in it according to the rules and standards set forth in the bylaws."

(3) "This corporation is organized for the following religious purpose [insert purpose here]. It is not organized for the private gain of any person."

(b) A corporation including the statements described in subdivision (a)(1) or (a)(3) shall be subject to the provisions of this code applying to charitable corporations.

(c) The statement described in subdivision (a)(2) may indicate that participantship is limited to those sharing some common interest or occupation, or common commitment to some goal or purpose, to those purchasing, owning, providing or selling particular services or goods, or who desire the goods or services to be provided by the corporation, to those desiring to associate with each other for social or recreational purposes, or by any other general standard identifying some group smaller than the general public for whose mutual benefit the corporation is organized. Nothing in this section or in a provision of the articles adopted pursuant to it shall be construed to require a nonstock corporation to admit any particular person to participantship in it.

(d) The articles shall not set forth any further or additional statement with respect to the purposes or powers of the corporation, except by way of limitation or except as expressly required by any law of this state other than this division or any federal or other statute or regulation (including the Internal Revenue Code and regulations thereunder as a condition of acquiring or maintaining a particular status for tax purposes).

Article 3: Articles of Incorporation

Section 5230. (a) The articles of incorporation shall set forth one, but not more than one, of the following:

(1) "This corporation is organized for the following public purpose [insert language describing purpose here]. It is not organized for the private gain of any person."

(2) "This corporation is organized for the mutual benefit of [insert here language indicated by subdivision (c)], and such persons may become participants in it according to the rules and standards set forth in the bylaws."

(3) "This corporation is organized for the private gain of its directors, officers or participants and is not a mutual benefit organization."

(4) "This corporation is organized for the following religious purpose [insert purpose here]. It is not organized for the private gain of any person."

(b) A corporation including the statements described in subdivision (a)(1) or (a)(4) shall be subject to the provisions of this code applying to charitable corporations.

(c) The statement described in subdivision (a)(2) may indicate that participantship is limited to those sharing some common interest or occupation, or common commitment to some goal or purpose, to those purchasing, owning, providing or selling particular services or goods, or who desire the goods or services to be provided by the corporation, to those desiring to associate with each other for social or recreational purposes, or by any other general standard identifying some group smaller than the general public for whose mutual benefit the corporation is organized.

Nothing in this section or in a provision of the articles adopted pursuant to it shall be construed to require a nonstock corporation to admit any particular person to participantship in it.

(d) The articles shall not set forth any further or additional statement with respect to the purposes or powers of the corporation, except by way of limitation or except as expressly required by any law of this state other than this division or any federal or other statute or regulation (including the Internal Revenue Code and regulations thereunder as a condition of acquiring or maintaining a particular status for tax purposes).

DISCUSSION: We are proceeding upon the assumption that the code ought to at least distinguish between charitable corporations and others, as agreed at our November meeting. The purpose of Section 5230 is to facilitate whatever distinction that we may wish to draw by requiring corporations to characterize themselves in their articles, so that they may be readily identified.

Alternative I is the simplest of the three alternative sections. It basically distinguishes between charitable corporations and all others, attempting no characterization of these others. Religious organizations are separately identified from remaining charitables for the convenience of subsequent drafting, as we may wish to exempt them from requirements that would otherwise be imposed upon all nonstock corporations. It is likely, for example, that the state would not consistent with the First Amendment prescribe any rules of internal governance for a religious organization. While we do not here confront the issues that may arise which are peculiar to religious corporations, this approach should facilitate drafting solutions when we do deal with those issues.

It should be noted that other provisions of the code prohibit a non-charitable corporation from calling itself a charity, a church, a foundation, or varients of such terms. See §5222(b). Moreover, we may wish to include provisions prohibiting any but charitable or religious corporations from holding themselves out as charities, regardless of the name they employ. In any event, there is authority in the case law for treating an organization as a charitable one where equitable principles so require, regardless of its self-characterization. See Lynch v. Spilman, 67 Cal.2d 251, 62 Cal.Rptr. 12 (1967).

The arguable difficulty in Alternative I is its failure to place any limitation upon the formation of nonstock non-charitable corporations with no participants [members], and which are organized in fact to conduct a profit-making endeavor for the private benefit of the director-owners. This is basically the problem presented to the Committee on pages 10 through 13 of the memorandum of November 23, 1976, considered at our last meeting. Alternative II represents an effort to deal with this problem.

The approach of Alternative II is reflected in its provisions (a)(2) and (c), which are the only differences between it and Alternative I. Alternative II, in effect, leaves the non-charitable corporation with no option under the nonstock code other than forming itself as a mutual benefit organization. The organization itself, of course, defines the group of people for whose mutual benefit it is created and the code would make no attempt, as a general matter, to impose upon such a corporation a requirement that any particular person or class of persons be admitted to participation [membership]. Such a provision is not as limiting as it might appear. For example, a nonstock corporation such as Mastercharge would have no difficulty forming itself under such a provision. Its articles would simply indicate that it is organized for the mutual benefit for those banks with Mastercharge cards. Trade associations would likewise be able to organize under such a provision. In theory, this section would exclude, however, the private entrepreneur who forms a nonstock corporation which in fact has no purpose other than the conducting of a business for the founders' personal financial gain. For example, one could form an automobile club or a tennis club under the current nonprofit law and commence offering services to the public in competition with both true membership clubs and profit making organizations offering the same services. While the organization would superficially resemble other clubs which in fact confer participantship [membership] rights upon club members, in fact the founding entrepreneur would retain complete control over selection of the board of directors and rights to all the assets upon dissolution. The founder would do so by having the only voting rights in the organization.

The issue is whether such a profit making "club" should be allowed to organize under the nonstock code rather than as a business corporation. This section attempts to preserve the concept of nonstock corporations for use as mutual benefit entities, excluding this kind of organization. The difficulty, assuming that one agrees with the policy underlying Alternative II, is in the practical enforceability of its language. It obviously does not attempt to impose upon the mutual benefit organization detailed requirements to insure that people are admitted to participantship [membership]. To do so would run the risk of intruding unduly into the affairs of private social clubs and other organizations.

Alternative III takes a somewhat different approach. It follows the outlines of Alternative II, but openly allows a nonstock entrepreneur to organize under subdivision (a)(3). Alternative III thus adopts a policy of allowing such groups to employ the nonstock code, so long as they openly identify themselves as such. The difficulty is in distinguishing between a mutual benefit organization and an organization operating for the private gain of its members.

Question

Which approach should be adopted?

Section 5231. The articles of incorporation shall also set forth, in addition to the statement required by §5230:

(a) The name of the nonstock corporation.

(b) The following statement: The corporation may engage in any lawful act or activity for which a nonstock corporation may be organized under the General Nonstock Corporation Law of California.

(c) The name and address in this state of the corporation's initial agent for service of process in accordance with [subdivision (b) of Section 1502].

(d) The classes of members or participants, if any, and if there are two or more classes, the rights, privileges, preferences, restrictions and conditions attaching to each class.

(e) The articles shall not set forth any further or additional statement with respect to the purposes or powers of the corporation, except by way of limitation or except as expressly required by any law of this state other than this division or any Federal or other statute or regulation (including the Internal Revenue Code and regulations thereunder as a condition of acquiring or maintaining a particular status for tax purposes).

DISCUSSION: This section follows the approach of the CC §202, although certain provisions are necessarily different, such as the content of the statements required by subdivisions (b) and (c). Note also that subdivision (d) assumes that classes of both members and participants will be allowed.

Subdivision (d), on classes of members or participants, differs in that it cross-references a section which does not appear in the CC. That section has not yet been drafted, but as envisioned would provide for some administrative mechanism by which misleading or unjust class structures might be avoided. The section is more fully discussed in Chapter 4.

Section 5232. (a) The articles of incorporation may set forth any or all of the following provisions, which shall not be effective unless expressly provided in the articles:

(1) a provision granting, with or without limitations, the power to levy assessments upon the members or participants;

(2) a provision setting forth special qualifications of persons who may be members or participants, [beyond those which may be indicated in subdivision (a)(2) of §5230, or (subject to §5410), setting forth that it shall have no members or participants];

(3) a provision limiting the duration of the corporation's existence to a specified date;

(4) a provision requiring, for any or all corporate actions (except as provided in [sections dealing with cumulative voting, removal of directors and dissolution]) the vote of a larger proportion of, or of all of, the members or participants of any class, or of a larger proportion of, or all of, the directors, than is otherwise required by this division;

(5) a provision limiting or restricting the activities in which the corporation may engage or the powers which the corporation may exercise or both;

(6) a provision conferring upon the holders of any evidences of indebtedness, issued or to be issued by a non-charitable corporation organized or existing under this division, the right to vote in the election of directors and on any other matters on which participants may vote under this division even if the non-charitable corporation does not have participants;

(7) a provision conferring upon participants the right to determine the consideration for which participantships shall be issued;

(8) a provision which would allow any member or participant to have more or less than one vote in any election or other matter presented to the members or participants for a vote, except that no such provision may be put into effect without first complying with §[X];

(9) in the case of a subordinate body instituted or created under the authority of a national organization, a provision setting forth either or both of the following:

(a) that the subordinate body thus incorporated shall dissolve whenever its charter is surrendered to, taken away by, or revoked by the head or national body granting it, in accordance with [sections governing decision to dissolve], but without the necessity of obtaining a vote of its participants, as would otherwise be required.

(b) that in the event of its dissolution pursuant to an article provision allowed by subdivision (9)(a) of this section, or, in the event of its dissolution for any reason, any assets which would otherwise be distributed in accordance with [sections governing distribution of assets] shall instead be delivered to the parent body, but the dissolution shall otherwise be governed by [sections on dissolution] insofar as they apply, except that the parent body shall stand in the place of participants for the purpose of Section [section making participants liable for any surplus wrongfully distributed to them].

(b) Nothing contained in subdivision (a) shall affect the enforceability, as between the parties thereto, of any lawful agreement not otherwise contrary to public policy.

(c) The articles of incorporation may set forth any or all of the following provisions:

(1) The names and addresses of the persons appointed to act as initial directors.

(2) Provisions concerning the transfer of membership interests, in accordance with Section 5412.

(3) Any other provision, not in conflict with law, for the management of the activities and for the conduct of the affairs of the corporation, including any provision which is required or permitted by this division to be stated in the bylaws.

DISCUSSION: This section follows closely CC Section 204, the major differences being in subdivision (a)(8) and (a)(9). For discussion of (a)(8), see comment under §5231. Note also that at this point we leave open the question of cumulative voting, although it is referenced in places such as (a)(4) of this section, in the event it is adopted.

Subdivision (a)(9) derives from current law, §§9203 and 9802, but departs from it in that (a) the provisions must be stated in the articles, and (b) they are optional -- that is, the subordinate body is not required by state law to follow them, but is permitted to do so, and presumably will do so to the extent required by the parent organization as a condition for obtaining a charter. The language of our provision also departs from current law in an effort to make clear that the general rules governing dissolution still apply, and in ensuring that the parent body is liable for any claims upon the assets received, where it would be liable if it were a member or participant receiving assets upon dissolution.

Subdivision (b) is taken verbatim from the CC. Subdivision (c) is also similar to the CC, but drops the provision allowing the articles to set restrictions upon the right to transfer shareholder interests, instead referencing Section 5412. Transfer of membership interests presents a different question than stock restrictions. See Section 5412 in Chapter 4.

Note that subdivision (a)(2) as drafted assumes that Alternative II or III of §5230 is adopted, and that it also assumes that non-charitables might be formed with no participants.

Finally, it should be observed that (a)(6) as written would apply only to non-charitable corporations.

Section 5233. For all purposes other than an action in the nature of quo warranto, a copy of the articles of a corporation duly certified by the Secretary of State is conclusive evidence of the formation of the corporation and prima facie evidence of its corporate existence.

DISCUSSION: This section adopts verbatim CC Section 209.

Section 5234. If initial directors have not been named in the articles, the incorporator or incorporators, until the directors are elected, may do whatever is necessary and proper to perfect the organization of the corporation, including the adoption and amendment of bylaws of the corporation and the election of directors and officers.

DISCUSSION: This section adopts verbatim CC Section 210.

Article 4: Powers

Section 5240. (a) A nonstock corporation shall have the power to

(1) Adopt, use, and at will alter a corporate seal, but failure to affix a seal does not affect the validity of any instrument.

(2) Adopt, amend, and repeal bylaws.

(3) Qualify to conduct its activities in any other state, territory, dependency or foreign country.

(4) Issue, purchase, redeem, receive, take or otherwise acquire, own, sell, lend, exchange, transfer or otherwise dispose of, pledge, use and otherwise deal in and with its own bonds, debentures and notes.

(5) Pay pensions, and establish and carry out pension, saving, thrift and other retirement, incentive and benefit plans, trusts and provisions for any or all of the directors, officers and employees of the corporation or any of its subsidiary or affiliated corporations.

(6) Issue certificates evidencing membership or participation but such certificates shall contain the statements that

(a) either

(i) (if the corporation is charitable) the corporation can never make distributions to its members; or

(ii) (if the corporation is not charitable) the corporation may only make distributions to its participants upon dissolution;

(b) (if the corporation is charitable) a statement that the membership is not transferrable;

(c) (if the corporation is non-charitable) a statement as to whether the participation is transferrable, and if so, a statement that a copy of the restrictions on transferrability imposed by the corporation, if any, are on file with the Secretary of the corporation and are open for inspection by a participant on the same basis as the records of the corporation.

(b) A nonstock corporation shall also have all of the powers of a natural person in carrying out its activities, including, without limitation, the power to

(1) make donations, regardless of specific corporate benefit, for the public welfare or for community funds, hospital, charitable, educational, scientific, civic or similar purposes.

(2) subject to the provisions of Section [on loans to insiders], assume obligations, enter into contracts, including contracts of guarantee or suretyship, incur liabilities, borrow or lend money or otherwise use its credit, and secure any of its obligations, contracts or liabilities by mortgage, pledge or other encumbrance of all or any part of its property and income.

(3) participate with others in any partnership, joint venture or other association, transaction or arrangement of any kind whether or not such participation involves sharing or delegation of control with or to others.

(c) The powers allowed by this section shall be subject to any limitations contained in the articles, and to compliance with other provisions of this division and any other applicable laws.

Defined terms: certificates, distributions

DISCUSSION: The format of this section is substantially the same as CC Section 207 from which it principally derives, although it separates into two subdivisions, (a) and (b), the inherently corporate powers and the other powers.

Paragraph (1), (2) and (3) of subdivision (a) are taken verbatim from the CC. Paragraph (4), while derived from the CC, differs in that reference to shares or "other securities" is deleted, as is the cross-reference to Section 510 of the CC governing the status of shares acquired by the issuer. Paragraph (5) differs by deletion of the references to profit sharing and various share option plans. Paragraph (6) derives from Section 9607 of current law, although the required statements regarding transferability and distributions are new. Note the distinction we draw between charitable and non-charitable corporations.

Paragraphs (1), (2) and (3) of subdivision (b) derive from the CC except that the reference to "franchises" is deleted from (2).

Subdivision (c) derives from the introductory sentence of CC §207.

Current law also includes provisions specifically authorizing a nonstock corporation to receive property, including stocks and bonds, to act as trustee, and to do all other acts necessary or expedient to the affairs or purposes of the corporation. §9501. These are deleted here as superfluous, and there are no analogous provisions in the CC.

Section 5241. (a) Nothing in this division shall preclude a nonstock corporation from carrying on a business at a profit, but the articles may limit or restrict this power.

(b) Nothing in this division shall exempt the business activities of a nonstock corporation from any law that would otherwise apply which regulates, limits, restricts, or prohibits any form of business activity.

(c) Any gain or profit that results from the business activity of a nonstock corporation may be applied to any lawful activity in which it may engage.

(d) This section is declarative of existing law.

DISCUSSION: Section 9200 of the current code provides that

> "carrying on business at a profit as an incident to the main purposes of the corporation and the distribution of assets to members on dissolution are not forbidden to nonprofit corporations, but no corporation formed or existing under this part shall distribute any gains, profits, or dividends to any of its members as such except upon dissolution or winding up."

Although the language of the current law might have been read as restricting the business activities of a nonstock corporation to those which are incident to some other principal purpose, judicial gloss on this section has established that a nonstock corporation, even a charitable one, may conduct business activities as one of its principal purposes. Groman v. Sinai Temple, 20 Cal.App.3d 614, 99 Cal.Rptr. 603 (1971), and this section seeks merely to conform the statutory language to this gloss. It should therefore effect no change in existing law. If of course remains the case that the nonstock corporation may make distributions to its members; see Section 5232 below. The purpose of subdivision (d) is to ensure that business activities currently conducted by nonstock corporations are not questioned by virtue of this section.

Questions

1. Is subdivision (b) really needed, and if so, should it go here or at the beginning of the Code in a more general section?

2. Should (d) be part of the statute?

Section 5242. (a) A nonstock corporation shall not make any distributions to its members or participants unless as authorized by [section on dissolution].

((b) Nothing in subdivision (a) shall preclude a nonstock corporation from

(1) paying reasonable compensation to participants, members, or directors for services actually rendered, except as prohibited by §[X].

(2) providing goods or services to its participants at a discount or otherwise, as a principal activity.)

DISCUSSION: The portion of this section prohibiting distribution of gains, profits or dividends to members or participants derives from Section 9200 of current law; see comment to Section 5241 above. This section must obviously provide for the exception of the dissolution of non-charitable nonstock corporations. The provision allowing the corporation to pay compensation to its members, participants or directors may be redundant, but its repeitition here may aid in establishing beyond doubt that such compensation does not violate the prohibition upon dividends. However, in the case of charitable corporations, membership on the board of directors of persons employed by the corporation may constitute a violation of fiduciary obligations. Section [X], yet to be drafted, will spell out these fiduciary duties and is thus cross-referenced here. Section 9200 of current law provides that a nonstock corporation may be formed for the purpose of "rendering services", and in Groman v. Sinai Temple, supra., the court held that the Code does not prohibit a charitable corporation from conducting a funeral business at a profit while affording its members a discount for cemetary or mortician services. Subdivision (b)(2) codifies this rule. However, the subdivision may raise more problems than it cures, since it arguably gives statutory sanction to an evasion of the ban upon distributions. The evasion would take the form of a distribution of gain through easily resaleable goods, perhaps sold to the member at a nominal fee. Moreover, it is unlikely that absent this section a court would conclude that a nonstock corporation such as FedCo violated the prohibition upon distributions.

An alternative, and we believe superior, way of dealing with these issues would be to define distribution in Chapter 1 in a manner excluding compensation for services actually rendered, while leaving the question of excess compensation to be dealt with in the sections on fiduciary obligations. This would eliminate all need for (b)(1), and in our view both (b)(1) and (b)(2) could therefore be deleted.

Question

Should subdivision (b) be retained? Recommendation: No.

Section 5243. Subject to Section 5244:

(a) No limitation upon the activities, purposes, or powers of the nonstock corporation or upon the powers of the members, participants, officers, or directors, or the manner of exercise of such powers, contained in or implied by the articles or by Chapters 18, 19, and 20 shall be asserted as between the nonstock corporation or member or participant and any third person, except in a proceeding (1) by a member or participant or the state to enjoin the doing or continuation of unauthorized activities by the nonstock corporation or its officers, or both, in the cases where third parties have not acquired rights thereby, (2) to dissolve the nonstock corporation, or (3) by the nonstock corporation or by a member or participant suing in a representative suit against the officers or directors of the nonstock corporation for violation of their authority.

(b) Any contract or conveyance made in the name of a nonstock corporation which is authorized or ratified by the board, or is done within the scope of authority, actual or apparent, conferred by the board or within the agency power of the officer executing it, except as the board's authority is limited by law other than this division, binds the nonstock corporation, and the nonstock corporation acquires rights thereunder whether the contract is executed or wholly or in part executory.

(c) This section applies to contracts and conveyances made or to be performed by foreign nonstock corporations in this state and to all conveyances by foreign nonstock corporations of real property situated in this state.

DISCUSSION: Section 5243 is virtually identical to CC Section 208, and current law. See former Section 803 of the old corporations law, applied to nonstock corporations in Osteopathic Physicians & Surgeons v. California Medical Ass'n., 224 Cal.App.2d 378, 401, 36 Cal.Rptr. 641 (1964). Chapters 18, 19 and 20 refer to dissolution.

The principal difference between this and CC §208 is the reference to §5244. See that section.

Section 5244. (a) Notwithstanding Section 5232, in the case of a nonstock corporation holding assets in charitable trust, a director, member, or other person with an interest in the trust property, or the Attorney General, may bring an action to enjoin the breach of the charitable trust regardless of whether third parties have acquired rights by virtue of the breach.

(b) In an action under this section, the court may enjoin the performance of a contract if all of the parties to the contract are parties to the action and if it is equitable to do so.

(c) Notice shall be given to the Attorney General by any other person bringing an action under this section, and the Attorney General may intervene.

Defined terms: member, charitable trust

DISCUSSION: This section provides an exception to Section 5243 which is not found in the CC. It derives, however, from existing case law; see Holt v. College of Osteopathic Physicians and Surgeons, 61 Cal.2d 750, 40 Cal. Rptr. 244, 394 P.2d 932 (1964), overruling in part George Pepperdine Foundation v. Pepperdine, 126 Cal. App.2d 154, 271 P.2d 600 (1954). This case did not focus upon the problem created when the rights of third parties are cut off; rather, the case stands for the proposition that certain private parties with sufficient interest, as well as the Attorney General, can sue to enjoin the breach of a charitable trust. Nevertheless, the Holt opinion allowed the trial court in that case to enjoin the performance of contracts in violation of the charitable trust. The court identified directors of the charitable corporation as having sufficient standing to bring such an action by virtue of their office, and quotes with approval language from a prior case stating that "the only person who can object to the disposition of the trust property is one having some definite interest in the property -- he must be a trustee, or a cestui, or have some reversionary interest in the trust property." 61 Cal.2d at 753. The statutory language employed above is intended to reflect this holding, except for the addition of "members" to the list of those who may bring such an action by virtue of their position.

The provision requiring notice to the Attorney General when such an action is brought by some other person is also reflective of existing law and of the language in Holt; see 61 Cal.2d at 756 and In re Los Angeles County Pioneer Society, 40 Cal.2d 852, 861, 257 P.2d 1.

Questions

(1) Should the ultra vires doctrine have greater reach in the case of a nonstock corporation violating a charitable trust than in the case of a business corporation or other nonstock corporation? If so, should actions in the expanded area be limited to the Attorney General, or should private parties be allowed to bring them as well?

Note that the trust the breach of which is actionable under this section may be based upon restrictions in the articles of incorporation, or may arise entirely independently from the articles, under general principles of trust law.

(2) Do we wish to provide in addition for some form of private action by an innocent third party who loses contract rights by virtue of an injunction issued under this section, to be brought against the directors or officers responsible for the breach of trust in question?

Article 5: Bylaws

Section 5250. Bylaws may be adopted, amended or repealed by approval of the members or participants [see Section X] or the board, except as provided in Section 5251. The board's power to adopt, amend or repeal bylaws shall be subject to the power of the participants [(or members) (but not of members)]. [Except in the case of a charitable corporation,] the articles or bylaws may restrict or eliminate the power of the board to adopt, amend or repeal any or all bylaws, subject to subdivision (a)(4) of Section 5232.

DISCUSSION: This section follows closely CC Section 211. Current law, as stated in Section 9400, is similar except that (a) it explicitly reserves to the members the power to adopt a bylaw fixing the number of directors, except where the articles or bylaws fix an indefinite number; and (b) it explicitly allows the articles or bylaws to require a supermajority vote of the members to change the bylaws. Point (a) is covered here in Section 5251, and point (b) is now covered by Section 5232(a)(4).

This principal difference between this section, compared to current law and the CC, is the potential different treatment of charitable corporations. For charitable corporations the obligations of directors are principally to the charitable purpose rather than to the members, if there are any. A greater degree of independence from members may be preferable.

The membership vote actually required by this section would be fixed in Chapter One where "approval of the members" would be defined, as in CC Section 152, and a cross-reference to this definitional section is included in this section, as it is in CC Section 211.

The cross-reference to Section 5251 derives from the CC, which has an analogous reference to CC §212, and is presumably meant to refer to the provision in that section protecting a minority interest from having the total number of directors reduced below the point at which they could successfully cumulate their votes to elect one. The matter of cumulative voting will be considered later.

Question

Should a distinction be drawn between the rights of members or charitable corporations and participants of non-charitable corporations to adopt, amend and repeal bylaws?

Section 5251. (a) The bylaws shall set forth (unless such provision is contained in the articles, in which case it may only be changed by an amendment of the articles) the number of directors of the corporation; or that the number of directors shall be not less than a stated minimum nor more than a stated maximum (which in no case shall be greater than two times the stated minimum minus one), with the exact number of directors to be fixed, within the limits specified, by approval of the board or, except in the case of the charitable corporation, the participants, in the manner provided in the bylaws, subject to subdivision (a)(4) of Section 5232. The number or minimum number may be one or more.

(b) Once persons have been admitted to participation [or membership], a bylaw specifying or changing a fixed number of directors or the maximum or minimum number or changing from a fixed to a variable board or vice versa may only be adopted by approval of the participants [or members] (Section X); provided, however, that a bylaw or amendment of the articles reducing the number or the minimum number of directors to a number less than five cannot be adopted if the votes cast against its adoption at a meeting, or the participants [or members] not consenting in the case of action by written consent, are equal to more than 16 2/3 percent of the votes the participants [or members] are entitled to cast.

(c) The bylaws may contain any provision, not in conflict with law or the articles, for the management of the activities and for the conduct of the affairs of the corporation, including but not limited to:

(1) any provision referred to in Section 5232(c).

(2) the time, place and manner of calling, conducting and giving notice of members', participants', directors' and committee meetings, or of conducting mail ballots.

(3) the qualifications, duties and compensation of directors; the time of their annual election; and the requirements of a quorum for directors' and committee meetings.

(4) the appointment and authority of committees of the board.

(5) the appointment, duties, compensation and tenure of officers.

(6) the mode of determination of members or participants of record.

(7) the making of annual reports and financial statements to members or participants.

(8) admission and transfer fees.

(d) the bylaws shall provide for the manner of admission, withdrawal, suspension, and expulsion of participants or members for forfeitures or termination of participantships, consistent with the requirements of Section 5414 of this division.

Defined term: mail ballot

DISCUSSION: This section follows closely CC Section 212, insofar as it applies to non-charitable corporations, with the following differences:

(a) one person boards of directors are allowed.

(b) the addition of "or of conducting mail ballots" to (c)(2).

(c) the addition of (c)(8).

(d) the addition of (d). This last is the only change of consequence. Even if the chapter on participants is ultimately drafted without a provision setting forth some minimal protections that would be required before expulsion or forfeiture, a separate basic requirement of due process is that the rules -- whatever they are -- are set out in advance rather than created on an ad hoc basis. This section is presently framed, however, on the assumption that there will be a separate section setting forth minimum procedural protections, and that section is cross-referenced here, in (d). This provision could be enforced by providing that no expulsion carried out in violation of the statutory requirements would be effective. See Section 5414. The section dealing with expulsion may provide different rights for members than for participants. In the alternative we may wish to reconsider the question of whether bylaws must set forth the manner in which members are expelled.

Note also that this section is drafted on the assumption that the code will mandate cumulative voting for non-charitable corporations. A decision on this point, of course, is yet to be made.

Question

Should distinctions be drawn between the rights of participants and members in determining the make up of the board of directors?

Section 5252. Every corporation shall keep at its principal executive office in this state, or if its principal executive office is not in this state at its principal business office in this state, the original or a copy of its articles and bylaws as amended to date, which shall be open to inspection by the members or participants at all reasonable times during office hours. If the principal executive officer of the corporation is outside this state and the corporation has no principal business office in this state, it shall upon the written request of any member or participant furnish to such member or participant a copy of the articles or bylaws as amended to date.

DISCUSSION: This section follows almost verbatim CC Section 213. The only change is in making this section apply to the articles as well as the bylaws. This was suggested by Section 5266 of the Law Revision Commission draft. While the change is not of major importance, since the articles would be available in any event from the Secretary of State, it appears on balance to be a good idea.