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Forfeiture of Non-Profit Corporation Charters

Kevin Sheard*

MANY OF THE PROVISIONS of general corporation law apply to non-profit corporations in common with corporations for profit. Yet since the non-profit groups do form a class by themselves, it is worthwhile to examine the law on forfeiture of charter as applied particularly to them. While the closely related problem of *refusal* by state officials to issue corporate charters is of interest, it has been well covered in five excellent legal articles which were cited as the sole authority in a landmark New York case.¹

There is some confusion in terms because a judicial or administrative finding of a forfeiture seems to imply that the corporation is actually out of existence and the court or other agency is merely giving public recognition of the fact. Actually a decree or finding of forfeiture is held to be a necessary part of the ending of the corporate existence.² Without the official action the corporate life goes on regardless of what has happened which might justify the official action. This is graphically illustrated in the case of *California Labor School v. Subversive Activities Control Board*.³ The United States Court of Appeals for the District of Columbia held that the mere cessation of business was not the equivalent of a finding of a dissolution and termination of existence. Similar findings are frequent when an outsider attacks the existence of the corporation to show that it is

* Professor of Law, Cleveland-Marshall Law School of Baldwin-Wallace College.

¹ *Association for the Preservation of Freedom of Choice v. Shapiro*, 9 N. Y. 2d 376, 214 N. Y. Supp. 2d 388, 174 N. E. 2d 487 (1961). The law review articles cited are found in 55 Col. L. Rev. 380 (1955), 66 Yale L. J. 545-550 (1957), 6 Howard L. J. 169 (1960), 46 Cornell L. Q. 290 (1961), and 12 Bus. Lawyer 454 (1956). Note the opinion of Brennan, J. in *In re Fraternidad Hispana-Americana*, 39 N. Y. Misc. 2d 106, 240 N. Y. Supp. 2d 110 (1963), which if followed will severely limit the doctrine laid down in *Assn. for Freedom of Choice*.

² In some states officers of the executive department may find a forfeiture. See, for example, Utah, where the Secretary of State may, on notice and hearing, declare a non-profit corporation charter forfeit. Note the vigorous dissent by Henriod, J. in *Entre Nous Club v. Toronto*, 4 Utah 2d 98, 287 P. 2d 670 (1955), in which he attacks (albeit unsuccessfully) the power of the Secretary of State as being in derogation of due process. As to procedure see, Oleck, *Non-Profit Corporations and Associations*, Sec. 229 (1956).

³ 322 F. 2d 393 (D. C. App. 1963). This case is unusual because it was the corporation itself which pleaded its non-existence.

incapable of taking property. Lacking a formal determination of forfeiture, even the fact that the corporation has turned over all its assets to another will not prevent it from taking property willed to it.⁴

Even provision in the articles and constitution of a parent lodge cannot be used to show that there has been a termination of an incorporated sub-lodge. A dissolution under "Theosophical Law" notwithstanding, the sub-group continued as a corporation until such time as a court might decree the forfeiture.⁵ This is not to say that there might not be other penalties for failure to exercise the franchise, as, for example, a disqualification to act as trustee.⁶

Granted, then, that some formal procedure is necessary to terminate the corporate existence, the question of what kinds of proceedings are necessary arises. In general, these are judicial, although in a few states other officers are invested with the appropriate authority.⁷ For the purposes of this note the difference between *quo warranto* and an information or proceeding in the nature of a *quo warranto* will be ignored. In either case there is a challenge by the state to the continued existence of the corporation. This is, however, not the only method of instituting proceedings. Where members of the corporation are wronged, as opposed to situations where the public is wronged, those members may maintain an action for forfeiture and dissolution.⁸

Where two or more non-profit corporations have been organized to serve a public purpose, may one directly attack the other for failure to carry out the common purpose? Despite its title, *People ex rel. Vivisection Investigation League v. American Society for the Prevention of Cruelty to Animals*⁹ was a private action, because the Attorney General of New York had refused to act. The burden of the League's complaint was that the Association was not really carrying out the purpose for which

⁴ *Old Colony Trust v. 3rd Universalist Society of Cambridge*, 285 Mass. 146, 188 N. E. 711, 91 A. L. R. 837 (1934). Here the corporation successfully asserted its continued existence.

⁵ *Keeler v. Schultz*, 47 Cal. 2d 801, 306 P. 2d 430 (1957).

⁶ *Syrian Antiochean St. George's Orthodox Church v. Ghize*, 258 Mass. 74, 154 N. E. 839 (1927).

⁷ See note 2 *supra*.

⁸ *Hughes v. Schwartz* (Appeal of the 11th Ward Republican Club), 389 Penna. 103, 132 A. 2d 681 (Penna. 1957). The wrongs complained of included failure to elect officers, sale of beer, and absence of corporate purpose.

⁹ 20 A. D. 762, 247 N. Y. Supp. 2d 487 (1964).

it was organized in that it did not strongly condemn the docking of horses' tails. The court held that even though the two organizations shared a purpose, that fact did not grant standing for an attack on the franchise of one by the other.

Another method of attack on an existing non-profit corporation is through an outside "remainderman" who would take over the corporate assets in the event of a forfeiture. In a Pennsylvania case, the Presbytery of Philadelphia successfully maintained that it had standing to sue for the forfeiture and dissolution of the Susquehanna Avenue Presbyterian Church, which had repudiated the tenets of the parent body. The reasoning was based on the fact that the articles of the local church provided that its purpose was to uphold the Presbyterian faith and forms of worship with a proviso that in case of dissolution its assets were to go to the Presbytery.¹⁰

Pennsylvania, which has a system of judicial approval *prior* to the granting of articles of incorporation of non-profit organizations, was the scene of an attempt to insert still another method of attack on the existence of the corporation. In *Sherman et al. v. Yiddisher Kultur Farband*¹¹ a non-member petitioned the court which had approved the charter of what he described as a Communist front organization, for a decision of nullity of the articles. His reasoning was that a Communist front organization had obtained its articles by a fraudulent application which concealed its true nature. Further, the very nature of the Communist activities was such that they were unlawful. The Supreme Court of Pennsylvania overruled the lower court, which had ousted the corporation, on the ground that a non-member of the group had no standing to sue for dissolution since he had no private interest, but it indicated that had the lower court on its own motion instituted the proceedings it then could properly have ousted the corporation. Mr. Justice Musmanno dissented. In his characteristically colorful language, he argued that the lower court was entitled to be informed by anyone who knew of a gross fraud perpetrated upon it. It should then be permitted to cleanse its records "once it is proved they have been contaminated by a perjurious hand, leprous with deception, deceit and betrayal."¹²

¹⁰ In re dissolution of The Susquehanna Ave. Presbyterian Church, 31 District and County Repts. 597 (Penna. 1938).

¹¹ 375 Penna. 108, 99 A. 2d 868 (1963).

¹² *Ibid*, p. 871.

Without attempting to argue the merits of a judicial method of approving articles before incorporation, it is obvious that such a revocation by "cleansing the record" should be confined to states where such prior judicial review exists.¹³

In Ohio the Secretary of State chartered the National Knights of the Ku Klux Klan of Ohio, Inc., on October 5, 1964.¹⁴ Immediately, public outcries arose, with statements from politicians denouncing the action. Finally, on October 21, 1964, the Secretary of State announced that the articles had been accepted by mistake and that he was revoking them. This procedure differed from that in the *Yiddisher Kultur Farband* case¹⁵ in two respects, one favorable to its validity and one contra. First, it met the criterion laid down by the Pennsylvania Supreme Court that the "cleansing of the record" be by the issuing authority (the lower court which had approved the articles in the Pennsylvania case) on its own motion. Second, the Secretary of State, not being a court would presumably not be qualified to adjust his own records. In Ohio the case is headed for the courts and the decision may or may not follow the Pennsylvania case with respect to these points of difference.

Non-Criminal Grounds for Forfeiture

Assuming that there is standing for challenging a non-profit corporation's right to exist, the question of grounds arises. The usual ones alleged are non-user and mis-user.¹⁶ Although it is perhaps a matter of little practical importance, the line between mis-user and non-user can be very blurred indeed in some cases. In the case of *State ex rel. Denu v. Rapid City Library Association*,¹⁷ the association was chartered to open a reading room in Rapid City and to furnish it with reading material. Originally the library was in fact maintained in Rapid City and there was a librarian who tended a collection of literature which was constantly being added to. Later the librarian was dropped and the books were left unguarded. Eventually the material which had not been stolen or lost was transferred to a state institution *one mile distant* from the heart of Rapid City.

¹³ *E.g.*, Purdon's Penna. Stat. Annot., Corporations, Sec. 2851-207.

¹⁴ Cleveland Plain Dealer, October 6, 1964.

¹⁵ See n. 11, *supra*.

¹⁶ C.J.S., Corporations, Secs. 1656 and 1663.

¹⁷ 32 S. D. 248, 142 N. W. 973 (1913).

The South Dakota Supreme Court held that forfeiture was indicated for failure to furnish the services called for in its charter. The problem with this case lies in the fact that some of the purposes provided for in the articles were in fact being carried out. That is, books were provided even though there was a long period in which fresh material was not added to the collection. Can it validly be said that the one mile difference in location was fatal to the purpose of the corporation? Finally, although the court made much of the absence of a librarian, such a functionary was not provided for in the articles. It would seem that the discussion was irrelevant. In justice to the court it should be noted that there was some evidence that the room of the association was used by another. It would appear, though, that a mere prohibition of the practice would suffice to correct that evil.¹⁸

Is the rule, then, that all of the powers and purposes of a corporation must be exercised? Many courts have held that the answer is, "No." The Texas charter of the *First Divine Association in America* provided, among other things, that the association would maintain nurses' quarters and a school. It did not do so, but it proceeded in doing what the court considered its major purpose, that of "preaching the gospel of the Divine Lord." Thus, the articles were not subject to forfeiture.¹⁹

While failure to carry out the purposes of the corporation is frequently linked to a mis-user because of diversion of assets, the mis-user is usually considered a separate ground. In the case of the *Kansas City Medical School*²⁰ the grounds merged almost indistinguishably. The school kept no records, was operated for private gain, sold diplomas, had incompetent students instructing other students, had no real four year program, and no hospital. For good measure, it was shown that the "students" never came into contact with a sick person. Understandably, the court in this and a similar case²¹ did not trifle with defining mis-user and non-user, but simply ordered ousters.

¹⁸ See, *State ex rel. Little v. Regents of University*, 55 Kan. 389, 40 P. 656 (1895).

¹⁹ *State v. First Divine Association in America*, 248 S. W. 2d 291 (Tex. 1952).

²⁰ *State ex rel. Otto v. Kansas City College of Medicine and Surgery*, 315 Mo. 101, 285 S. W. 980 (1926).

²¹ *State ex rel. Otto v. St. Louis College of Medicine and Surgery*, 317 Mo. 49, 295 S. W. 537 (1927).

Yet, mis-user need not be accompanied by a non-user or even a defeat of the purposes of the corporation. In an early Ohio case, a *Farmers' College* which was formed to give instruction in agriculture and to maintain a professorship of agriculture was found to be instructing females and offering a great many other courses which greatly diminished the importance of the agricultural department. While the court admitted that the enrollment of the females might be a mis-user (it did not decide), this did not in anyway defeat the purposes of the corporation, nor did the growth of departments other than agriculture. The existence of the mis-user was not ground for forfeiture although it might be for an injunction ousting the practice.²²

The same court was not so lenient with another college which some years later leased itself to an entrepreneur for \$180.00 per year. The lessee under the corporate charter was entitled to keep all receipts, and awarded degrees on the basis of other institutions' transcripts and the writing of a thesis. The question of the profit making aside, the court found that such awarding of degrees was a mis-user and justified ouster.²³

While the Court of Appeals for the District of Columbia was not faced with the question of ouster, since all that was asked for was an injunction, the question arose there in 1923. Here the *National Association of Certified Public Accountants* awarded "degrees" of C.P.A. Such a power was stated in its articles, but not in the statute under which its incorporation was effected. The court upheld the granting of an injunction against awarding degrees, but in its dictum went further and announced that such an abuse of the powers granted by statute was ground for forfeiture.²⁴ It should be noted that here there was no allegation that the association had failed to carry out the legitimate purposes authorized by the statute under which it was incorporated.

Non-Profit or Profit Corporation?

The problem of how to recognize a non-profit corporation has engaged the courts for some time. In Ohio, for instance, a so-called non-profit burial association was so rigged as to act pri-

²² *State v. Farmers' College*, 32 Ohio State 799 (1877).

²³ *State ex rel. Atty. Gen. v. Mount Hope College*, 63 Ohio State 341, 58 N. E. 799 (1900).

²⁴ *National Assn. of C. P. Accountants v. U. S.*, 292 F. 699 (D. C. App. 1923).

marily as a device by which a burial company could make contracts with people for their own funerals. On paper the association made mass contracts with the company, which then allowed a 20% discount from the price of the funeral chosen by the lucky members. Since the burial company was the "official undertaker" to the association and could determine its own prices for the chosen funeral, it was apparent that the non-profit corporation was admirably suited to serve the purposes of the burial company, as the 20% discount could be made to disappear by raising the list prices. This was strengthened by the fact that the trustees of the association were the same individuals as the officers and directors of the company. There were a number of other abuses, which except for the fact that no trustee elections were held, are not here relevant. The court ordered that elections of trustees be held, and apparently felt that these elections would cure the defect of close alliance with the company.²⁵

In a short opinion, a New York court held that an association whose ostensible purpose was to provide ambulances to the American and Canadian armies during the Second World War was really a profit making corporation. It did this from evidence that each solicitor was entitled to 40% of the membership fee paid by each person he solicited as a member.²⁶ The court was undoubtedly influenced by the rash of questionable war relief societies pursuing projects of doubtful utility. It left unsolved, however, an important question. Granted that under some circumstances 40% is too much to pay a solicitor, what is the proper measure of compensation? Many organizations do pay solicitors. It may be a quite necessary method of obtaining support for worthy causes. But that is another subject.

In the medical college cases in Missouri, and in other similar cases in other states,²⁷ a strong case was made out for forfeiture even independently of other abuses on the grounds that the earnings of the schools went into private pockets. In the *Mount Hope College* case,²⁸ the profit making was an element which the court thought justified forfeiture of the charter.

²⁵ State ex rel. Wachenheimer v. Toledo etc. Burial Assn., 18 Ohio Circ. Ct. Op. 233 (1906).

²⁶ Bennett, Atty. Gen. v. American-Canadian Ambulance Corps, Inc., 179 N. Y. Misc. 21, 37 N. Y. Supp. 2d 470 (1942).

²⁷ See n. 20 and 21 *supra*. See also, Independent Medical College v. Akin, Atty. Gen., 182 Ill. 274, 55 N. E. 345 (1899).

²⁸ See n. 23, *supra*.

Closely allied, but not identical to using the corporation as private property, is the question of wastage of assets of the corporation. In one case a society originally formed in the eighteenth century had for its purpose the support of a group of monk-like members of the Dunkard Sect. Eventually, the last of the monastic members died and there was no new recruiting. The corporation continued to exist, however, and over the years sold land belonging to it and gradually dispersed many of the assets through ways not made clear in the opinion. The result was that the court dissolved the corporation, stating that even though some assets were left to the corporation the wastage of some demonstrated that the organization had no valid purpose.²⁹

Anti-Social Activities

Out and out anti-social uses of the non-profit corporation are, of course, grounds for forfeiture. The courts take the position that these activities, being criminal, or quasi-criminal, are beyond the powers of the corporation and the corporation is charged with performing acts not within their charters. It would appear simpler to short cut the rulings and to make criminal activity *per se* punishable by forfeiture.

The cases show that the earlier non-profit corporations were charged primarily with evasion of the local option liquor laws by running grog shops.³⁰ Occasionally there would be an attempt to circumvent the laws against prize fighting.³¹ In any event, these cases are so few as to suggest that no one really cared about the circumvention.

Another kind of illegal activity was involved in *People v. White Circle League of America*.³² This case was connected with the constitutional case of *Beauharnais v. Illinois*³³ and was concerned with violation of the Illinois statute against group libel. After finding that the League was guilty of violating the law, the court stated the issue as "whether the persistent violation of a criminal law by a corporation amounts to the exercise of

²⁹ Commonwealth ex rel. Schnader, Atty. Gen. v. Seventh Day Baptists of Ephrata, 317 Penna. 358, 176 A. 17 (1935).

³⁰ E.g., State v. Easton Social, Literary and Musical Club, 73 Md. 97, 20 A. 783 (1840).

³¹ State on inf. of Wear v. Business Men's Athletic Club, 178 Mo. App. 548, 163 S. W. 901 (1914).

³² 408 Ill. 564, 97 N. E. 2d 811.

³³ 343 U. S. 250, 75 S. Ct. 725, 96 L. Ed. 919 (1951).

powers not conferred by law which justified the annulment of its charter³⁴ . . . ?” Without hesitation, the court answered its own question in the affirmative.

Communist Activities

A relatively new ground for attack on the franchise of a non-profit corporation is that its name appears on the subversive list of the Attorney General of the United States or on a list promulgated on the authority of a state board or commission. The tribulations of the *Yiddisher Kultur Farband* give some guide to the ways in which this will be handled by the courts. As pointed out above, the Supreme Court of Pennsylvania originally held that the attack, if any, must be brought by the Attorney General of the commonwealth.³⁵ Later the issue was presented by the Attorney General in a new case.³⁶ While the United States Attorney General's list was not introduced into the case, evidence was adduced to show that the organization was in fact organized for the purpose of carrying on Communist propaganda. However, before the court could meet the issue squarely, the Farband caved in and agreed to dissolve. The remainder of the litigation revolved around whether or not the group could handle its own dissolution.

In New York the question of the relevance of the Attorney General's list was squarely met. The *International Worker's Order* was attacked and, in support of the application for voiding its charter, the state Attorney General showed that the organization was on the national list of subversive organizations.³⁷ The Supreme Court, Special Term, held that mere listing as a subversive organization by the Attorney General of the United States, *ex parte*, is not ground for dissolution as the element of due process is lacking in such a unilateral action. The court held, however, that *proof* of Communist affiliation, coupled with a present danger of defrauding citizens, was sufficient to justify forfeiture of the franchise. Specifically, here, the danger lay in the fact that the assets of the corporation were kept liquid and

³⁴ N. 32, *supra*, p. 814. See also, Symposium on Group Defamation, 13 Clev-Mar. L. R. 1-117 (1964).

³⁵ *Sherman v. Yiddisher Kultur Farband*, 375 Penna. 108, 99 A. 2d 868 (1953).

³⁶ Commonwealth ex rel. *Truscott v. Yiddisher Kultur Farband*, 382 Penna. 553, 116 A. 2d 555 (1955).

³⁷ *Application of Bohlinger in re I. W. O.*, 106 N. Y. Supp. 2d 953 (1951).

the court felt that the state Attorney General was justified in feeling that this was to permit easy transfer of these funds to the Soviet Union. This opinion was affirmed by the Appellate Division of the Supreme Court.³⁸

The question whether the criminal activity, if such there be, is that of the corporation or of its agents also arises. In the liquor law evasion cases the question of disavowal by the corporation of the acts of the agents did not arise.³⁹ It did, however, come up in an early Alabama case where a society ostensibly for the raising of funds for the state museum was charged with conducting a thinly disguised lottery. Its defense was that its agents were disregarding instructions given to them. On its attempt to introduce evidence as to what its instructions actually were the state objected. The upper court ruled that despite its own skepticism the defendant was entitled to show that there was a difference between the activities of the corporation and those of its agents.⁴⁰

In the New York case already referred to above, the *International Worker's Order* attempted to separate itself from the officers and directors.⁴¹ It was shown by the state that, of ten officers six were members of the Communist Party, of twenty-two members of the executive committee 16 were members of the party, and the corporation conducted a distribution of literature favorable to the Communist Party.

The New York Supreme Court, after making the point that this kind of affiliation was clearly equivalent to corporate action which could not be avoided by simply pointing to the agents as the solely responsible parties, then called attention to the Smith Act as defining the criminal nature of the activities. Dropping that aspect, the court went on in the narrower field and held that since the corporation was acting for political ends "whether Democratic, Republican, or Communist" it was exceeding its charter rights. Further, since it was in fact organized to promote the Communist cause it had perpetrated a fraud on the state by its application for a charter as a fraternal benefit society. It was, thus, a fit subject for a judicial determination of forfeiture.

³⁸ 113 N. Y. Supp. 2d 755 (1951).

³⁹ See n. 30, *supra*.

⁴⁰ *Tuscaloosa Scientific and Art Assn. v. State ex rel. Murphy*, 58 Ala. 54 (1877).

⁴¹ N. 33, *supra*.

It is interesting to note that in Mr. Justice Musmanno's dissent to the opinion of the court in the first *Yiddisher Kultur Farband* case, he laid great stress on the element of Communist affiliation.⁴² He felt that it would be sufficient to forfeit the charter. While he spoke as a dissenter, it does not follow that the court would not go along with him in a proper case. Here the issue before the court was not whether forfeiture was justified, but rather on the procedural course to take. While it is unlikely that the court would adopt the vigorous language of the dissent in that case, they probably would have adopted the principle in the second case had not the Farband consented to dissolution.

As in the case of business corporations, non-profits are subject to dissolution when the carrying out of their objects becomes impossible by reason of a deadlock among those in control of the group.⁴³ In *Olechny v. Theodus Kosciuszko Society of Thompsonville, Conn., Inc.*, an ecclesiastical schism resulted in a deadlocked association. Originally founded by members of the Roman Catholic Church, the society had a by-law by which five black balls would automatically exclude any prospective member. All apparently went well until the Polish National Catholic Church was formed and about one-third of the members of the society decided to join the new church. The majority of the members attempted to fine the dissenters who did not appear at the Roman Catholic Sacraments. The minority retaliated by blackballing all proposed members who were Roman Catholics. When the majority took the same action against the adherents of the Polish National Church, suit was brought for dissolution, alleging that it was impossible to carry out the group purpose. Pending the hearing of the suit, the majority (Roman Catholic) amended the by-laws to eliminate the blackball provision and to limit new membership to Roman Catholics. The lower court held that such changes did not cure the impossibility to carry on. The Supreme Court of Errors of Connecticut, by a 5-3 decision, ruled otherwise. They reasoned that since the by-laws were amendable by a majority vote, the outlawing of the blackball was within the power of the group. Similarly, confining new membership to Roman Catholics was permissible. Some crumb of comfort was available to the Polish

⁴² N. 31, *supra*.

⁴³ 128 Conn. 534, 24 A. 2d 249 (1942).

National group in that the court found that fines were beyond the power of the corporation.

This case could be taken as illustrative of the reluctance of the courts to order forfeiture. It can, however, be criticised on the grounds that however nice the legalisms, the Polish National group would find that all new members were opposed to their interests. In effect, the Roman Church group could recruit new members freely while the smaller group could not. Thus, the organization was reformed to penalized dissenters from an outside organization, *i.e.*, the Roman Catholic Church, this in the interests of finding no deadlock.

Conclusion

From the foregoing the strong resemblance to the law governing corporations for profit will be noticed. The few differences which exist, such as that of the "remainderman," arise from the nature of the non-profit corporation.

All in all the cases on forfeiture of non-profit charters are not common. When the number of charters which have been granted is compared with the number of forfeitures it is apparent that one of two situations prevails. Either the organizations and their operators are extremely law abiding or they are simply not being supervised with enough vigor by those charged with keeping them honest.