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Organization and Operation of Non-Profit Corporations—Some General Considerations

Robert S. Pasley*

**MY ASSIGNMENT TODAY** is to discuss with you some general matters relating to the organization and operation of non-profit corporations. Before doing so, I would like to stress what Professor Oleck has brought out, namely, the importance of this subject to the practicing lawyer. Most of us, and I think this is true of law teachers as well, tend to think of the non-profit corporation as a kind of adjunct to the business corporation, and a rather unimportant adjunct at that. This is certainly not true historically, and I do not believe it is true today. In terms of origins, the non-profit corporation long preceded the profit corporation. In the medieval period, as Maitland has pointed out, the typical corporation was the borough or the monastery.¹ The law of corporations developed for centuries without any thought of business entering into it. It was not until the development in England of the great overseas trading companies and joint stock companies in the 16th and 17th centuries as forerunners of the stock corporation² that corporate law began to assume its present business aspect, an aspect which now tends to dominate. Nevertheless, the non-profit corporation has not lost its importance.

Professor Oleck has listed in his paper the many different types of non-profit corporations, running the gamut from the small social club to the huge foundation. I am sure you were impressed by the wide variety of types that he enumerated. But there are others of almost equal importance. For example, I think of the non-profit research corporation. During and immediately following World War II, this emerged as an important part of the defense industry, but it is by no means limited to that area. You have all heard of the Rand Corporation, which makes technical studies on all sorts of problems, both military and civilian. And there are many others. I have discussed elsewhere some of the problems raised by the use of the non-profit corporation in the defense industry.³

An interesting aspect of such corporations is that many of them were organized under the auspices of, and are affiliated with, major universities. But what was regarded 25 years ago as patriotic cooperation in the “war effort” has now become in the eyes of many an unholy tie with the “military-industrial complex.” And so many of these uni-

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[Note: This paper is part of the Symposium on Non-Profit Organizations.]

1 See Rooney, Maitland and the Corporate Revolution, 24 N.Y.U. L. Rev. 24 (1951).


3 Pasley, Organizational Conflicts of Interest, 1967 Wis. L. Rev. 5, at 14-18.
Universities are engaged in disaffiliating themselves from their adopted children. But this too presents its problems. My own university, Cornell, having decided to sell the Cornell Aeronautical Laboratory, located in Buffalo, now finds itself embroiled in litigation as a result of its efforts to carry out that decision.4

Professor Oleck also mentioned another aspect of non-profit corporations, observing that most of them are in fact run by a small group he called "activists." In university parlance, the "activist" is the student or faculty member who demonstrates, seizes buildings, threatens to destroy the institution, and so on. A proposal much in favor today, in an attempt to respond to the activist, or to channel his energies along more constructive lines, is to "restructure" the "governance" of the university. Now although many of those who glibly speak of "restructuring" are only dimly aware of the fact, a university is itself a non-profit corporation, of a special kind called a "charitable corporation," the restructuring of which presents many legal, as well as practical, problems.5

To come now to my assigned topic, I propose to discuss some of the more general aspects of non-profit corporations under the following headings:

Definitions
Purpose and Powers
Formation
Finance
Members

My observations will be based principally on the Model Non-profit Corporation Act6 and the recently enacted New York Not-for-Profit Corporation Law.7 The former has been adopted in some six or seven states and parts of it have been enacted in four other states.8 Some 26 states have not adopted it in any form. (It has not proved possible to obtain up-to-date information from all the remaining states.) The latter will take effect September 1, 1970. Both acts have come in for

4 At the instance of some disaffected employees of the Laboratory, who objected to being "sold out" to a profit-making enterprise, and on the urging of the State Atomic Energy Commission, the Attorney-General of New York brought a proceeding to enjoin the sale. A preliminary injunction was granted, pending a hearing on the merits. This hearing has been held, but no final decision has yet been rendered.
5 Some of the practical problems were discussed by Irving Kristol, A Different Way to Restructure the University, New York Times Magazine, Dec. 8, 1968, reprinted in Confrontation—The Student Rebellion and the Universities, ed. by Daniel Bell and Irving Kristol (Basic Books, Inc. 1969).
6 Joint Comm. on Continuing Legal Education of the ALI and the ABA, Model Non-profit Corporation Act (Rev. ed. 1964). Hereafter cited as "Model Act."
some criticism this morning. Admittedly, they are far from perfect but they are better than nothing, and many of the other states have little more than nothing.

The Preface to the 1964 Edition of the Model Act points out that it is designed as an enabling statute, to authorize the organization and administration of non-profit corporations, and it purposely disclaims getting into the area of regulation by the State. Moreover, it is recognized by the draftsmen of the Act that it will have to be adapted, modified, and expanded before adoption. The New York statute, of course, is an attempt to legislate comprehensively in the area.

Definitions. The Model Act defines a non-profit corporation as one, no part of the income or profit of which is distributable to its members, directors, or officers. The New York statute uses a slightly different term, the “not-for-profit” corporation. There is a subtle distinction in meaning between the two, although I do not think any difference was really intended. The New York title is slightly more accurate, because a not-for-profit corporation can make a profit. The point is that it is not organized for the purpose of making a profit, although it may make one which is incidental to its major enterprise, interest, or activity. If such a corporation does make a profit, that profit is not distributable to its members. You get into some borderline areas here. For example, does a cooperative make a profit? The traditional answer is No, and supporters of the cooperative movement always deny indignantly that cooperatives make profits. But they do pay dividends, which are theoretically simply a return to the members of savings made through the cooperative enterprise. Putting aside marginal cases like this, the basic test is a simple one. A corporation which does not distribute any part of its profits to its members, directors, or officers can qualify as a not-for-profit corporation.

Purposes and Powers. For what purposes may a not-for-profit corporation be organized? The Model Act, in § 4, says “any lawful purpose,” including but not by way of limitation, a long catalog of purposes, such as charitable, educational, civic, religious, social and so on. But it excludes labor unions, cooperatives, and insurance corporations, not because they are necessarily non-profit, but because for other reasons it was felt that they could not appropriately be brought under the statutory umbrella. An alternative § 4, however, would authorize formation of a non-profit corporation for “any lawful purpose.”

The New York statute excludes educational corporations, religious corporations, benevolent orders, certain corporations organized under special acts and, apparently, banks, insurance companies, cooperatives,

9 Model Act, § 2(e).
10 N.Y. Act, §§ 102(a) (5), (10), 508.
11 Id., § 103.
and some others. The statute lists the permissible purposes of not-for-profit corporations under four categories. The first, Type A, includes, among others, the social club and the political association, and also includes professional and trade associations. The second category, Type B, is the traditional charitable, educational, scientific, or cultural organization. Type C permits incorporation for "any lawful business purpose." Type D is a catch-all provision covering anything not already listed, whether business or non-business, which is authorized as a non-profit corporation under any other New York corporate law. In effect, with certain specified exceptions, both under the Model Act (especially the alternative § 4), and under the New York statute, you can organize a non-profit corporation for almost any purpose. What you may not do, however, is to provide for the return of profits, or any distribution of profits, and still retain your non-profit character.

Both statutes have sections on the powers of non-profit corporations, as distinguished from their purposes. The usual powers of any corporation are listed, but there are a few interesting additions. Both statutes give non-profit corporations the power to make charitable donations, which used to be a controversial issue as to corporations generally, but apparently is so no longer. Both permit indemnification of officers and directors, another controversial area. Another interesting power given by the New York statute is the power to be a member of, to manage, or incorporate other not-for-profit corporations. So theoretically you could have a series of non-profit holding companies, which might or might not be a good thing. In practice, this is not apt to happen very often, except perhaps in the case of large foundations desiring to establish special purpose affiliates.

A word about ultra vires: Both statutes adopt the modern point of view. I say "modern" because it is the view espoused by most writers today, namely, that a corporate transaction should not be voidable by either party thereto on the ground that it is ultra vires; in other words ultra vires will not be a defense. But such a transaction is subject to attack by a member or director of the corporation seeking an injunction, or by the Attorney-General in a proper proceeding to enjoin the corporation or to annul or dissolve it.
**Incorporation.** Incorporation is made fairly simple under both statutes.\(^{20}\) Even one person can incorporate. Now you may say that this permits abuse. Perhaps, but as a practical matter we all know that this is what happens anyhow. Under the traditional approach, requiring three or five incorporators, you often have only one person with the primary interest, the others being only dummies.

Once the articles of incorporation are filed with the appropriate state officials, and the certificate issued, the latter becomes conclusive evidence that all the necessary prerequisites for incorporation have been met.\(^{21}\) So if the certificate has been issued, you cannot raise the defense that the corporation has not been properly organized. Once again, however, the Attorney-General may look behind the certificate and question the proper organization of the corporation.\(^{22}\)

With respect to approvals and consents, nothing is said in the Model Act about them. But in New York, as well as many other states, it has long been the law that the incorporation of a non-profit corporation must have the approval of a justice of the Supreme Court, and in certain cases of other officials, such as the Board of Regents for an educational corporation or the Bureau of Social Welfare for a children's aid society. This requirement of court approval has been partly, but not wholly, eliminated from the New York statute.\(^{23}\) It is no longer required for category A corporations (social clubs, professional associations, and so on). But category B (charitable and educational corporations and the like), category C (any lawful business purpose), and a few other corporations still require it. Quite often you may also need the approval of other state agencies.\(^{24}\)

Now what does this requirement of judicial approval really mean? Is it merely a formality, which will be granted once the necessary technical requirements have been met, or will the court exercise its discretion and judgment and say "Yes" to one application and "No" to another? In New York it is fairly clear that the court will exercise an informed discretion and will not grant approval unless it is satisfied from the application and supporting papers that there is a need for the corporation and that it does not violate any law or public policy of the state. It would seem from the reported cases that the New York courts have been fairly free in exercising this authority and withholding their approval. For example, in *Matter of Bronx County Cadet Corps, Inc.*,\(^{25}\)

\(^{21}\) Model Act, § 31; N.Y. Act, § 403.
\(^{22}\) Ibid.
\(^{23}\) N.Y. Act, § 404(a).
\(^{24}\) Id., § 404(b)-(n).
the court withheld its approval because the corporation was to be a private military organization set up to train young boys in "military tactics, procedures and discipline," functions the court thought were more properly vested in the Government. If private military organizations are to be authorized, it should be done by the legislature, not by the courts. Again, in *Sidney Gelb’s Chapter for Cancer Research, Inc.* the court said "No." There are many other organizations engaged in cancer research, and the application showed no reason why another was needed. Approval was also withheld in *Application of Council of Orthodox Rabbis, Inc.* Although it would seem that the purpose of the proposed organization was perfectly proper, the court said that there were other organizations performing the same function. The application did not convince it that another was needed, or that petitioners were in a position to accomplish their purpose.

On the other hand, the court should not withhold its approval merely because it does not like the purposes of the proposed organization. In *Matter of Association for the Preservation of Freedom of Choice Inc. v. Simon*, the stated purpose was to "promote the right to individual freedom of choice and association." It appeared though that the real purpose was to oppose "open housing" and similar legislation, not necessarily on racist grounds, but as a matter of principle. The Supreme Court disapproved the petition on the ground that the purposes of the corporation were opposed to the public policy of New York State, as evidenced by its laws against racial discrimination. While the petitioners had the right to promote such views, they could not demand the privilege of incorporation therefor. The Appellate Division affirmed, but the Court of Appeals reversed, in a 5-2 decision. The court took the position that, since there was nothing unlawful in advocating changes in the laws, or in challenging their constitutionality, incorporation of a membership corporation as a vehicle for promoting such views should not be denied.

A somewhat similar case arose in Pennsylvania a number of years ago. The incorporators stated that their intention was to place particular emphasis on the "evangelization and conversion of adherents of the Roman Catholic faith, providing spiritual, temporal, and financial

26 17 Misc. 2d 599, 187 N.Y.S. 2d 134 (Sup. Ct., Queens Co. 1959).
29 17 Misc. 2d 1012, 187 N.Y.S. 2d 706 (Sup. Ct., Queens Co. 1959), aff’d. on rehearing, 18 Misc. 2d 534, 188 N.Y.S. 2d 885 (1959).
30 10 App. Div. 2d 873, 202 N.Y.S. 2d 218 (2d Dep’t. 1960) (Technically, the court denied a petition to revoke Justice Shapiro’s two opinions denying approval).
31 Supra, n. 28. The majority opinion was written by Judge Foster, the dissenting opinions by Judges Burke and Froessel.
SOME NON-PROFIT CONSIDERATIONS

assistance, especially to their converted clergy.” Reversing the lower
court, the Supreme Court of Pennsylvania held that incorporation should
not be denied. The purposes of the proposed corporation could not be
declared unlawful and injurious to the community. Accordingly, the
court had no discretion to refuse the charter applied for.

The late Judge Musmanno, the great dissenter, disagreed in his
usual vigorous and colorful style. While the petitioners had a constitu-
tional right to express their views and to attempt to convert members
of another faith, they had no right to demand the “imprimatur” of the
State in the form of a corporate charter. He argued that the proposed
organization would “stir up strife, discord, wrangling and violence over
creed, dogma, and doctrine,” and that the incorporators were “intent
on unleashing the winds of intolerance, the gales of prejudice and the
forces of hate and ignorance.”

Now where do you draw the line between bigotry, discrimination, or
racism, and the free exchange of ideas? The two cases I have just dis-
cussed, from New York and Pennsylvania, indicate that where the pur-
poses are not illegal and are not completely contrary to public policy,
incorporation should not be denied even though the court may not like
what the corporation proposes to do. But a large area of discretion still
remains. The impact of this requirement will be greatly lessened
under the new New York statute. After September 1, 1970, a Type A
organization can be incorporated without judicial approval being ob-
tained. But for Type B and Type C corporations, approval will still be
required.

Finance. It does seem anomalous that non-profit corporation statutes
would have to say anything about finance, but they do. Both the Model
Act and the New York statute prohibit the issuance of shares of stock. You
might think that this would go without saying, but the fact is that
there are a few states where it is possible to have a non-profit stock cor-
poration. This seems strange and would not be possible under the
statutes we are discussing. But it is possible to issue certificates or cards
evidencing membership in the corporation. It is also possible to require
the members to make a capital contribution. In such case they receive
a certificate evidencing their capital contribution, which will be re-

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33 Id. at 248; 111.
34 Ibid.
35 Ibid.
36 In general, see Dwight, Objections to Judicial Approval of Charters of Non-Profit
37 Model Act, § 28; N.Y. Act, § 501.
38 E.g., No. Car. 2B Gen. Stat. of N.C. § 55-3(a) (Michie, 1965) (§ 55-3(b) prohibits
any further formation of non-profit stock corporations).
39 Model Act, § 11; N.Y. Act, § 601(e) (3). The N.Y. Act § 601(d) makes such cer-
tificates or cards non-transferable.
turned to them when the corporation dissolves, or which, under proper circumstances, in the case of a Type A corporation, with the consent of the corporation, they may transfer to a new member if they should resign. This arrangement is common in the case of a club which needs money to get organized.

Then, under the New York statute there is this curious thing called the "subvention." This is another type of capital contribution, but a voluntary one, as distinguished from one required by the charter or the by-laws. Once again, certificates may be issued to evidence the subvention. It is simply a further, voluntary capital contribution, although in some cases (private foundations, for example) it may be a mere shifting of money from one pocket to another. One interesting feature of the New York statutory provision on subvention certificates is that interest may be paid on them, but may not exceed 3/4 of the legal rate. I don't know the purpose of this limitation, but it is in the statute.

It is customary in a club or other society to charge the members initiation fees, annual dues, and sometimes special assessments. These constitute the normal income of the club, plus its receipts from its various activities, such as the club dining room. It is permissible to make a profit on such incidental operations, but the club may not distribute such profit to its members.

The New York statute has a special section on "Administration of assets received for specific purposes." In the case of a charitable corporation, this relates to the question: In what capacity does a charitable corporation hold its property? Is it a trustee of a charitable trust or does it hold its property outright? The obvious answer is that it holds its property outright like any other corporation (although it may, like anyone else, be constituted a trustee of a specific gift). Actually, the question is a difficult one, because the dividing line between a charitable corporation and a charitable trust is often very fuzzy. In some states, such as Michigan, Pennsylvania, and others, statutory provision is made for a special type of corporation called the

40 N.Y. Act, §§ 502, 503. There is no corresponding provision in the Model Act.
41 Id. § 504.
42 Id. § 505.
43 Id. § 504(d).
44 Id. §§ 507, 508.
45 Id. § 513.
"trustee corporation." 48 A typical example is where a settlor or testator leaves a substantial sum of money to incorporate, let us say, a school or a library. It is a charitable corporation but is run very much like a charitable trust. The significance of most of these statutes is that the duty of supervision imposed on the trustees (directors) is comparable to that imposed on the trustee of a charitable trust.49 But the section of the new New York statute which I have mentioned provides that even in this situation a Type B corporation holds its property, even property dedicated to special purposes, in full ownership and not as a technical trustee (although of course it must use the property for the purposes indicated by the donor). This avoids the difficulty and technical question whether in such a case you do or do not have a trust. Of course, if a charitable corporation dissipates its property, or uses it for a purpose not permitted by the donor, it can be called to account before a court having equity powers by the Attorney-General, or by a director or member.50

Another important question concerns investments. How free are the directors of a non-profit corporation, especially a charitable corporation, to make investments? Are they held to the strict limits imposed on the trustee of a private trust, or may they invest in so called "non-legals"? The New York statute provides (and this is true to a limited degree under present New York law) that unless otherwise provided in the deed of gift, will or other instrument, the directors are free to invest in such property as they deem appropriate and advisable.51 This is substantially the "prudent man" rule. This matter of investment related to the duties of directors which I am not going to go into further because that will be the subject of a separate address.

With respect to a sale of a substantial portion of the corporate assets, there is the usual provision which you find in most corporation statutes that such a sale must be approved by the directors and by 2/3ds of the members.52 Let me add that in case of the charitable corporation it is usually necessary, or at least advisable, to obtain judicial approval of such a sale.53

As to dividends and distributions, the only kind that are permitted are upon liquidation, or perhaps in some situations in the form of a return of contributed capital, but there may be no distribution of profits.54

49 Pasley, op. cit. supra, n. 47, at 638.
50 Id. at 640.
52 Model Act, § 44; N.Y. Act, § 510.
53 N.Y. Act, § 510(a) (3).
54 Id., §§ 515, 516, 1005.
Members. Under both statutes, the members (and this includes officers and directors), are not personally liable for the debts of the corporation; in other words, you have limited liability. This might seem an obvious consequence of incorporation, but some of the older statutes did make members of non-profit corporations liable for corporate debts. Of course they are liable if they haven’t paid their assessments or dues, to the extent of their unpaid obligation. And directors and officers may be liable to creditors if they have caused loss by violation of their fiduciary duties.

As to members generally, I will say only two things. First, it is not necessary to have members, but many non-profit corporations do, clubs for example. Sometimes such members are called “associates” to distinguish them from directors and officers. Secondly, to show you how close the new statutes are to the business corporation acts, there are provisions in the New York statute for members’ derivative suits, just as in the case of a private corporation, together with provisions for indemnification of officers and directors.

I’ll say just a few words on exclusion of applicants for membership in non-profit organizations and expulsion of members. Generally speaking, a private corporation, which is not substantially affected with a public interest and which is not subject to special civil rights statutes, may exclude anyone from membership at will. An existing member may be expelled, but only subject to the requirements of “natural justice,” that is, upon notice of the charges, after a hearing with an opportunity to refute the charges against him, and in accordance with the procedures, if any, prescribed in the association’s own regulations or by-laws. This matter is very important nowadays in the case of dismissal or suspension of students.

Perhaps of greater importance, though, is the impact of the new civil rights legislation on non-profit corporations. Although, generally speaking, bona-fide private organizations are exempt, many organizations which claim to be private have nevertheless been made subject to such legislation. This depends partly on the nature of the activities involved,
the extent to which they perform a public service, and partly on the degree of "state action" involved, for example, as measured by the amount of public assistance, if any, furnished. Even here, the only type of discrimination which is usually forbidden is that based on race, religion, or sex. If you want to organize a Red-Headed League, as did the mythical Ezekiah Hopkins, that is apparently all right.

I've said little or nothing about foundations, since this will be the subject of the next address. I am reminded of a cartoon which some of you may have seen, of a rather unhappy looking man in T-shirt and dungarees, unshaven, standing in a cluttered kitchen changing a washer. His even more bedraggled looking wife is there in her housecoat, examining critically the joint tax return which he has just prepared and has asked her to sign. She asks: "Have you considered all the loopholes: municipal bonds, percentage depletion, foundations?" The later speakers will tell you about some of these loopholes.

63 E.g., the Civil Rights Act of 1964 applies to "places of public accommodation" but not to private clubs which are in fact not open to the public. 42 U.S.C. §2000a (1964). Cf. N.Y. Civil Rights Law §40 (McKinney, 1948); 18 Pa. Stat. Ann. §4654 (Purdon, 1963). The New York statute applies, inter alia, to all educational institutions, public or private, which are under the supervision of the regents of the state of New York, or which are supported in whole or in part by public funds or by contributions solicited from the general public.

64 See Pasley, op. cit. supra n. 60, pp. 206-12; 42 U.S.C. § 2000a(d).