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Agents Without Principals: The Economic Convergence of the Nonprofit and For-Profit Organizational Forms

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> Let me tell you about the rich.
> They are different from you and me.
> —F. Scott Fitzgerald[1]

> Yes, they have more money.
> —Ernest Hemingway[2]

It is always startling when a distinction long believed to be a difference of kind turns out to be a difference of degree. Many of our attitudes, as well as our laws, about charitable enterprise derive from our belief that nonprofit organizations are "different" from business organizations. As a result of their unique social value, we grant nonprofit organizations subsidies that we withhold from proprietary enterprises. For example, federal income tax law exempts the income earned by nonprofit hospitals while taxing the income earned from identical procedures conducted by proprietary hospitals.[3] Recent years have brought increasing criticism of tax and other subsidies extended to the nonprofit sector.[4] But we cannot really understand whether, and which, subsidies are appropriate until we examine the premise. Thus, this Article raises the antecedent question: are nonprofits different?

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1. F. SCOTT FITZGERALD, *The Rich Boy* (1926), *in* BABYLON REVISITED AND OTHER STORIES 152 (1960).

2. F. SCOTT FITZGERALD, THE CRACK-UP 125 n.* (1945) (notebook entry of "Ernest's wisecrack").

3. *See* I.R.C. § 501(c)(3) (1994).

4. *See, e.g.*, John D. Colombo, *Why Is Harvard Tax Exempt? (And Other Mysteries of Tax Exemption for Private Educational Institutions)*, 35 ARIZ. L. REV. 841 (1993).

This question can be explored from a variety of perspectives—legal, economic, historical, political, psychological, religious, and sociological.[5] One might expect the economic account to be the simplest, and least controversial. Surprisingly, however, the accepted economic account of organizational form explains very little about the differences between nonprofits and for-profits. In many ways, all firms, nonprofit and for-profit, bear more resemblance to each other than their organizational differences suggest. Because all firms operate through people, firms arise and behave similarly in response to economic forces. These economic issues are so rich that they merit independent study.

Even a casual observer knows that a proprietary business has "owners" and a nonprofit does not. Indeed, the economics literature rests its conception of the nonprofit sector on the centuries-old rule, imposed by law,[6] that forbids a charity from distributing profits to owners. Indelibly named fifteen years ago by economist and law professor Henry Hansmann,[7] this "nondistribution constraint"[8] constitutes, to its admirers,

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5. *See generally* Evelyn Brody, Institutional Dissonance in the Nonprofit Sector (Mar. 10, 1996) (unpublished manuscript, on file with the *New York Law School Law Review*) (exploring whether nonprofits are different than for-profit entities from some of these various perspectives).

6. The Statute of Charitable Uses, 43 Eliz., ch. 4 (1601), represents the first English attempt to enforce this common-law rule by legislation.

7. Henry Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835, 838 (1980) [hereinafter Hansmann, *Role of Nonprofit Enterprise*].

8. Professor Hansmann describes nonprofits and the nondistribution constraint in this way:

> A nonprofit organization is, in essence, an organization that is barred from distributing its net earnings, if any, to individuals who exercise control over it, such as members, officers, directors, or trustees. By "net earnings" I mean here pure profits—that is, earnings in excess of the amount needed to pay for services rendered to their organization; in general, a nonprofit is free to pay reasonable compensation to any person for labor or capital that he provides whether or not that person exercises some control over the organization. It should be noted that a nonprofit organization is not barred from earning a profit. . . . It is only the distribution of the profits that is prohibited. . . .
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> Most nonprofits of any significance are incorporated. For these organizations, the nondistribution constraint is imposed, either explicitly or implicitly, as a condition under which the organization receives its corporate charter. . . .
>
> In the corporation law of some states, the nondistribution constraint is accompanied or replaced by a simple statement to the effect that the organization must not be formed or operated for the purpose of pecuniary gain.

Id. at 838-39; *see also* CAL. CORP. CODE § 5410 (West 1991 & Supp.) ("No corporation shall make any distribution."); N.Y. NOT-FOR-PROFIT CORP. LAW § 102(a)(5)

the elixir of life for the nonprofit sector. According to this school, the constraint against distributing profits both explains the existence of the nonprofit sector and keeps it honest, ensuring the dedication of assets and effort towards performing good deeds.[9] Professor Hansmann's compelling construct has even caught the attention of the United States Supreme Court.[10]

The nondistribution constraint theory, however, is circular. Because the public cannot judge quality, the theory posits,[11] the public creates

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(McKinney 1970) ("'Corporation' or 'domestic corporation' means a corporation . . . (2) no part of the assets, income or profit of which is distributable to, or inures to the benefit of, its members, directors or officers except to the extent permitted under this statute."); REV. MODEL NONPROFIT CORP. ACT § 13.01 (1987).

9. *See* Hansmann, *Role of Nonprofit Enterprise*, *supra* note 7, at 835-45; Henry Hansmann, *Reforming Nonprofit Corporation Law*, 129 U. PA. L. REV. 497, 504-09 (1981) [hereinafter Hansmann, *Reforming Nonprofit Corporation Law*].

10. Austin v. Michigan Chamber of Commerce, 494 U.S. 652, 675 n.6 (1990) (Brennan, J., concurring) (citations to Hansmann omitted):

> The leading theory of nonprofit enterprises holds that the rationale for use of the nonprofit form lies chiefly in the so-called "non-distribution constraint." . . . The nondistribution constraint helps overcome contractual failure in situations where the activities of the corporation are difficult to monitor, by removing the "profit motive" and assuring those who contribute to, and contract with, the corporation that the nonprofit's managers will not exploit informational deficiencies to pursue their own private interests. Hence, J[ustice] K[ennedy]'s proposed reliance on a nonprofit's donors to monitor and police the corporation's activities overlooks the *raison d'être* of the nonprofit form.

11. Professor Hansmann describes three situations in which the public or the patron of a firm would prefer to deal with a nonprofit: first, third-party payers, like persons making donations to the American Red Cross for disaster relief; second, public goods, like public monuments or scientific research; and, third, complex personal services, like hospital care or education. Hansmann, *Reforming Nonprofit Corporation Law*, *supra* note 9, at 504-09. In each of these cases Hansmann sees an information asymmetry because the payor/donor cannot effectively judge the quality of the output of various services. In the first example, the donor will probably be unable to determine if the money is actually being spent on disaster relief because that relief could be offered far from the donor, say in a foreign country. *Id.* at 505. In the second example, the donor may be tempted not to make a donation at all and instead "free-ride" on the other contributions, because the eventual output will be a "public good"; in addition, donors will need assurances that their money is being used for the purposes (scientific research, public monument) for which the donor gave. *Id.* at 505-06. In the third example, the patient in a hospital may not know, because of lack of expertise, what quality or type of care is appropriate. *Id.* at 506.

In each of these examples, Hansmann argues, the nondistribution constraint solves the information asymmetry by creating a bond of trustworthiness between the nonprofit firm and the patron; the money spent by a nonprofit will be spent for a particular

nonprofits whose output quality cannot be judged. Worse, if the public simply looks to nonprofit status as a signal of trustworthiness, creating this legal form of organization bestows a "halo" on any nonprofit organization regardless of merit. Finally, even if the nondistribution constraint ensures that the sector is worthy, how does it help the public choose between competing nonprofits?

The more we examine the protean nondistribution constraint, the less it appears capable of explaining *how* a nonprofit organization does "good"—much less "better." At the same time, as we compare nonprofit organizations with their unabashedly profit-distributing proprietary cousins, we discover that business firms exhibit many of the traits of a firm without shareholders. Firms in both sectors look a great deal alike because both the nondistribution constraint in the nonprofit sector and the theory of profit-maximization in the proprietary sector often fail to deliver on their promises.[12]

Running throughout this article is the economic theme of the "principal-agent problem": Who decides to form a firm as either for-profit or nonprofit, and decides what its goals are? Who decides how the entity operates? To whom is the firm accountable? Decisional authority travels throughout the network of relationships that constitute the firm and its environment. In theory, at the goal-setting level, business firms are profit-maximizers while nonprofits maximize either quality or quantity of output. But in practice, because of internal and external constraints, business corporations are less purely profit-driven than we think, and working for a nonprofit corporation is more like any other job. Various economic forces—like resource dependency, institutional isomorphism, and organizational slack—mold nonprofits and for-profits into similar configurations with similar problems.

My economic account might appear to be a story without a heart. What about the vast numbers of people who donate time and money to nonprofit organizations because they believe in serving society? To question the economic uniqueness of the nonprofit form, however, is not to slight the valuable services provided in the nonprofit sector and the altruism expressed by many affiliated with it.[13] Rather, I examine the extent to which the organizational legal form—nonprofit with a nondistribution constraint—affects motivations and operations. After all,

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purpose, and not converted to personal gain. *Id.*

12. The paradox of profit seeking is described by Louis Putterman: "[W]hereas the existence of a residual claimant and holder of alienation rights is regarded as the best guarantor of efficient resource use where conventional goods are concerned, it is the absence of such an agent that is called for [in the case of trust goods]." Louis Putterman, *Ownership and the Nature of the Firm*, 17 J. COMP. ECON. 243, 256 (1993).

13. *See* Brody, *supra* note 5.

someone who desires, say, to care for young children could work in a proprietary day-care center as well as in a nonprofit (or, indeed, governmental) day-care center. For such a person, the nondistribution constraint might be a constraint but it would not be a *binding* constraint.

In the end, the same economic force motivates nonprofit firms as for-profit firms: the desire for a reputation as a worthy recipient of future trade, be it donations, purchase of services, government contracts, or labor. Each of the nonprofit's constituents has its own goals, which can be furthered either by exercising "voice" (imposing conditions on the donation or contract) or "exit" rights (withholding future donations or dealings). Similar sources of resource dependency can be found in the for-profit sector: shareholders, customers, and workers have their own "voice" and "exit" rights. Accordingly, this Article also examines whether the resources unique to the nonprofit sector—donors of money and time—can be relied on to ensure greater accountability. However, "accountability" is a double-edged sword: whether society *wants* to privilege donors with shareholder-like control is a normative question.

This Article consists of four parts. Part I provides an overview of the nondistribution constraint, and summarizes its inherent problems and limitations: From an economic perspective, the nondistribution constraint does not effectively distinguish between a nonprofit and its for-profit counterpart or between one nonprofit and another. Parts II, III, and IV set forth a description of the three major forces that lead to organizational conformity and the convergence of the proprietary and the nonprofit sectors. Part II examines why firms form: a "demand-side" approach looks at who wants to deal with firms, and a "supply-side" approach compares the economic motivations and constraints faced by founders of firms. Part III peers inside the "black box" of the firm, comparing proprietary and nonprofit management. Finally, Part IV examines how firms adapt to dependency on key constituents both inside and outside the organization. This part also considers whether donors and volunteers provide increased nonprofit accountability. Here, however, we recall that the nonprofit sector as a whole derives less than one-third of its revenue from donations, and few nonprofits depend on a single or small number of donors. Thus, the relationship between non-profits and their donors again resembles the relationship between large for-profits and their shareholders. Given the general economic convergence of the two sectors, the Article concludes by suggesting that unless nonprofits can more sharply distinguish themselves from for-profits on other grounds, society might prefer to subsidize charitable and other social outputs produced by all organizations rather than subsidize nonprofits based on their organizational form.

I. Overview

To economists beginning with Ronald Coase in 1937,[14] all firms (nonprofit, proprietary, or even governmental) exist to solve the problem that has come to be called "transaction costs." Think of the "make or buy" dilemma. If, for example, a newspaper publisher can cheaply and reliably contract with paper suppliers, the publisher will simply buy this input; but if the demand for paper fluctuates wildly, and the publisher and suppliers cannot draft a contract that will anticipate all possible opportunistic behavior by each other, the publisher might be better off buying a paper producer.[15] When contracts fail, firms form.

To transaction-cost economists, nonprofit firms similarly solve a "contract failure." Professor Hansmann argues that the existence of nonprofits stems from information asymmetry between the charity and the patron. That patron might be a donor, making a gift to aid a beneficiary the donor never sees;[16] alternatively, due to lack of expertise, the patron might be a client, such as a hospital patient, who cannot judge the quality of services provided.[17] The nonprofit organization delivers these "trust goods," the production of which the donor or patron cannot monitor.[18] Without the nondistribution constraint ensuring, in theory, that the assets will be used for a particular charitable purpose and not converted to personal gain, these important trust goods might never be supplied.

Although using a firm instead of contracts solves one problem, it creates another. We are still dealing with the world of real people. Once we interpose a nonprofit firm between the patron and the beneficiary, we enter the realm of the "principal-agent problem." Agency costs are the heart of the maxim: "If you want something done right, you have to do it yourself." To an economist, agency costs arise because the agent simply does not have the same incentives as the principal. Agency costs include, among other things, the principal's costs of monitoring the agent (against misunderstanding, shirking, and even theft), and the agent's cost

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14. Ronald Coase, *The Nature of the Firm*, *reprinted in* R.H. COASE, THE FIRM, THE MARKET, AND THE LAW 33 (1988).

15. *See generally* OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM (1985) [hereinafter WILLIAMSON, ECONOMIC INSTITUTIONS] (particularly chapters 4 and 5 on vertical integration).

16. Hansmann, *Role of Nonprofit Enterprise*, *supra* note 7, at 846-47.

17. *Id.* at 866; *see also* Hansmann, *Reforming Nonprofit Corporation Law*, *supra* note 9; Henry Hansmann, *Economic Theories of Nonprofit Organization* [hereinafter Hansmann, *Economic Theories of Nonprofit Organization*], *in* THE NONPROFIT SECTOR: A RESEARCH HANDBOOK 27 (Walter W. Powell ed., 1987) [this collection hereinafter cited as THE NONPROFIT SECTOR]; *supra* note 11; discussion *infra* part II.

18. *See* BURTON A. WEISBROD, THE NONPROFIT ECONOMY 60 (1988).

of bonding (such as accepting low initial wages to back up the promised performance).[19]

To Professor Hansmann, the nondistribution constraint solves the principal-agent problem as well. Under his theory, the promise not to distribute profits functions as a "bond" to the public that the charity is more trustworthy than a proprietary enterprise in meeting the needs of donors or in providing clients with services whose quality cannot be judged.[20] Moreover, this bond substitutes for the monitoring that would otherwise have to be done by donor or client, thus avoiding additional monitoring costs or even the risk that charitable activity could not be carried out at all.

While the theory is initially compelling, the nondistribution constraint cannot carry this much weight. "Trustworthiness" is a device that people adopt in the face of uncertainty, but the question of uncertainty in the nonprofit firm is actually quite complicated. The nondistribution constraint cannot alone create trust; after all, the public sector also functions under a nondistribution constraint, but many people do not trust the government to use its resources wisely.

First, there might be information uncertainty on both sides. Just as the patron may be unable to judge the quality of a particular service provided by the nonprofit, the nonprofit itself may not be able to make accurate judgments about the quality of services it is providing. For example, neither a hospital patient nor the hospital might know the best action to take, particularly when balancing (or trading off) quality and costs (although, of course, the hospital likely knows more than the patient).[21]

Second, in a case of information asymmetry, trust cannot alone solve the firm's *internal* agency costs. Even assuming the hospital knows the optimal care to provide, how does the hospital solve the principal-agent problem with its own employees? What ensures that the hospital effectively monitors its employees? While the nondistribution constraint may bar direct payments to insiders, it does not suffice to ensure that the charity will spend its money in any particular way. The nondistribution constraint is a negative constraint: it tells the nonprofit what it cannot do with its resources, rather than what it must do with them.

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19. *See generally* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

20. *See supra* note 11.

21. A nonprofit hospital is a peculiar case to illustrate the trustworthiness of the nonprofit sector; after all, the patron's broker into the hospital, and the person who determines most of the patient's care, is the doctor, who is usually a self-employed, proprietary agent.

Indeed, while the nondistribution constraint might convince the patron that the nonprofit is more trustworthy than a for-profit in situations of opportunistic behavior, the nonprofit could be even less trustworthy than proprietary entities in avoiding inefficient expenditures. The costs of nonprofit trustworthiness might be higher than the profits a proprietary enterprise would generate and distribute to its owners. In these situations, the nondistribution constraint is not only unnecessary but wasteful.

We are beginning to see tensions between organizational constraints and efficiency tools in traditional nonprofit industries where proprietary enterprises have entered. For example, proprietary hospitals sometimes base compensation on the profits of the enterprise, both to best motivate workers and to preserve the enterprise from undue risk.[22] Profits-based compensation, of course, expressly violates the nondistribution constraint.[23]

Finally, and perhaps of most practical importance, assuming the nondistribution constraint can explain why the nonprofit sector as a whole should be more trustworthy, it cannot explain how individual nonprofits differentiate themselves, and how the public should choose between *competing* nonprofits. Increasingly, the services provided by nonprofits are brokered by intermediaries (such as insurance companies and HMOs) or the government (such as Medicare and Medicaid).[24] While individual

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22. *See* Mark A. Hall, *Institutional Control of Physician Behavior: Legal Barriers to Health Care Cost Containment*, 137 U. PA. L. REV. 431, 486-88 (1988) (discussing hospital efficiency bonus plans).

23. Nonprofits are pushing this restriction. Consider the incentive compensation plan adopted by a nonprofit trade association, whose "board members had successfully used incentive compensation in their businesses." Toby Mack, *Putting Incentive Compensation to Work*, ASS'N MGMT., Dec. 1993, at 38, 38. Mack describes their motives in decidedly equity-like terms: "[O]ne of the underlying premises of our plan is that when times are good, the people who make it happen share the goodies. In leaner times, we all share the pain. It's part of being a stakeholder." *Id.* at 44, 103. While an association might appear to produce nonquantifiable services, this organization depended on the sale of products, programs, and business services for over two-thirds of its revenue. *Id.* at 40. Incentive compensation could thus be based on growth in membership, gross revenue (from membership, conventions and publication sales), and net income (from the foregoing, plus cost savings from budget). *Id.* at 43. The organization took particular care to set reasonable projections: "If leadership suspects that budget targets were set low to produce higher incentive payouts, the trust on which elected leadership accepts the incentive compensation program for staff will be broken." *Id.*

24. *See, e.g.*, Paul A. Pautler & Michael G. Vita, *Hospital Market Structure, Hospital Competition, and Consumer Welfare: What Can the Evidence Tell Us?*, 10 J. CONTEMP. HEALTH L. & POL'Y 117, 164 (1994) (discussing the brokering of services by preferred provider organizations); Theodore N. McDowell, Comment, *The Medicare-*

clients might lack information and the incentive to investigate providers, these intermediaries do not. Perhaps the proper nonprofit role should be information monitoring—that is, monitoring the quality of a for-profit firm rather than directly providing traditional "nonprofit" services.[25]

Instead of searching for a "trustworthy" organizational form, we can ask the more complex question, "To whom is the nonprofit accountable?" In a business firm, "accountability" is the mechanism by which the corporate board and management (the "agents") answer to the shareholders (the "principals").[26] Accountability also exists in nonbusiness principal-agent relationships: for example, politicians answer to the electorate. In the nonprofit sector, however, accountability raises difficult questions because, despite the hypothesis of Professor Hansmann and others, in most nonprofits there is no clear category of principals. Under law, the nonprofit firm is not the agent of a particular donor or client or beneficiary.[27] As a result, most state nonprofit laws, perhaps without intending to, create agents without principals.

To some degree accountability is a normative issue, whose resolution depends on one's view of the proper role of the nonprofit sector in society and the extent to which it should be left alone. If we accept the nonprofit sector as "private," as it is under law, then does accountability simply become a function of answering to whoever holds the purse? And if no

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Medicaid Anti-Fraud System, 36 EMORY L.J. 691, 707 (1987) (discussing the brokering of services by health maintenance organizations).

25. Even the proprietary sector uses devices to overcome information asymmetry and build "trust," such as name brands, warranties, reputation, and, most recently, ISO registration. *See, e.g.*, GREG HUTCHINS, THE ISO 9000 IMPLEMENTATION MANUAL (1994) (stating that to assure customers of quality, companies can voluntarily register for third-party certification based on uniform standards promulgated by the International Organization for Standards).

26. I use the terms "principal" and "agent" in their economic senses. Legally, the directors are agents of the *corporation*. *See generally* RESTATEMENT (SECOND) OF AGENCY § 14C (1957).

27. New York nonprofit corporation law provides that a charitable corporation holds full ownership rights in donated property and is not deemed a trustee. *See* N.Y. NOT-FOR-PROFIT CORP. LAW § 513(a) (McKinney 1970 & Supp. 1996) ("[A] corporation shall hold full ownership rights in any assets . . . that may be given, granted, bequeathed or devised to or otherwise vested in such corporation . . . and shall not be deemed a trustee of an express trust of such assets."). However, if a gift is earmarked for a specific purpose, the governing board of the charitable corporation is obligated to use the gift for that purpose. *See id.* § 513(b). California law provides that a charitable corporation holds its assets in trust for the express purposes enumerated in the corporation's articles of incorporation. *See* Queen of Angels Hosp. v. Younger, 66 Cal. App. 3d 359, 365 (1977). However, if a donor expressly declares a contribution for a specific purpose, the corporation is obligated to follow that specific purpose. *Id.*

major donors exist, as is commonly the case, is the nonprofit accountable to no one?

As a legal matter, of course, nonprofit organizations are not "owned." However, economic theory fragments ownership into three characteristics: the right to profits, the right to control and utilize assets, and the right to alienate.[28] A firm that cannot distribute profits is not the same thing as a firm without profits. Moreover, a firm without shareholders is not a firm without controllers. Finally, the "absence of alienable residual claims in nonprofits does not mean that residual risk is not borne."[29] Because no individual may claim a nonprofit's surplus, nor can anyone sell interests in a nonprofit, control over nonprofit assets and operations becomes the strongest rights that exist in such an organization.

Just as it does for business corporations, the law grants plenary authority to the nonprofit board of directors to manage the affairs of a nonprofit corporation. Those who govern a nonprofit firm can exercise discretion to maximize different goals. Because of the presumed information asymmetry between the nonprofit and the patrons, the nondistribution constraint alone cannot assure the patron that his donation (or fee) will achieve his intent. If the public cannot tell what is happening inside the nonprofit, the patron cannot know whether the nonprofit is using his or her money to maximize the quality of the charity's services, to reduce their cost to the public, to augment pecuniary and nonpecuniary compensation of the charity's workers, or even to save for the benefit of future patrons.[30]

It would then seem that, as a legal matter, control carried out without the oversight of shareholders produces a board of directors fundamentally different from the board of a for-profit corporation. In an attempt to substitute for the absent shareholders, the law, somewhat awkwardly, still imposes the fiduciary duties of loyalty and care on nonprofit boards. But because of the lack of classes of private persons with standing to sue,[31]

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28. *See, e.g.*, Putterman, *supra* note 12, at 245; *see also* Armen Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777 (1972).

29. Eugene F. Fama & Michael C. Jensen, *Agency Problems and Residual Claims*, 26 J.L. & ECON. 327, 342 (1983) [hereinafter Fama & Jensen, *Agency Problems*].

30. Professor Hansmann recognizes that the nondistribution constraint must be enforced in order to be effective, Hansmann, *Role of Nonprofit Enterprise*, *supra* note 7, at 873-76, but he does not focus on the larger misspending and waste that can occur without rising to the level of profit distribution.

31. *See* Mary G. Blasko et al., *Standing to Sue in the Charitable Sector*, 28 U.S.F. L. REV. 37 (1993).

in many ways this fiduciary duty is really a legal obligation without a legal sanction.[32]

Ironically, though, the situation is little better on the proprietary side. The "separation of ownership and control" in large business corporations leads to their own "principal-agent problem"—how the shareholders (the principals) can ensure that the board members (the agents) act in their interests. Granted, business boards are subject to additional disciplines, such as stock markets that continuously value corporate performance. Nevertheless, the striking legal difference between the for-profit model and the nonprofit model would be more apparent than real if, in practicality, the nonprofits' untethered, self-perpetuating board structure were not unique to the nonprofit sector. In reality, because shareholders usually elect directors from a slate nominated by the current directors, the board of a publicly held corporation faces much the same replication imperative as a self-perpetuating nonprofit board.

Once we peer into the black box of the firm, nonprofit or proprietary, we find a second "principal-agent problem"—the relationship between the board and its officers.[33] By law, in both types of corporations, the board of directors controls the organization by setting policy for the officers who conduct the day-to-day management. But board members in both types of corporations are part-timers, often volunteers, serving for a variety of altruistic, social, and even selfish reasons, and are not likely to be technically skilled in the "business" of the enterprise.[34] In contrast to board members, many chief executive officers, in both types of corporations, are often more energetic, dominating, "true believers," and technically proficient.

From reading the newspapers, one could almost model a "hubristic cost" to nonprofit operations. When a charismatic charitable leader

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32. As Henry Hansmann observed: "Although the prohibition on distribution of profits is more or less clearly embodied in the nonprofit corporation law of nearly all the states, most states in fact make little or no effort to enforce this prohibition." Hansmann, *Role of Nonprofit Enterprise*, *supra* note 7, at 873. *See also* HARRIET BOGRAD, THE ROLE OF STATE ATTORNEYS GENERAL IN RELATION TO TROUBLED NONPROFITS 12 (Yale Univ. Program on Nonprofit Organizations Working Paper No. 206, Aug. 1994); Office of the Ohio Attorney General, *The Status of State Regulation of Charitable Trusts, Foundation, and Solicitations*, 5 COMM'N ON PRIVATE PHILANTHROPY AND PUBLIC NEEDS, RESEARCH PAPERS 2705 (U.S. Treas. Dep't 1977). Perceiving weak state enforcement, some call for increased IRS action on tax-exempt organizations, and tighter rules to reach more (and more broadly defined) cases of insider benefit. *See, e.g.*, Kenneth L. Karst, *The Efficiency of the Charitable Dollar: An Unfulfilled State Responsibility*, 73 HARV. L. REV. 433 (1960).

33. Succeeding agency problems run all the way down the corporate hierarchy.

34. I am speaking here of the "outside" directors, that is, those who are not also officers of the organization.

stumbles, the shockwave can topple the charity and ripple throughout the nonprofit sector.[35] The public thrills to the downfall of Jim Bakker,[36] Jimmy Swaggart,[37] Covenant House's Father Ritter,[38] and United Way director William Aramony.[39] However, we also find that in the business sector "the typical chief executive has long seen himself as John Wayne in a suit: macho, visionary, and totally in control."[40] And it is not just company founders, such as the legendary Henry Ford.[41] In practice, the power relationship between a business chief executive and the board of directors often matches that seen in a nonprofit organization. Indeed, economists and management scholars have long recognized that the top officers of business corporations in practice often control the selection of board nominees, much as we find in the nonprofit sector.

While the press focuses on the most notorious examples of nonprofit leaders actually raiding the till, many more subtle forms of "rent seeking" occur, all perfectly legal (if undesirable). In the end, as Melvin Eisenberg observes of the business sector, "it may well be that the most important contemporary problem concerning managerial accountability is not the manager who consciously violates his trust, but the manager who does his best but whose best is not good enough."[42] What factors operate as a check when nonprofit management is incompetent, lazy, or socially wasteful?

Managers, whether nonprofit or proprietary, actually control a very small portion of their firm's environment.[43] "Resource dependency"[44]

35. *See generally* Brody, *supra* note 5 (discussing the public's expectations for a "pure" nonprofit sector, despite the real pressures operating on nonprofits).

36. *See Former Leader of PTL Ministry Is Found Liable for $130 Million*, N.Y. TIMES, Dec. 15, 1990, § 1, at 12 (discussing the fraud case against Jim Bakker, the former head of the PTL Ministry).

37. *See* Peter Applebome, *Swaggart's Troubles Show Tension of Passion and Power in TV Evangelism*, N.Y. TIMES, Feb. 28, 1988, § 1, at 30.

38. Rayna Skolnik, *Rebuilding Trust: Nonprofits Act to Boost Reputations*, PUB. REL. J., Sept. 1993, at 29, 31-32.

39. *See* David Shenk, *Board Stiffs: How William Gates and Paul Tagliabue Helped William Aramony Bilk America*, WASH. MONTHLY, May 1992, at 9.

40. Matthew Bishop, *A Survey of Corporate Governance*, ECONOMIST, Jan. 29, 1994, at 13, 14 (specially paginated section appearing after page 58).

41. *See* Dodge v. Ford Motors, 170 N.W. 668 (Mich. 1919) (describing the unsuccessful attempt by minority shareholders of Ford Motors to reverse Henry Ford's decision to spend corporate funds as he determined).

42. Melvin A. Eisenberg, *New Modes of Discourse in the Corporate Law Literature*, 52 GEO. WASH. L. REV. 582, 590 (1984).

43. *See generally* JEFFREY PFEFFER & GERALD R. SALANCIK, THE EXTERNAL CONTROL OF ORGANIZATIONS: A RESOURCE DEPENDENCE PERSPECTIVE (1978).

affects both the policy and operations of the nonprofit. Nonprofits in the same field compete for directors, donations, government contracts/grants, employees, volunteers, and clientele.[45] Nonprofits protect their turf and lobby for greater autonomy and less regulation.[46] Nonprofits, on occasion, sell their name to the highest corporate bidder.[47] "Organizations compete not just for resources and customers, but for political power and institutional legitimacy, for social as well as economic fitness."[48] Nonprofits, in short, struggle to survive and to gratify their goals, just like every other organization.[49]

Similarly, business corporations must attract resources, such as employees, suppliers, creditors, government contracts, and customers. Thus, market competition among nonprofits for these factors of production and demand should help weed out the performing nonprofits from the nonperformers. But if efficient use of these constituents is the standard we apply in holding the nonprofit accountable, then why are business corporations also not accountable to them, rather than accountable only to their shareholders?

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44. Resource dependency refers to external constraints upon an organization, such as elements relating to input supplies and distribution channels, which an organization will attempt to manage or control. *See* PFEFFER & SALANCIK, *supra* note 43; Henry N. Butler & Barry D. Baysinger, *Vertical Restraints of Trade as Contractual Integration: A Synthesis of Relational Contracting Theory, Transaction-Cost Economics, and Organizational Theory*, 32 EMORY L.J. 1009, 1046-47 (1983).

45. *See, e.g.*, WEISBROD, *supra* note 18, at 3-4. Professor Weisbrod first collected his nonprofit ideas in THE VOLUNTARY NONPROFIT SECTOR (1977). *See also* John A. Byrne, *Profiting from the Nonprofits*, BUS. WK., Mar. 26, 1990, at 66, 67 (cover story) (noting "increasing competition from a new generation of social entrepreneurs attacking such problems as AIDS, Alzheimer's disease, child abuse, and drunk driving").

46. *See generally* J. Craig Jenkins, *Nonprofit Organizations and Policy Advocacy*, *in* THE NONPROFIT SECTOR, *supra* note 17, at 296.

47. *See, e.g.*, Maria Mallory, *The Cola Wars Go to College*, BUS. WK., Sept. 19, 1994, at 42, 42 (discussing the $10 million, 10-year contract giving the Coca-Cola Company exclusive rights to the soft-drink market on Rutgers University campuses; a $14 million, 10-year pact between the Pennsylvania State University and Pepsi-Co started the trend in 1992).

48. Paul J. DiMaggio & Walter W. Powell, *The Iron Cage Revisited: Institutional Isomorphism and Collective Rationality in Organizational Fields* (1983) [hereinafter DiMaggio & Powell, *The Iron Cage Revisited*], *reprinted in* THE NEW INSTITUTIONALISM IN ORGANIZATIONAL ANALYSIS at 63, 66 (Walter W. Powell & Paul J. DiMaggio eds., 1991) [this collection hereinafter cited as THE NEW INSTITUTIONALISM].

49. *See generally* Richard Steinberg, *Nonprofit Organizations and the Market*, *in* THE NONPROFIT SECTOR, *supra* note 17, at 118, 118; *see also* HOWARD E. ALDRICH, ORGANIZATIONS AND ENVIRONMENTS 265 (1979) ("The major factors that organizations must take account of in their environments are other organizations.").

We thus should ask whether the resources unique to the nonprofit sector—those people who donate money and time—can and do substitute for the equity holders in a business corporation. First, perhaps surprising to the modern reader, few nonprofits actually rely on donations for the bulk of their support: for the nonprofit sector as a whole, just over one-fourth of gross receipts come from cash donations.[50] In many cases, no donor or group of donors effectively influences nonprofit policy. At the other extreme, in nonprofits where donations dominate, privileging donors with accountability rights loops back into another market failure, the "separation of supply from demand"—if by "demand" we mean the beneficiary's demand rather than the donor's. A nonprofit organization dependent on a concentrated or organized donor base might be forced to make poor choices. In a business corporation, shareholders presumably want one thing—money. If the public's taste turns to other products, the business sector will shift production. In contrast, the nonprofit sector, can behave more paternalistically and conservatively. Because donors often do not consume the services they donate, donor control can lead to inefficient overproduction of what particular donors want to support.[51]

In the end, we find that while the nondistribution constraint imposed by nonprofit law weakly substitutes for the absent shareholders, for-profit firms themselves are often weakly accountable to their shareholders. The principal-agent analysis reveals that proprietary firms cannot perfectly carry out the desires of the firm's "principals." Because of the control

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50. In 1989, private contributions (totalling $111 billion) accounted for 27.2% of total receipts of the nonprofit sector (up from 26.2% in 1982). VIRGINIA ANN HODGKINSON ET AL., NONPROFIT ALMANAC 1992-93: DIMENSIONS OF THE INDEPENDENT SECTOR 9 (1992). This average masks enormous variations by subsector: contributions made up 5.5% of total health services funds (down from 9.7% in 1977); 14.6% in education and research (about the same as 1977); 33.9% in social and legal services (up from 31.9%); 30.9% in civic, social, and fraternal (up from 28.6%); and 62.5% in arts and culture (down from 65.7%). *Id.* (While this list omits religious organizations, presumably that is because they receive nearly all of their support from contributions; indeed, in 1990, 53.7% of individual contributions went to religion. *Id.* at 43.) Compare the $111 billion contribution total in 1989 with the estimated value of volunteer services in 1989, $170 billion, representing 40% of the total labor in the sector. *Id.* at 46-47 & 20 (volunteer time was calculated at the average hourly wage for nonagricultural employees (plus a value for fringe benefits)—an odd formula, because the report, at 8, states that the average wage in the nonprofit sector was 74% of the average wage for all other nonagricultural employees). Volunteers accounted for 15% of labor in health services organizations; 22% in education; 43% in social services; 62% in civic, social, and fraternal; 67% in arts and culture; and 74% in religious organizations. *See id.* at 8.

51. *See, e.g.*, Lester M. Salamon, *Partners in Public Service: The Scope and Theory of Government-Nonprofit Relations*, *in* THE NONPROFIT SECTOR, *supra* note 17, at 99, 112 (discussing philanthropic paternalism).

powers granted to corporate management, business firms are less profit-maximizing than the shareholders might wish. As for nonprofit firms, the law has never privileged donors and patrons with shareholder-like authority. The very independence of nonprofit managers to further various goals, however, undercuts the assumed trustworthiness produced by the nondistribution constraint. As a practical result, business firms and nonprofit firms converge into similar enterprises, functioning in many similar ways, and, to a large degree, governed by self-perpetuating management.

II. FORMATION OF THE FIRM: DEMAND-SIDE AND SUPPLY-SIDE APPROACHES

To understand whether nonprofits are unique, we first must understand why nonprofits form. To understand why nonprofits form, we first must understand why any firms form. Once we see why business firms and nonprofits form, we can see how for-profit firms differ, if at all, from nonprofits.

A. *Transaction Costs, Agency Costs, and the Utility Function of the Firm*

Economists model human behavior assuming autonomous, rational actors, guided by their preferences and seeking to maximize their utilities through market transactions.[52] As Ronald Coase demonstrated, property rights can be allocated by the law to either contracting party and, in the absence of transaction costs, the parties will bargain for equally efficient uses.[53] A frictionless market does not, however, exist in the real world. In the last several decades, economists have focused on the difficulties that actors face while engaging in transactions.

"Transaction costs" have many components. Information and search costs include the costs of acquiring information.[54] Opportunistic behavior (the possibility that the person with whom you are transacting will cheat you)[55] requires extensive supervision, or "monitoring costs."

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52. *See* Ronald Jepperson, *Institutions, Institutional Effects, and Institutionalism*, *in* THE NEW INSTITUTIONALISM, *supra* note 48, at 143, 158.

53. *See* R.H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960).

54. *See* George J. Stigler, *The Economics of Information*, 69 J. POL. ECON. 213 (1961).

55. WILLIAMSON, ECONOMIC INSTITUTIONS, *supra* note 15, at 47-48 ("By opportunism I mean self-interest seeking with guile. . . . [O]pportunism refers to the incomplete or distorted disclosure of information, especially to calculated efforts to mislead, distort, disguise, obfuscate, or otherwise confuse. It is responsible for real or

The sad fact that one cannot know everything one needs in order to make a decision (due to cognitive limitations or "bounded rationality") leads to taking risks under uncertainty.[56] Also, the costs of contracting and the result that some worthy activities will simply not be undertaken in the face of prohibitive transaction costs result in a "deadweight loss" to society.

Economists recognize that institutions[57] reduce uncertainty by providing dependable frameworks for economic exchange.[58] Our institutions include economic capitalism and our legal system, both of which privilege private property and contract. In simple transactions, the parties can write a contract allocating obligations and rights. In more complex relationships, however, contracts become unwieldy and, ultimately, impracticable. The institution of the "firm" is used as a substitute for a whole network of contracts (formal and informal) between capitalists, labor, suppliers, customers, and the government (as regulator).[59] Thus, law-defined organizations, such as partnerships and

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contrived conditions of information asymmetry, which vastly complicate problems of economic organization.").

56. The expression "bounded rationality"—the cognitive assumption that economic actors try to be rational but can be so only to a limited degree—was coined by Herbert Simon. *See* HERBERT A. SIMON, MODELS OF MAN 198 (1957); *see also* RICHARD M. CYERT & JAMES G. MARCH, A BEHAVIORAL THEORY OF THE FIRM (1963); JAMES G. MARCH & HERBERT A. SIMON, ORGANIZATIONS 169 (1958); WILLIAMSON, ECONOMIC INSTITUTIONS, *supra* note 15, at 45-46; Armen A. Alchian, *Uncertainty, Evolution, and Economic Theory*, 58 J. POL. ECON. 211, 211 (1950) ("[W]here foresight is uncertain, 'profit maximization' is *meaningless* as a guide to specifiable action.").

57. As mentioned in the introduction to this Article, Ronald Coase is the father of institutional economics. Excerpts from many seminal texts, including Coase's 1937 *The Nature of the Firm*, have been gathered in THE ECONOMIC NATURE OF THE FIRM: A READER (Louis Putterman ed., 1986).

58. *See* DOUGLASS C. NORTH, INSTITUTIONS, INSTITUTIONAL CHANGE AND ECONOMIC PERFORMANCE (1990). On the other hand, "although we stress that rules and routines bring order and minimize uncertainty, we must add that the creation and implementation of institutional arrangements are rife with conflict, contradiction, and ambiguity." Powell & DiMaggio, *Introduction* to THE NEW INSTITUTIONALISM, *supra* note 48, at 28; *see also* Brody, *supra* note 5.

59. More precisely, even the term "firm" is a simplification. *See, e.g.*, Armen A. Alchian & Susan Woodward, *The Firm is Dead; Long Live the Firm: A Review of Oliver E. Williamson's* The Economic Institutions of Capitalism, 26 J. ECON. LIT. 65, 76 (1988) ("[A] bright line distinguishing 'inside' and 'outside' is missing. . . . [W]e believe a better and more useful concept is a coalition."). Similarly, we could view a nonprofit organization as a network of relationships between donors, labor (paid and volunteer), beneficiaries or clientele, and the government (as both regulator and, sometimes, as grantor). *See generally* Thomas S. Ulen, *The Coasian Firm in Law and Economics*, 18 J. CORP. L. 301 (1993).

corporations, provide "standard-form" sets of contracts.[60] If I, as an investor, want to supply a small amount of capital to a real estate venture, I need not negotiate over contributions, distributions, work, and wages with every other supplier of equity, labor, and other inputs; rather, I can just buy stock in the real estate company. But a firm creates its own costs.

Any principal-agent relationship involves "agency costs": the monitoring costs by the principal, the bonding costs by the agent, and the residual loss.[61] To economists, "ownership" includes the various rights of entitlement to profits, control, and alienation. In all but the smallest firms, control becomes separated from ownership (think of "passive" investors). Thus, viewing shareholders as the principals and the firm as the agent, Michael Jensen and William Meckling identified a type of agency cost attributable to the costs of the "separation of ownership and control."[62] The economic challenge becomes how to devise ways of aligning the interests of the manager with the interests of the principal.[63] As described below, this is not easy.

1. The Separation of Ownership and Control

What does "ownership" mean in the case of a business corporation? Obviously, the corporation owns its assets. The shareholders own the stock. Workers own their labor; suppliers own their supplies; and lessors (and, in some economic sense, the lenders) own the factory and equipment. All of these inputs are owned by the separate factors of production. But it is to the shareholders—and, generally, only to the shareholders—that the board of directors must account. There is a good reason for this: Shareholders "are the only voluntary constituency whose relation with the corporation does not come up for periodic renewal"; and

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60. Private institutions designed to reduce transaction costs abound *within* organizations; consider, for example, law firm partnerships and schools offering academic tenure.

61. Jensen & Meckling, *supra* note 19, at 308. Bonding costs are the costs paid by the agent to induce the principal to hire the agent. *Id.* The residual loss is "the dollar equivalent of the reduction in the principal's welfare" resulting from the "divergence between the agent's decisions and those decisions which would maximize the welfare of the principal." *Id.*

62. *Id.* at 309.

63. *See id.* at 323 ("These methods include auditing, formal control systems, budget restrictions, and the establishment of incentive compensation systems which serve to more closely identify the manager's interests with those of the outside equity holders.").

shareholders "are also unique in that their investments are not associated with particular assets."[64]

By law and in theory, at least, the shareholders of a business corporation elect the members of the board of directors.[65] Furthermore, the shareholders can (again theoretically) replace members of the board simply for misfeasance, or in some states for no reason at all.[66] However, in reality, shareholders of modern corporations perform very little monitoring.

It is really only the smaller model of joint enterprise that fits the statutory paradigm of stockholders who control the board of directors who oversee management by the officers.[67] In the larger corporations, any notion of shareholder voice has been discarded, except for large minority interests.[68] Rather, as a practical matter, shareholders dissatisfied with

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64. Oliver E. Williamson, *Corporate Governance*, 93 YALE L.J. 1197, 1210 (1984) [hereinafter Williamson, *Corporate Governance*].

65. The business corporation law limits the shareholders' control powers to extraordinary transactions, such as voting for the board or approving a merger. *See, e.g.*, N.Y. BUS. CORP LAW § 614(a) (McKinney 1986) (election of board); *id.* § 903(a) (McKinney 1986) (approval of merger). In return for giving up day-to-day management authority, the shareholders are granted liquidity for their investment: if they do not like how the board is running the company, the shareholders can take the "Wall Street walk" and sell their shares. Thus, under the proprietary corporation statutes, a great deal of power vests in the board and the executives. *See* discussion *infra* part III.

66. State corporation statutes vary in this regard, with some states permitting shareholders to remove directors only for cause, while others permit removal with or without cause. *Compare* N.Y. BUS. CORP. LAW § 706(a), (b) (McKinney 1986) (directors may be removed only for cause unless the certificate of incorporation or by-laws provide for removal without cause) *with* DEL. CODE ANN. tit. 8, § 141(k) (1991) (directors may be removed with or without cause).

67. This description covers the American corporate legal system only. Other countries look less to a liquid market for shares than to more direct monitoring devices, such as cross-ownership. *See, e.g.*, Mark J. Roe, *Some Differences in Corporate Structure in Germany, Japan and the United States*, 102 YALE L.J. 1927 (1993); *see also* Bishop, *supra* note 40, at 15 (specially paginated section appearing after page 58) (In Japan, "[n]either the board nor the president drives the firm's strategy. That job is left mainly to middle managers. It is not obvious how accountability can be introduced into this structure.").

68. Institutional investors, led by such massive public pension funds as CalPERS, demand, and have succeeded at times in obtaining, more information and seats on the boards of corporations in which they invest, as well as the ouster of particular executives they disfavor. After all, due to the sheer size of the pension sector (several trillion dollars, and mounting) and its limited purpose (to make prudent investments), the "Wall Street rule" no longer offers a realistic solution to a dissatisfied shareholder—because pension funds already own much of corporate America, they cannot improve their positions by selling stock amongst themselves; rather, they have to increase their voice

the performance of the corporation can only exercise their exit threat by selling stock.[69] The massive publicly traded enterprises, which produce over half of the country's gross national product, amount to orphans of the corporate law.

In their famous 1932 book, *The Modern Corporation and Private Property*, Adolph Berle and Gardiner Means identified the separation of ownership and control as the hallmark of the modern publicly held corporation.[70] Indeed, this very separation "makes possible tremendous aggregations of property."[71] The demand for passive investments[72] produces ever increasing concentration of economic power in the hands of managers of large corporations, limited only by ability of the few to effectively manage such large wealth.[73] Who, precisely, are these powerful managers? Because corporate law grants the board of directors authority over the activities of a corporation, "we may say for practical purposes that control lies in the hands of the individual or group who have

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in management. *See, e.g.*, Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 U.C.L.A. L. REV. 811 (1992); Salvatore O. Franco, Note, *Should Institutional Investors Play a Role in Shaping Mexico's Economic Policy?*, 16 N.Y.L. SCH. J. INT'L & COMP. L. (forthcoming spring 1996). *But see* Bishop, *supra* note 40, at 16-17 (specially paginated section appearing after page 58) (the incentives of public pension funds cause them to be too risk averse; activist funds are the rare exception). Indeed, CalPERS named a new chief executive, who said "the fund's role as corporate governance watchdog would become a less adversarial, less public one." *Pension Fund Boss to Rein In Focus*, CHI. TRIB., Sept. 24, 1994, § 2, at 3.

69. *See* MANCUR OLSON, JR., THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS 55 (2d ed. 1971), describing the free-rider problem of shareholder action:

> [I]n a large corporation, with thousands of stockholders, any effort the typical stockholder makes to oust the management will probably be unsuccessful; and even if the stockholder should be successful, most of the returns in the form of higher dividends and stock prices will go to the rest of the stockholders . . . .

70. *See* ADOLPH A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 4-5 (1932).

71. *Id.* at 5.

72. Berle and Means also lamented the "spiritual" change in ownership from active to passive:

> It has often been said that the owner of a horse is responsible. If the horse lives he must feed it. If the horse dies he must bury it. No such responsibility attaches to a share of stock. The owner is practically powerless through his own efforts to affect the underlying property.

Id. at 66.

73. *Id.* at 18.

the actual power to select the board of directors."[74] In the largest corporations, control is not exercised by a majority of the shareholders; indeed rarely does a single shareholder own even one percent of the stock of these corporations.[75]

Professors Berle and Means describe the realities of board elections in a corporation with dispersed ownership, finding that control resides with those who select the proxy committee (which selects the slate of board candidates presented to the shareholders). But existing board members appoint the proxy committee, ensuring that they "can virtually dictate their own successors."[76] In a corporation with sufficiently dispersed ownership, "the management can thus become a self-perpetuating body even though its share in the ownership is negligible."[77]

Modern economists are much less troubled by this separation of ownership and control.[78] When a shareholder buys shares on the stock exchange, one of the assets she buys is the incumbent management of the corporation. When the shareholder loses confidence in the management, she can sell the stock. In the meantime, the stock market signals the value of the corporation, and of its management.[79]

The ability to transfer ownership of corporate stock, in the view of some, keeps corporations "honest."[80] The market punishes bad business judgment by depressing the value of the stock. Indeed, the ability to control the organization itself has value, and competition for this good ensures its highest value.[81] In the "market for corporate control," a

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74. *Id.* at 69.

75. *See id.* at 47-48 (discussing the dispersion of stock ownership).

76. *Id.* at 87.

77. *Id.* at 87-88; *cf. id.* at 88 n.23 ("The nearest approach to [the modern proxy system for electing proprietary boards] which the present writer has been able to discover elsewhere is the organization which dominates the Catholic Church. The Pope selects the Cardinals and the College of Cardinals in turn select the succeeding Pope.").

78. *See, e.g.*, Robert Hessen, *The Modern Corporation and Private Property: A Reappraisal*, 26 J.L. & ECON. 273, 288 (1983) (arguing that shareholders freely choose to invest and are therefore not being denied control that they truly expected to exercise).

79. *Id.* at 288 ("The new shareholders do not want to interfere with [a competent management system]; on the contrary, they are willing to entrust their savings to it.").

80. *See* Steven C. Bahls, *Resolving Shareholder Dissension: Selection of the Appropriate Equitable Remedy*, 15 J. CORP. L. 285, 289 (1990) (explaining that the ability of a shareholder to sell his shares and the potential that the sale will depress the market value of the stock indirectly ensures qualified management).

81. *See* Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 112 (1965).

buyer might engage in a takeover in order to toss out the bad managers.[82] Thus, corporate takeovers serve to focus the minds of those already in control, and induce them to make the most efficient use of internal resources. This may be viewed as an indirect requirement of accountability to shareholders.

Recent legal scholarship about the business sector has raised questions of corporate responsibility—whether corporations owe obligations that reach beyond the wealth-maximization of shareholders, to the welfare of workers, suppliers, creditors, and the local community.[83] State legislatures have expressed these concerns in "corporate constituency statutes" that permit (or even, in some states, require[84]) the board to make business decisions taking these other interests into account.[85] Skeptics see corporate constituency laws as thinly disguised anti-takeover statutes, enacted at the behest of incumbent managers of threatened corporations.[86] Calling them "hidden-implicit [special-interest] statutes," Jonathan Macey views them as "couched in public interest terms to avoid

82. Oliver Williamson credits the emergence in "takeover by tender offer" to the organizational transformation of large corporations from a "U-form" (unitary form) to an "M-form" (multidivisional form): "In takeovers, the main advantage of an M-form firm over a U-form enterprise is the ability of an M-form acquiror to 'digest' its acquisition." Williamson, *Corporate Governance*, *supra* note 64, at 1225. "Rather than integrate the acquired assets with the old, the M-form structure separates operating divisions from a general office in which strategic decision making is centralized; thus, the corporation can, if desired, divest unwanted divisions or subsidiaries." *Id.* at 1224-26.

83. *See, e.g.*, A.L.I., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS (1992); Comm. on Corp. Laws, *Other Constituencies Statutes: Potential for Confusion*, 45 BUS. LAW. 2253 (1990); Eric W. Orts, *Beyond Shareholders: Interpreting Corporate Constituency Statutes*, 61 GEO. WASH. L. REV. 14 (1992); Roberta Romano, *Corporate Governance in the Aftermath of the Insurance Crisis*, 39 EMORY L.J. 1155 (1990).

84. *See, e.g.*, CONN. GEN. STAT. ANN. § 33-313(e) (West Supp. 1995) (to sunset January 1, 1997) (requiring directors to consider interests of non-stockholder constituencies in change-of-control situations); IDAHO CODE §§ 30-1602, 1702 (Supp. 1995) (same rule).

85. Orts, *supra* note 83, at 16, 73. For a compilation of at least 28 states that have enacted corporate constituency statutes, see Al Myers, Note, *Whom* May *the Corporation Serve?—An Argument for the Constitutionality of Non-Stockholder Constituency Statutes*, 39 N.Y.L. SCH. L. REV. 449, 449 n.1 (1994).

86. Roberta Romano, *A Guide to Takeovers: Theory, Evidence, and Regulation*, 9 YALE J. ON REG. 119 (1992). Under this view, management exhibits the worst form of the principal-agent problem: managers will even seek legislative protection in an effort to retain their jobs, thus preventing shareholders from realizing a high market value for the stock.

the political fallout associated with blatant special interest statutes."[87] This view finds support in the fact that these corporate constituency statutes fail to grant standing in court to the newly protected classes.[88]

2. The Firm's "Objective Function"

Neoclassical economists ignored principal-agent problems in maintaining that the purpose of a proprietary firm is to maximize profits.[89] By contrast, the law (both corporate law and partnership law) expressly recognizes the principal-agent problem in imposing fiduciary duties on the agents (the corporate directors and officers, or the managing partners).[90] For example, the duty of loyalty requires the agent to put the company's interests ahead of her own.[91] Nevertheless, the separation of ownership from control requires a re-evaluation of the firm's assumed profit-maximizing objective. As discussed in Part III, below, many

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87. Jonathan R. Macey, *Promoting Public-Regarding Legislation Through Statutory Interpretation: An Interest Group Model*, 86 COLUM. L. REV. 223, 233 (1986).

88. Orts, *supra* note 83, at 83.

89. Specifically, the rational firm is assumed to maximize profits and operate with perfect knowledge. CYERT & MARCH, *supra* note 56, at 8.

90. *See, e.g.*, N.Y. BUS. CORP. LAW § 717 (McKinney 1992) ("A director shall perform his duties as a director . . . in good faith and with that degree of care which an ordinarily prudent person in a like position would use under similar circumstances."). Aronson v. Lewis, 473 A.2d 805 (Del. 1984) (defining the standard of care directors owe (not to be grossly negligent) under the business judgment rule). Similarly, the law of trusts imposes duties on trustees. *See* AUSTIN W. SCOTT & WILLIAM F. FRATCHER, THE LAW OF TRUSTS § 2.5 (4th ed. 1987).

91. Corporate law does not necessarily attempt to duplicate the terms that the parties would negotiate if they had perfect foresight. For example, one major feature that incorporation offers is limited liability for shareholders. Because many voluntary creditors (such as lenders) can contract around this shareholder protection with security agreements and personal guarantees, the great burden of limited liability shifts to involuntary creditors (tort claimants). *See, e.g.*, Frank H. Easterbrook & Daniel R. Fischel, *Limited Liability and the Corporation*, 52 U. CHI. L. REV. 89 (1985). Limited liability from tort could not have been achieved by private contract between the parties conducting the activity. On the other hand, some provisions of corporate law impose mandatory terms on the parties. For example, the law allocates management power to the board of directors, and gives shareholders the right to elect and remove directors. *See, e.g.*, Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1417 (1989) ("States almost universally forbid perpetual directorships"); *see also* John C. Coffee, Jr., *The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role*, 89 COLUM. L. REV. 1618 (1989); Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549 (1989). *See generally* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW (1991).

economists posit that firms, rather than maximizing profits, instead maximize a utility, such as budget,[92] sales,[93] "satisfactory profits,"[94] or even long-run survival.[95]

There is a big difference between maximizing profit and maximizing some utility, such as budget. It goes to the all-important issue of who gets to play with the money, which is the heart of the principal-agent problem. A profit represents the fund available at the end of the day to be spent by the owners of the firm, or at least those with discretion over spending. A budget represents the fund available to pay the expenses of the firm, including wages. Thus, for example, one law school dean told me that he is a profit maximizer, but the faculty is a budget maximizer.

B. *Why Do Nonprofits Form?*

A nonprofit organization, too, is a firm. Is this firm also solving a transaction problem?

Consider two hypotheticals. The first is about Carmen, who loves opera.[96] If Carmen lives in a community with 2000 like-minded rich constituents, she can found a proprietary opera company and charge the $100 ticket price necessary to cover costs.[97] Alternatively, if this

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92. Hansmann, *Economic Theories of Nonprofit Organization*, *supra* note 17, at 37; Saul Levmore, *Irreversibility and the Law: The Size of Firms and Other Organizations*, 18 J. CORP. L. 333, 336 (1993) (explaining that managers of some firms, instead of maximizing profit, prefer "to extend their control over increasingly large budgets and activities").

93. WILLIAM J. BAUMOL, BUSINESS BEHAVIOR, VALUE AND GROWTH 45-52 (rev. ed. 1967) (firms maximize sales subject to a profit constraint).

94. *See* Herbert A. Simon, *A Behavioral Model of Rational Choice*, 69 Q.J. ECON. 99, 108 (1955) [hereinafter H. Simon, *A Behavioral Model*] (reasoning that firms can elect between a tradeoff of a certain level of satisfactory profits and other, perhaps conflicting, "preferences").

95. CYERT & MARCH, *supra* note 56, at 9 (citing Kenneth W. Rothschild, *Price Theory and Oligopoly*, 42 ECON. J. 297 (1947)) (entrepreneurial decisions aim to maximize the probability that the organization will survive indefinitely).

96. I am not the first person to pick on opera. *See, e.g.*, Ernest van den Haag, *Should the Government Subsidize the Arts?*, 10 POL'Y REV. 63, 66 (1979) ("Whatever the value of opera . . . it cannot be said, as it may be said in Italy or Austria, that opera has contributed to our national cohesion, history, culture, or consciousness—or that it has any chance of doing so now.").

97. "On a per performance basis, opera is by far the most expensive of the live performing arts to produce, involving as it does elements of all the others, combined typically with a lavish hand. Consequently, it is important economically to play to relatively full houses, so seasons tend to be short." JAMES HEILBRUN & CHARLES M. GRAY, THE ECONOMICS OF ART AND CULTURE: AN AMERICAN PERSPECTIVE 27 (1993).

constituency has sufficient political power, it can induce the government to found the opera, and cover (all or part of) the costs through taxation (forced extraction from the entire community). Alas, Carmen's community is not sufficiently populated with either opera lovers willing to pay $100 a ticket or members of the non-opera-going public willing to pick up the tab.[98] Does Carmen have any hope of hearing operas in her town?

Our second hypothetical is about Scrooge. He has accumulated vast wealth, is on his deathbed, and has no relatives. He feels strangely moved to give away all of his property to charity. He could easily accomplish this objective by directing Bob Cratchit, on his behalf and at the time of his death, to transfer Scrooge's assets to the poor. But Scrooge wants control even after death over the disposition of the assets. (Are you surprised?) Specifically, he wants his assets invested in a prudent mix of securities, and the income used each year, in perpetuity, to purchase turkeys each Christmas to give to the poor. What assurance can we give Scrooge that his wishes will be faithfully carried out?

The economic analysis of the nonprofit sector adopts a market-oriented approach to explain the existence of nonprofit organizations.[99]

Predict these scholars:

> [O]pera programming (probably because of the higher cost per production) is even more conservative than the programming of symphony concerts; very little is heard that was written later than the beginning of the twentieth century. . . . [O]ne cannot be very optimistic about the long-run prospects for opera, unless new works can be developed that will excite audiences.

Id. at 355 (footnote omitted).

98. In one study, only 3% of adults attended an opera in the last year (8% of those with income of $50,000 or more), 4% attended a ballet, 12% attended a play, 13% heard live classical music, 17% saw a musical, and 22% went to an art museum. Of all those who have ever attended an opera, 13% had income of less than $15,000; 14% earned between $15,000 and $25,000; 33% earned between $25,000 and $50,000; and 41% earned more than $50,000 (at a time when this income class represented 15.5% of all adults). This is the most top-heavy income distribution for all these "high-culture" arts categories. Dick Netzer, *Arts and Culture*, *in* WHO BENEFITS FROM THE NONPROFIT SECTOR? 174, 183 tbl. 6.2 (Charles T. Clotfelter ed., 1992).

99. Estelle James says that economists try too hard to fashion an argument for the existence of nonprofits, and for why they are concentrated in certain "key human-service sectors." Estelle James *in* Sharon Oster & Estelle James, *Comments* [hereinafter James, *Comments*], *in* THE ECONOMICS OF NONPROFIT INSTITUTIONS: STUDIES IN STRUCTURE AND POLICY 154, 156 (Susan Rose-Ackerman ed., 1986) [this collection hereinafter cited as THE ECONOMICS OF NONPROFIT INSTITUTIONS]. Rather, Professor James looks to the historical (empirical) record. She finds that around the world, religious organizations have been the founders of nonprofit schools (in order to maximize religious adherents, because "schools are one of the most important institutions of taste formation or socialization") and hospitals (when people are in urgent need, religious groups can gain

Both of our hypotheticals are examples of the type of "market failure" known as "contract failure."[100] In the absence of a nonprofit sector, these theories posit, Carmen could not see her operas and Scrooge would not endow a charitable trust. The existence of the nonprofit sector, under these explanations, overcomes the transaction costs between Carmen and the other opera-goers and between Scrooge and his trustees.

First, let's return to Carmen. Her problem is that she is willing to pay more to see opera than the average person. She is what economist Burton Weisbrod calls the "undersatisfied demander," because she is willing to bear a tax that others are not in order to obtain this good.[101] If Carmen can find sufficient opera lovers, they will found an opera company that charges an affordable $50 a ticket, and the difference in cost

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entry). *Id.* at 155. So why do people patronize religious schools and hospitals? Professor James suggests that those of the faith seek to perpetuate it; others might trust religious (as opposed to nonprofit) providers; and volunteer labor might keep the cost down. *Id.* at 156; *see also* JOHN E. CHUBB & TERRY M. MOE, POLITICS, MARKETS, AND AMERICA'S SCHOOLS 27 (1990) ("About half of all private schools are Catholic, and the rest are a diverse lot of religious schools, college preparatory schools, military academies, and schools for children with special problems or talents."). Of course, where the population is religiously heterogenous, social service coverage provided by religious nonprofits can fall short of universal. *See, e.g.*, Salamon, *supra* note 51, at 112 (noting that until the early 1960s, Catholic and Jewish charities provided most child welfare services in New York City; "[s]ince most of the poor blacks who migrated to the city in the post-World War II era were Protestants, however, they did not immediately find a 'home' in the established agency structure."(citation omitted)).

100. As discussed at the end of this subsection, one could alternatively view the Carmen case as one of government failure. *See, e.g.*, Avner Ben-Ner & Benedetto Gui, *Introduction* to THE NONPROFIT SECTOR IN THE MIXED ECONOMY 7 (Avner Ben-Ner & Benedetto Gui eds., 1993) [this collection hereinafter cited as THE NONPROFIT SECTOR IN THE MIXED ECONOMY].

101. "When demand is diverse . . . whatever quantities and qualities of services government provides will oversatisfy some people and undersatisfy others." WEISBROD, *supra* note 18, at 25. If "it were possible, and acceptable, for government to discriminate among consumers, charging each a tax price that left each one satisfied . . . [, so-called] Lindahl prices," the public sector could achieve the same end. *Id.* at 223 n.32. For an extended, more technical explanation, see Burton A. Weisbrod, *Toward a Theory of the Voluntary Nonprofit Sector in a Three-Sector Economy*, *in* THE ECONOMICS OF NONPROFIT INSTITUTIONS, *supra* note 99, at 21. *See also* Todd Sandler & John T. Tschirhart, *The Economic Theory of Clubs: An Evaluative Survey*, 18 J. ECON. LITERATURE 1481 (1980) (reviewing literature addressing the economic theory and justifications for clubs).

would be made up by their voluntary donations. In effect, Carmen and the other contributors would engage in voluntary price discrimination.[102]

But why does the opera company form as a *nonprofit* enterprise rather than as a proprietary one? (In order to focus on the importance of organizational form, we ignore the likely strong effects of tax exemption.)[103] Recall the legal restriction on nonprofit organizations—they cannot distribute surplus to their owners. Admittedly, the notion of profit in an opera company is a bit of a stretch, but think of other nonprofit enterprises that satisfy private constituents. For example, private universities and hospitals can, and often do, earn a surplus which they carry forward. According to Professor Hansmann's theory, this "nondistribution constraint" is the enterprise's bond that private persons will appropriate neither the donations nor the ticket purchases made by Carmen.

Professor Hansmann requires one more feature in his account of the nonprofit sector—what he calls "information asymmetry." Admittedly Carmen will see her operas, but she "cannot tell . . . whether her contribution of fifty dollars in fact purchased a marginal increment of

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102. The temptation to free-ride on the donations of others plagues collective action. *See* Hansmann, *Economic Theories of Nonprofit Organization*, *supra* note 17, at 36 ("[T]icket purchasers with unusually high demand for performing arts productions can simply be asked to contribute some portion of the consumer surplus they would otherwise enjoy at the nominal ticket price—and, interestingly, a large proportion is in fact willing to do so."). *See generally* OLSON, *supra* note 69. Professor Netzer breaks down the revenue sources, as of 1985, for several categories of the nonprofit arts and cultural subsector. Opera's total income came to $305 million, of which $182 million came from earned income (presumably mostly ticket sales) and $123 million came from donations. Of these donations, $18 million came from governments (foregone taxes are an uncounted additional subsidy) and $105 million came from private sources ($13 million from corporations, $12 million from foundations, and $80 million from individuals). Netzer, *supra* note 98, at 178 tbl. 6.1.

103. Commentators debate the influence of tax exemption, but, after all, nonprofit organizations existed in the United States before the creation of the income tax. (It is not so much that the opera needs the income-tax exemption—after all, it unlikely operates at a surplus—but that it can offer tax-deductibility for donations made to it. I.R.C. §§ 170, 501(c)(3) (1994). On the other hand, charities have long enjoyed property-tax exemption, and propertied opera companies probably also seek state and local property-tax exemption. I will be considering these issues in a future article on efficient tax subsidies. Nor are all modern-day nonprofits automatically federally tax-exempt. Most recently, in 1986 Congress removed the income tax exemption of the Blue Cross and Blue Shield plans and other insurance-providing nonprofits, such as certain health maintenance organizations. I.R.C. § 501(m)(3)(B); *see* Howard S. Levy, Note, Ronald J. Thompson v. Midwest Foundation Independent Physicians' Association (ChoiceCare): *The Conversion of Nonprofit Health Maintenance Organizations to For-Profit Status*, 16 N. KY. L. REV. 361 (1989).

corresponding value in the quantity or quality of service."[104] Scrooge, too, does not want his donation siphoned off by the fund managers. This information asymmetry between principal and agent occurs whenever the donor is separated from control. Professor Hansmann uses the example of the donor who sends money to CARE for famine relief overseas.[105] To Professor Hansmann, the nondistribution constraint so binds the fund managers that they might as well spend the money on doing good.[106] That is, Professor Hansmann does not compare the cost of private contracting (and monitoring) with the cost of institutionalizing the nonprofit sector; he believes that there is no way to privately contract for these services.[107] Thus, to turn Professor Hansmann's theory around, "nonprofit" enterprises would form even in the absence of a nonprofit law *if* the proprietary enterprise could privately bind itself to a nondistribution constraint.[108] That is, it is the mandatory nature of the nondistribution constraint that gives Scrooge the confidence to go forward.

Thus, Professor Hansmann's nondistribution constraint theory purports to solve two of the three agency costs: the principal's monitoring costs and the agent's bonding costs.[109] (Under these "demand-side" models, we can view either the donors or the consumers as the principals and the nonprofit managers as the agents; Professor Hansmann collectively refers

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104. Hansmann, *Economic Theories of Nonprofit Organization*, *supra* note 17, at 30 (example of a contributor to a listener-sponsored radio station).

105. *Id.* ("The difficulty is that the purchaser (donor), who has no contact with the intended beneficiaries, has little or no ability to determine whether the firm performs . . . it well. In such circumstances, a proprietary firm might well succumb to the temptation to provide less or worse service than was promised.").

106. *Id.* ("In situations such as these, the nonprofit organizational form, owing to the nondistribution constraint, offers the individual some additional assurance that her payment is in fact being used to provide the services she wishes to purchase.").

107. Theoretically, a proprietary famine-relief corporation could promise not to pay dividends, and agree to be sued (under a breach of contract theory) if it does. But, as Prof. Hansmann points out elsewhere, the business-law hoops one would have to jump through make binding oneself to this promise difficult, if not impossible. Hansmann, *Reforming Nonprofit Corporation Law*, *supra* note 9, at 517 (pointing out that shareholders and the board could always later amend the articles of incorporation to permit dividend distributions). But what if the stock bears a legend stating: "This stock may not be transferred except to another charity" (or "except to a nonprofit recognized as tax exempt under Internal Revenue Code section 501(c)(3)," which itself imposes a nondistribution constraint)?

108. A separate and important question, of course, is the "fit" between assuring the donor's intent and the nondistribution constraint. That is, is this the right solution to the principal-agent problem?

109. This leaves only the residual loss, defined *supra* note 61.

to donors and clients as "patrons.")[110] This demand-side theory also provides an explanation for when the government will provide the good, and when it will be left to the private nonprofit sector to do so. After all, the public sector also is subject to the nondistribution constraint,[111] and, through its power of taxation, can compel all to participate, thus reducing any free-rider problems.[112] In a more homogeneous society, with a uniform demand for the good, the populace will be willing to tax itself to supply the good.[113] Our highly mobile population sorts itself into "an equilibrium in which each municipality provides a bundle of public goods at a tax price which conforms to the preferences of the median voter."[114] Sometimes the voters fight not over money but over ideology, such as whether to offer abortions or restrict access, or whether to permit or forbid school prayer.[115] In any case, nonprofit organizations offer a heterogenous alternative to government.[116]

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110. Hansmann, *Reforming Nonprofit Corporation Law*, *supra* note 9, at 502-03. *But see* Ira M. Ellman, *Another Theory of Nonprofit Corporations*, 80 MICH. L. REV. 999 (1982) (arguing for limiting the nonprofit law to donative nonprofits, and designing a separate mutual-benefit nonprofit law for paying patrons).

111. WEISBROD, *supra* note 18, at 223 n.30.

112. On the other hand, Estelle James suggests that it is easier for private nonprofits to charge fees than for the government to do so, and so it is cheaper for government to subsidize nonprofits. James, *Comments*, *supra* note 99, at 156-57.

113. Charles M. Tiebout, *A Pure Theory of Local Expenditures*, 64 J. POL. ECON. 416 (1956) (the seminal article on how the greater homogeneity of lower governments, when compared with federal or state governments, can satisfy the median "consumer-voter"). Indeed, federal income tax exemption is granted to nonprofit organizations whose purposes include "lessening the burden of government." Treas. Reg. § 1.501(c)(3)-1(d)(2) (1995); *see* John G. Simon, *The Tax Treatment of Nonprofit Organizations: A Review of Federal and State Policies*, *in* THE NONPROFIT SECTOR, *supra* note 17, at 67, 76.

114. Roger Friedland & Robert R. Alford, *Bringing Society Back In: Symbols, Practices, and Institutional Contradictions*, *in* THE NEW INSTITUTIONALISM, *supra* note 48, at 232, 233 (citations omitted). Social choice theory, beginning with Kenneth Arrow's "Impossibility Theorem," asserts there is no reasonable way to make collective decisions. *See* KENNETH ARROW, SOCIAL CHOICE AND INDIVIDUAL VALUES (rev. ed. 1963). The argument in the text holds, however, regardless of whether the preferences of the median voter or those of a particular interest group prevail.

115. James Douglas, *Political Theories of Nonprofit Organization*, *in* THE NONPROFIT SECTOR, *supra* note 17, at 43, 47 ("The classic pluralist argument is that a voluntary nonprofit sector permits a greater diversity of social provisions than the state itself can achieve.").

116. *See, e.g.*, WEISBROD, *supra* note 18, at 41-42 ("Nonprofits are a potential safety valve."); *cf.* James M. Buchanan, *An Economic Theory of Clubs*, 32 ECONOMICA 1 (1965) (claiming that there is a middle ground to public and private groupings—the

The public's hunger for a trustworthy supplier does not explain why nonprofits almost exclusively limit their production to services rather than also produce goods.[117] While the characteristics of many goods present no information asymmetry (such as fresh fruit), demand often arises for tangible "trust goods." Why are there no nonprofit car dealers?[118] To answer this question, we must now shift our focus to the "supply side."

C. *Comparing the "Demand" Side to the "Supply" Side*

We have just looked at the circumstances in which people demand to deal with a more "trustworthy" form of enterprise. Now let us look at the supply side. What's in it for the founder (and other significant players)? I can think of two explanations for why a founder would renounce profits ownership—one eleemosynary and the other self-regarding (if not venal). First, the founder might seek only control of the enterprise, but no monetary reward. Alternatively (or perhaps as well), is the rent-seeking opportunity—the founder might believe she can capture the monetary reward in a form other than that which inures to owners of capital.[119]

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general theory of clubs).

117. Academics have found that the nonprofit industry operates almost totally in the service sector. *See, e.g.*, Avner Ben-Ner & Theresa Van Hoomissen, *Nonprofit Organizations in the Mixed Economy*, *in* THE NONPROFIT SECTOR IN THE MIXED ECONOMY, *supra* note 100, at 27. Professors Ben-Ner and Van Hoomissen further argue that only nonrival goods (and services) give rise to a nonprofit response. *Id.* at 34 n.7, 35. But hospital services are not nonrival. After all, one person can get great care and another poor care. *See also* Hansmann, *Role of Nonprofit Enterprise*, *supra* note 7, at 847 (suggesting that there is less information asymmetry in a consumer goods situation because the consumer takes delivery of the goods himself, and therefore the extra trustworthiness that a nonprofit provides is not required).

118. *Cf.* George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488 (1970) (describing asymmetric information). Consumer cooperatives develop for frequently purchased goods, like country clubs and discount clubs. *See* Hansmann, *Economic Theories of Nonprofit Organization*, *supra* note 17, at 34 ("Like public utilities, and in contrast to nonprofits, [consumer cooperatives] usually sell only simple standardized goods and hence do not typically seem to arise as a response to contract failure." (citations omitted)). Under Professors Ben-Ner and Van Hoomissen's theory, the noncontrolling demand-side stakeholders require that there be controlling stakeholders who purchase the nonprofit output at the same price. Ben-Ner & Van Hoomissen, *supra* note 117, at 48-49. But then by definition a nonprofit organization must have purchasing controlling stakeholders. How many cars can any one person buy?

119. Burton Weisbrod calls these nonprofits "for-profit[s] in disguise," and attributes their existence to lack of enforcement of the nondistribution constraint. WEISBROD, *supra* note 18, at 11. Henry Hansmann similarly decries the poor state

1. The "Replication Imperative" of the Nonprofit Board

The principal-agent problem gets more complicated, and more interesting, in the nonprofit world.[120] Who, if anyone, are the principals, and what is the relationship among the "agents"? Looking initially at a nonprofit organization as a firm, a nonprofit organization has workers and suppliers, and often lessors and lenders. A nonprofit corporation also has customers (sometimes called clientele or beneficiaries). And, in addition to its tangible assets, the entity owns a badge called "nonprofitness," a suggestion of credibility and deservedness that can translate into monetary value in dealings with the public.

In the business sector, the bundle of rights granted shareholders includes the right of oversight, and the right to have the board of directors act in their interests. In those few nonprofits that have a membership who elect directors, the members perform the oversight function of shareholders.[121] But otherwise there is no class analogous to shareholders because the law does not consider donors to have invested capital at risk in the same sense that the shareholders have. Most nonprofits, accordingly, have "self-perpetuating" boards. Moreover, the statutory substitute for shareholders—the state attorney general—can step in only in the extreme case of malfeasance.[122] In the absence of shareholders, therefore, the law must necessarily be granting additional

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enforcement of the nondistribution constraint. *See* Hansmann, *Reforming Nonprofit Corporation Law*, *supra* note 9, at 507-08, 600-15. My argument goes further, however. I am concerned not just with "excess payments" (Weisbrod) or private inurement (Hansmann) or even waste, but also with an enterprise whose returns can be allocated to reasonable costs of compensation (and other inputs except equity capital). *See, e.g.*, A.G. Holtmann & Todd L. Idson, *Wage Determination of Registered Nurses in Proprietary and Nonprofit Nursing Homes*, 28 J. HUM. RESOURCES 55 (1993) (the demand for higher quality nurses in nonprofit nursing homes, which produce higher quality services than proprietary nursing homes, explains the higher wages paid to nurses in nonprofits).

120. *Cf.* Oliver E. Williamson, *Economic Institutions: Spontaneous and Intentional Governance*, 7 J.L., ECON. & ORGANIZATION 159, 181-83 (1991) (special issue) (discussing "de facto" ownership under socialism).

121. *See* REV. MODEL NONPROFIT CORP. ACT §§ 1.40(21), 6.03 (1987).

122. However, the American Bar Association's Revised Model Nonprofit Corporation Act grants standing to the attorney general to protect the public interest. REV. MODEL NONPROFIT CORP. ACT § 1.7 (1987); *see also* Lizabeth A. Moody, *The Who, What, and How of the Revised Model Nonprofit Corporation Act*, 16 N. KY. L. REV. 251, 281 (1988) (The state's broad power of supervision over nonprofits "is one of the features of the Revised Act that is both most criticized and most complimented.").

control rights to the directors and other managers of a nonprofit corporation.[123]

The most important task of the nonprofit board is to ensure its own continuation. How do self-perpetuating nonprofit boards fulfill their replication imperative? Take, for example, one of the oldest nonprofit organizations, the Catholic Church. While the church has perpetual life, its pope does not. The task of continuing the papacy falls to the College of Cardinals. And who names cardinals to the college? The pope currently reigning.[124] The Catholic Church probably comes as close as humanly possible to organizational parthenogenesis.[125] As much true in

123. *Cf.* CHUBB & MOE, *supra* note 99, at 32. John Chubb and Terry Moe, in studying public schools, apply a similar control analysis to the public sector, in trying to ascertain why schools systems seem so unresponsive to the wishes of parents and students:

> The fundamental point to be made about parents and students is not that they are politically weak, but that, even in a perfectly functioning democratic system, the public schools are *not meant* to be theirs to control and are literally *not supposed* to provide them with the kind of education they might want. The schools are agencies of society as a whole, and everyone has a right to participate in their governance. Parents and students have a right to participate too. But they have no right to win. In the end, they have to take what society gives them.

Id.

124. *See, e.g.*, *Pope Appoints 30 New Cardinals: Selections Ensure Conservative Influence for Years*, CHI. TRIB., Oct. 31, 1994, §1, at 8 ("The College of Cardinals now numbers 137, but only 98 are 'cardinal electors,' meaning they are younger than 80 and therefore eligible to vote for a new pope."); Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, 319-20 (1983) [hereinafter Fama & Jensen, *Separation of Ownership and Control*] (comparing organizational structure of Catholic Church with those of Protestant and Jewish religions).

125. Even the Catholic church today suffers severe goal conflicts, because of "[t]wo competing visions of Catholicism: to nail down and to gather up." *See* Paul Wilkes, *The Popemakers*, N.Y. TIMES, Dec. 11, 1994, § 6 (Magazine) at 62, 101. The cardinals know that when they "gather in the Sistine Chapel . . . ultimately they will not choose a program; they will choose a man, and only a man." *Id.* Wilkes interviewed several cardinals who might be elected to succeed John Paul II. Joseph Cardinal Bernardin of Chicago imagined the process of selecting a pope:

> [I] would think that a man takes two things into a conclave, only two: his life and the Holy Spirit. . . . He takes his humanity, all his humanity. Yes, we are celibate males, but we are human beings first. Hopefully compassionate, sensitive human beings. . . . Somehow, some way, the choice will suddenly seem right. And it will be.

Id. at 84. While Godfried Cardinal Danneels of Belgium envisioned:

> Any man who enters the conclave desiring to be pope must either be mad or unconscious. He should be forced, dragged to the chair of St. Peter. A good pope should never have thought of himself as a pope in the first place. And

the nonprofit sector as in the business sector, when people set to the task of selecting their successors, the successor tends to resemble the chooser.[126]

Nonprofit trusteeship is a highly institutionalized activity, although the form the institution takes varies with the society that produced it.[127] The sheer number of nonprofit organizations has exploded; in 1940 there were about 14,000 nonprofits,[128] but by 1990 there were 1.4 million.[129] All of these organizations must staff their boards. As Peter Dobkin Hall observes, "the dramatically increased number of nonprofits has created an enormous demand for competent trustees—a demand that far exceeds the population of those with either trustee experience or an understanding of traditional trusteeship values."[130] The competition for directors has produced a pecking order in the nonprofit world, with "lesser" boards serving as stepping stones for more important (more visible) boards.[131] In effect, the smaller nonprofits serve as the farm system for developing directorial talent. In addition, the rise of corporate grant-making and other external pressures have led nonprofits to adopt more businesslike

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once elected, a good pope should never think of himself as pope.

Id. at 101.

126. *See, e.g.*, PFEFFER & SALANCIK, *supra* note 43, at 236-38 (discussing executive succession and organizational power). In addition to similarity in formal schooling and orientation, "individuals in an organizational field undergo anticipatory socialization to common expectations about their personal behavior, appropriate style of dress, organizational vocabularies . . . and standard methods of speaking, joking, or addressing others." DiMaggio & Powell, *The Iron Cage Revisited*, *supra* note 48, at 71 (citations omitted). Professors DiMaggio and Powell quote Rosabeth Moss Kantor, in her 1977 work *Men and Women of the Corporation*, who described this process as the "homosexual reproduction of management." *Id.* at 72.

127. *See generally* PETER D. HALL, INVENTING THE NONPROFIT SECTOR 135-206 (1992); Brody, *supra* note 5.

128. *See* HALL, *supra* note 127, at 136-37.

129. HODGKINSON, ET AL., *supra* note 50, at 16. The Internal Revenue Service's Business Master File of federally tax-exempt organizations necessarily understates the number of nonprofit organizations, primarily because the Internal Revenue Code excludes churches from having to file, and does not require registration for very small organizations. *Id.* In 1988-89, there were an estimated 350,521 churches, synagogues, and other religious organizations in the United States. *Id.* (citing to the annual Yearbook of American and Canadian Churches and the Statistical Abstract of the United States).

130. HALL, *supra* note 127, at 137; *see also* Melissa Middleton, *Nonprofit Boards of Directors: Beyond the Governance Function*, *in* THE NONPROFIT SECTOR, *supra* note 17, at 141, 144-45 (noting that many nonprofit boards are overwhelmingly dominated by white male professionals).

131. HALL, *supra* note 127, at 138.

practices, and to add business executives to their boards.[132] Nonprofits must in turn dip lower into the proprietary hierarchy, and these middle managers view nonprofit board service as a competitive advantage in their climb to the top of their own business organizations.[133]

No market for corporate control exists in the nonprofit organization. Henry Manne suggests, in the business context, that the stock market provides the only objective standard of managerial efficiency.[134] Professor Manne observes that the legal system, as evidenced by the "business-judgment rule" prevents courts from second-guessing business decisions or removing directors from the board.[135] Accordingly, he believes, the Securities and Exchange Commission and the courts poorly protect shareholders with such devices as fiduciary duties and the shareholders' derivative suit.[136] To Professor Manne, "[o]nly the take-over scheme provides some assurance of competitive efficiency among corporate managers and thereby affords strong protection to the interests of vast numbers of small, non-controlling shareholders."[137] If one substitutes "public donors" for Professor Manne's "small shareholders" and the "Internal Revenue Service" for the "Securities and Exchange Commission," Professor Manne could have been speaking of the nonprofit, tax-exempt corporation. Thus, we would also expect to find more nonprofit conservatism, in the sense of lack-of-change (if not laziness), to the extent that the "market for corporate control" in the proprietary sector uses the threat of takeover to keep corporations competitive and efficient.

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132. *Id.* at 138-39.

133. *See id.* at 209 ("Others, especially aspiring midlevel managers [of proprietary businesses] faced with constricting opportunities for promotion into the top ranks, saw voluntarism as a way of gaining a competitive edge over their rivals, mindful not only of the visibility that volunteering could bring but also of the usefulness of community contacts as sources of new business."). See generally BRIAN O'CONNELL, THE BOARD MEMBER'S HANDBOOK: MAKING A DIFFERENCE IN VOLUNTARY ORGANIZATIONS (1985) and the various books, pamphlets, and even videos of the National Center for Nonprofit Boards (Fall 1995 catalogue on file with *The New York Law School Law Review*), for training a new generation of legions of well-intentioned community members not schooled in noblesse oblige (titles include BRIDGING THE GAP BETWEEN NONPROFIT AND FOR-PROFIT BOARD MEMBERS and BEYOND STRATEGIC PLANNING: HOW TO INVOLVE NONPROFIT BOARDS IN GROWTH AND CHANGE). Similar training is provided by the Independent Sector (a trade association of charities).

134. Manne, *supra* note 81, at 113.

135. *Id.*

136. *Id.*

137. *Id.*

Of course, nonprofits still compete with each other, and the marketplace for their outputs can weed out nonperforming or nonresponsive organizations. Indeed, nonprofit members have a range of "voice" and "exit" choices; they can "seek change from within, withhold financial support, cease to associate with the group, or form a rival group of their own."[138] In the religious sector, split-offs commonly occur. As a more modern example, consider one impetus behind the dramatic restructuring of Girl Scouts of America: "Lurking in the background like a corporate raider was the Boy Scouts of America. It had launched a feasibility study of extending its membership to girls."[139]

2. Whose Mission?[140]

Again, analyzing control separate from ownership raises the question of what objective a nonprofit seeks to maximize.[141] The vow of

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138. Austin v. Michigan Chamber of Commerce, 494 U.S. 652, 710 (1990) (Kennedy, J., dissenting). *Austin* involved the political expenditures of a chamber of commerce; this Article has generally ignored the many differences between charities and trade associations (and other mutual-benefit nonprofits, such as labor unions and social clubs), and the electoral or lobbying activities of either category of nonprofit.

139. *See* Byrne, *supra* note 45, at 72 ("The two most popular [Girl Scout] proficiency badges now are 'Math Whiz' and 'Computer Fun' instead of 'Good Grooming' and 'Hosting a Party,'" perhaps indicating a competitive response to the Boy Scouts' threat.).

140. Economists refer to purpose as the "objective function." Nonprofits use the term "mission." This is more than a difference of semantics. The term "objective function" begs for a subject—*whose* objectives? By contrast, the idea of a "mission" comes supplied with a subject—the reified nonprofit organization, a person in its own right.

141. Rather than describe the objective function (or purpose) of a particular organizational form, economists Eugene Fama and Michael Jensen cast choice of organizational form as a problem in organizational ecology.

> Social and economic activities, such as religion, entertainment, education, research, and the production of other goods and services, are carried on by different types of organizations, for example, corporations, proprietorships, partnerships, mutuals, and nonprofits. Most goods and services can be produced by any form of organization, and there is competition among organizational forms for survival in any activity. Absent fiat, the form of organization that survives in an activity is the one that delivers the product demanded by customers at the lowest price while covering costs.

Fama & Jensen, *Agency Problems*, *supra* note 29, at 327. Professors Fama and Jensen's account suffers from two serious weaknesses. First, they model the nonprofit sector as a donative world, in which (following Hansmann) the donor is the principal, and the nonprofit form provides the assurance against appropriation of residual claims. Second, their model necessarily predicts complete sorting into one or the other sector, and thus

nondistribution is not necessarily a vow of poverty.[142] But if a nonprofit is a profit-maximizer, it must be for reasons different from those of a for-profit firm. Remember, there are no residual claimants in a nonprofit. Because of this nondistribution constraint, the nonprofit organization has only two choices when it earns a monetary surplus: to reinvest (save) or to spend. Saving means only postponing the decision of how to spend the surplus. However the organization resolves the temporal issue, it must eventually decide how it can better "do good," either by reducing prices or by increasing costs (whether or not that translates into higher quality). So even a nonprofit that behaves like a profit-maximizer in the short run must, over the long run, eventually be a utility maximizer. (The "short run," however, can be a very long time—universities, for example, typically spend less than all the earnings from their endowments.[143])

No scholars have found that nonprofit organizations take a vow of poverty. A few economists have asserted various objective functions for nonprofits, "such as prestige maximization, maximization of employee income, redistribution of income, or maximization of a specified quantity/quality tradeoff."[144] One study of tax returns "suggest[s] that welfare, education, and arts [organizations] are 'service maximizers,' [while] health firms are budget maximizers."[145] Other economists assume that nonprofits maximize "disguised profits (discretionary spending), output quantity and quality and various inputs, such as staff

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cannot explain the simultaneous (or transitory) existence of different organizational forms in some commercial (that is, nondonative) activities, such as hospitals, nursing homes, and day care centers.

142. Howard P. Tuckman & Cyril F. Chang, *Nonprofit Equity: A Behavioral Model and Its Policy Implications*, 11 J. POL'Y ANALYSIS & MGMT. 76, 77-78 (1992) ("[T]he vast majority of charitable nonprofit organizations accumulate equity and . . . the real value of their equity grows over time." (citations omitted)).

143. *See* Joel C. Dobris, *Real Return, Modern Portfolio Theory, and College, University, and Foundation Decisions on Annual Spending from Endowments: A Visit to the World of Spending Rules*, 28 REAL PROP. PROB. & TR. J. 49, 70-71 (Spring 1993) (describing Harvard University's endowment plan); Henry Hansmann, *Why Do Universities Have Endowments?*, 19 J. LEGAL STUD. 3, 5 (1990).

144. Richard Steinberg, *The Revealed Objective Functions of Nonprofit Firms*, 17 RAND J. ECON. 508, 508 (1986) (citing Hansmann); *cf.* François Abbé-Decarroux, *The Perception of Quality and the Demand for Services: Empirical Application to the Performing Arts*, 23 J. ECON. BEHAV. & ORG. 99, 100 (1994) (employing a "notion of quality that relates to economic effects on demand and/or production costs, and not that stemming from purely aesthetic considerations," and suggesting that "quality can be determined only with the help of several criteria of differing types").

145. Steinberg, *supra* note 144, at 508 (citation omitted).

size."[146] A social scientist states that nonprofits "tend to maximize their budgets and program, their influence over their areas of specialization, and their prestige and autonomy."[147] One management article asserts: "The bottom-line measure of a nonprofit organization's effectiveness is its survival. Survival is ensured to the extent the manager 'spans the boundaries' so that the important functions of effective acquisition and maintenance of resources are performed."[148]

The nondistribution constraint in nonprofit law is designed for enterprises in which the capital requirements are met by donations. In other words, the suppliers of capital do not demand (and legally cannot receive) an economic return on capital. This constraint does not bind, however, in an enterprise with low capital needs, or whose capital needs can be met through grants, contracts, borrowing or retaining earnings. For example, many social service organizations rely almost exclusively on a combination of government contracts and fees for services.[149] Under these circumstances, returns to capital can be fully satisfied, and a founder might prefer to cloak the enterprise in nonprofit garb in order to appropriate the "halo" effect of operating as a nonprofit.[150]

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146. Jerald Schiff & Burton Weisbrod, *Competition Between For-Profit and Nonprofit Organizations in Commercial Markets*, *in* THE NONPROFIT SECTOR IN THE MIXED ECONOMY, *supra* note 100, at 127, 129 (footnote omitted).

147. John O'Looney, *Beyond Privatization and Service Integration: Organizational Models for Service Delivery*, 67 SOC. SERV. REV. 501, 512 (1993).

148. Richard D. Heimovics & Robert D. Herman, *The Salient Management Skills: A Conceptual Framework for A Curriculum for Managers in Nonprofit Organizations*, 19 AM. REV. PUB. ADMIN. 295, 302 (1989).

149. *See* STEVEN R. SMITH & MICHAEL LIPSKY, NONPROFITS FOR HIRE: THE WELFARE STATE IN THE AGE OF CONTRACTING 38-39 (1993) (identifying three types of service nonprofits: the traditional, old-line, usually endowed agency; the small, grassroots community agency, run on a shoestring budget; and the agencies founded in the last twenty years, "directly in response to the availability of government funds for job training, mental health, and other contemporary services"). The move to privatize social services has caused a surge in the number and size of nonprofit social service agencies. *See, e.g.*, *id.* at 6 ("[G]overnment purchase of service contracting with nonprofit service agencies in Massachusetts rose from $25 million in 1971 to $850 million in 1988." (footnote omitted)).

150. *Cf.* Burton A. Weisbrod & Mark Schlesinger, *Public, Private, Nonprofit Ownership and the Response to Asymmetric Information: The Case of Nursing Homes*, *in* THE ECONOMICS OF NONPROFIT INSTITUTIONS, *supra* note 99, at 133, 145:

> As recognition of the signal value of institutional form grows, and organizations enter the industry with the "preferred" form, we can expect "debasement of the currency" of that form. Organizations will tend to "disguise" themselves, taking on the formal trappings of the preferred form while behaving differently. There are barriers to such misrepresented entry

In particular, a nonprofit's utility function could be either profit maximization or utility maximization and still be consistent with the legal bar on paying returns to capital *if*, as is commonly the case, the organization engages in a labor-intensive activity. To the extent the organization increases costs, then labor (and any other favored factor of production) captures the surplus. Labor costs could increase either by hiring more labor, or by increasing the compensation paid to existing labor (either directly or through enhanced working conditions).[151]

Thus, perhaps we do not see nonprofits providing goods because there is less of an opportunity by the provider to capture the benefits of opportunistic behavior. In the service industries, which are labor-intensive, the supply-side stakeholders can siphon off the "profit" in compensation. Manufacturing is more capital-intensive, and presents less of an opportunity to siphon.[152]

Resource-constrained nonprofits have recently sought novel sources of revenue. Charitable conduct of business activities has exploded since President Ronald Reagan reduced government expenditures on social services.[153] Much of the controversial activity involves the production of goods embodying no particular information asymmetry, such as museum gift shops selling reproductions.[154] Economists assume that

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> . . . [but n]onetheless, disguised entry of this sort is likely to narrow the differences in organizational behavior.

151. *See, e.g.*, Netzer, *supra* note 98, at 191-92 (explaining that between 1966 and 1974, a period of large increases in both government and foundation support for the performing arts, the increase in contributed income to nonprofit theater companies was almost matched by the total dollar value of the "excess" increases in wages).

152. *Cf.* Mark Pauly & Michael Redisch, *The Not-For-Profit Hospital as a Physicians' Cooperative*, 63 AM. ECON. REV. 87, 98 (1973) ("The supposed quality consciousness of [not-for-profit] hospitals . . . is easily explained; 'quality' is a synonym for application of nonphysician labor and capital in physician-income-enhancing ways . . . .").

153. *See, e.g.*, Estelle James, *How Nonprofits Grow: A Model*, *in* THE ECONOMICS OF NONPROFIT INSTITUTIONS, *supra* note 99, at 185, 188 [hereinafter James, *How Nonprofits Grow*] (describing plans by National Public Radio to raise money for its radio production through, among other projects, "the sale of audio cassettes of NPR programs and the transmission of business information by satellite communication. 'We're prepared to enter almost any profession except the oldest one,' declared the president of NPR, as he announced his plans to rely on cross-subsidization increasingly in the years ahead"). "Unrelated" business activities (as defined) are subject to the corporate income tax. *See* I.R.C. §§ 511-15 (1994).

154. Proposals to tax these commercial activities have, from time to time, been advocated by the proprietary sector, but, having worked at the staff level in the Treasury Department during the latest go-around in 1989, I can attest to the difficulty in trying to draw lines between "related" and "unrelated" business activities.

nonprofits engage in these activities (and indeed seek to maximize the profits from them) as a way to cross-subsidize their preferred nonprofit activities.[155] Even where these commercial activities involve information asymmetry, however, "[o]nce we accept the fact that [nonprofit organizations] will find it in their utility-maximizing interest to cross-subsidize, and will engage in some activities simply to earn a profit (but won't tell you ahead of time which these are), the alleged superiority of [nonprofit organizations] under asymmetric information disappears."[156]

D. *Summary of Why Firms Form*

In this part, we explored the reasons for the formation of firms, whether for-profit or nonprofit. Initially, both types of arrangements are designed to overcome transaction costs in providing goods or services. However, we saw that because of principal-agent problems, large for-profit firms generally operate independent of shareholder control. While nonprofits have no shareholders, a close examination of the standard explanation for nonprofit formation similarly reveals a split between the patrons and the firm. The nondistribution constraint is supposed to overcome agency costs by inducing patrons to trust nonprofits, whose outputs the patrons cannot judge because of information asymmetry. Unfortunately wanting to deal with a trustworthy supplier does not guarantee the existence of a trustworthy supplier. As a negative constraint, the nondistribution constraint does not ensure that the organization spends its money in any particular way. In addition, nonprofits almost exclusively provide services, and the law generally permits competitive returns to labor; the nondistribution constraint bars only returns to equity capital. Accordingly, certain in service industries, "for-profits in disguise" can seek to appropriate the halo of nonprofit status without a large cost to the founders/managers.

III. INSIDE THE BLACK BOX: MANAGEMENT OF THE FIRM

Neoclassical economics deals with markets—the interaction of producers and consumers, and the dynamics of how prices are set by competition. Once economic activity became concentrated in firms, neoclassical economics concluded that the market sets prices through the

155. *See* James, *How Nonprofits Grow*, *supra* note 153, at 187 ("Because the [nonprofit] manager has tastes, preferring to deliver one service rather than another, and because some of the preferred services may not cover their own costs, these organizations characteristically find themselves taking on profit-making activities that will cover the deficit incurred in other activities.").

156. James, *Comments*, *supra* note 99, at 155.

interaction of firms. The neoclassical economist ignored what went on within the producing enterprise: the firm was a "black box," and all firms were considered to make the most efficient use of their internal resources in order to maximize profits.[157] Then came a revolution in economics as radical as atomic physics was to Newtonian physics.

Economists recognized that their emphasis on markets "relegated the study of organizations to business schools, or worse still, to sociologists."[158] Herbert Simon recently suggested that "organizational economy" would be a more appropriate way than "market economy" to describe developed countries.[159] Recognizing that most producers are employees rather than owners, Professor Simon describes their lack of incentives to maximize the profits of firms, since profits redound to the benefit of owners. Professor Simon views the problem as universal: "profit-making firms, nonprofit organizations, and bureaucratic organizations all have exactly the same problem of inducing their employees to work toward the organizational goals."[160] Thus, he concludes, organizational form does not, a priori, make it any easier (or harder) to align the interests of the employees with organizational goals, regardless of whether those goals are profit-maximization or anything else.[161]

In other words, we find a second, internal principal-agent problem, where the management is the principal and the employees are the agents. The difficulties and constraints of managing the firm alter the goals and purposes of the firm itself. Regardless of how much the principals want a firm to act in their interests, strong forces cause organizations to behave in the interests of all of their workers, which is one reason firms of all forms come to look so much alike. In various ways, organizations copy each other and adopt the standards dictated by broadly based constituents.

Paul DiMaggio and Walter Powell, in a famous account of "institutional isomorphism," identify three types of mimicry to "help explain the observations that organizations are becoming more homogeneous and that elites often get their way, while at the same time enabling us to understand the irrationality, the frustration of power, and

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157. Joseph E. Stiglitz, *Symposium on Organizations and Economics*, 5 J. ECON. PERSP. 15, 15 (1991) ("Many economists argued that there was no need to look carefully into the black box called the firm: firms maximized profits (stock market value); if managers didn't, they would be replaced; and firms that didn't maximize value wouldn't survive.").

158. *Id.*

159. Herbert A. Simon, *Organizations and Markets*, 5 J. ECON. PERSP. 25, 28 (1991).

160. *Id.*

161. *Id.*

the lack of innovation that are so commonplace in organizational life."[162] First, DiMaggio and Powell find "coercive isomorphism," resulting from adherence to standardized procedures and structures imposed on an organization, either as a result of government regulation, affiliated group agreement, or satisfaction of a particular resource on which the organization depends.[163] Second, Professors DiMaggio and Powell find that, as a response to uncertainty, organizations voluntarily imitate or model themselves after other organizations that they perceive to be more legitimate or successful.[164] Finally, professionalism provides normative pressures to conform. Professors DiMaggio and Powell find that the recent growth in the professional classes primarily occurred among the managers and specialized staff of large organizations.[165]

As discussed above, the public values nonprofit organizations for their perceived diversity and flexibility when compared with the public sector. Nevertheless, nonprofits are no less firms than are for-profits. Innovation is hard to produce under a "population ecology" theory of organizations: "Once an organization has made a public claim to mobilize resources, has induced individuals to cede some control in return for specific inducements, has invested in physical and human capital of specific types, and has designed a product or service to appeal to a certain audience, it has greatly limited its range of feasible transformations."[166] The theory of organizational inertia explains why newly created organizations are less likely to survive than older organizations (the "liability of newness"),[167] and "death rates" of organizations apparently decline exponentially as organizations age.[168] So how does innovation in an industry occur? If the demand side remains heterogenous, while organizations become more homogeneous, then the growing unfulfilled demand for products and services "creates opportunities for 'outlaw' entrepreneurs to experiment with new organizational forms."[169]

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162. DiMaggio & Powell, *The Iron Cage Revisited*, *supra* note 48, at 79.

163. *Id.* at 67-69.

164. *Id.* at 69-70 ("Thus in the arts one can find textbooks on how to organize a community arts council or how to start a symphony women's guild.").

165. *Id.* at 70-73; *see infra* part IV.

166. Michael T. Hannan & John Freeman, *Structural Inertia and Organizational Change*, 49 AM. SOC. REV. 149, 156 (1984).

167. *Id.* at 157 ("[I]t takes time for an organization to acquire institutional reality to its members and to become valued in its own right.").

168. *Id.* at 158 ("Old organizations tend to develop dense webs of exchange, to affiliate with centers of power, and to acquire an aura of inevitability.").

169. Walter W. Powell, *Expanding the Scope of Institutional Analysis*, *in* THE NEW INSTITUTIONALISM, *supra* note 48, at 183, 198 (discussing Professor Hannan's work).

A. *The Balance of Power Between Board and Executive*

A board of directors can greatly harm the organization by defaulting on its monitoring function. Dominating, charismatic chief executives fill the business world, and not in just small, family-owned businesses. "Microsoft" means Bill Gates;[170] in the not-too-distant past "Apple" meant Steve Jobs, and "Chrysler" meant Lee Iacocca. William Agee nearly brought down Morrison-Knudson.[171] "CEO disease"—the egotistical chief executive—can be fatal to a company.[172]

In the proprietary sector, we find opposing theories of good corporate governance, both based on the information asymmetry enjoyed by management. "Inside directors"—those who hold management positions within the nonprofit corporation—are already most familiar with the organization's operations, if not the policy issues. Corporate officers seek board participation because they believe their superior knowledge of the workings of the business enhance board decision making. To those most worried about agency theory, however, information asymmetry results in the foxes guarding the henhouse.[173] Because the management can behave opportunistically, the shareholders need an independent board of directors in order to protect their interests.

Some legal reformers advocate that a majority of the boards of large corporations be outsiders.[174] Melvin Eisenberg argues that as a practical matter the typical board is passive, allowing most of its functions to be performed by senior management while retaining only the task of selecting

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170. *See* G. PASCAL ZACHERY, SHOWSTOPPER! 232 (1994) ("The richest American by virtue of his roughly seven billion dollars in Microsoft stock, Gates was an object of envy and awe, paranoia and adulation. . . . The real Gates resembled a big-city political boss; more Richard Daley than Rockefeller. This was because his power depended on both exploiting and nurturing a chain of dependents, everyone from applications writers to PC makers to customers.").

171. *See, e.g.*, Diana B. Henriques, *Ties That Bind: His Directors, Her Charity*, N.Y. TIMES, Mar. 21, 1995, at D1.

172. John A. Byrne et al., *CEO Disease*, BUS. WK., Apr. 1, 1991, at 52, 54 ("It is still rare when the board of directors or a company's shareholders . . . hold a corporate chieftain accountable before it's too late.").

173. *See* Ronald J. Gilson & Reinier Kraakman, *Reinventing The Outside Director: An Agenda For Institutional Investors*, 43 STAN. L. REV. 863, 872-76 (1991).

174. *E.g.*, Melvin A. Eisenberg, *Legal Models of Management Structure in the Modern Corporation: Officers, Directors, and Accountants*, 63 CAL. L. REV. 375 (1975). Eisenberg was the reporter for the American Law Institute's "corporate governance project," the initial draft of which contained a majority-outsider rule. *See* Stephen M. Bainbridge, *Independent Directors and the ALI Corporate Governance Project*, 61 GEO. WASH. L. REV. 1034, 1040 (1993).

and monitoring the chief executive, a task it does poorly.[175] Reformers fail to recognize, however, that we can give opposite accounts of independent directors.[176] As Stephen Bainbridge phrases it: "The faithful monitor story posits that independent directors assiduously carry out their oversight obligations. In contrast, the rubber stamp story claims that they are little more than management puppets."[177] Being both independent and a director seems to require the impossible: remedying the information asymmetry without devoting full-time resources to management; avoiding the natural tendency to shun conflict and favor incumbent management; and overcoming the free-rider problem of any group activity.[178]

Much has been made of the recent increase in "outside" directors on the boards of publicly traded corporations. As of 1987, seventy percent of directors were outsiders.[179] As a separate measure, only fifty percent of corporations had a majority of outside directors in 1938; this percentage surged to eighty-three percent by 1979.[180] One can question how independent these outside directors really are because the chief executive officers, who generally identify potential board candidates, like to place CEOs of other companies on their boards. The risk, of course, is that the successful candidates would return the favor by drawing the line between the board's role and management's role too often to the benefit of management.[181]

Being an outside director can result in richer management experience, allowing for better decision-making by that director at his or her "day" job.[182] One surveyed director commented: "I can give you a long list of situations I've handled better here at my company because I've been through them or seen them or thought them through elsewhere as an outside board member. It's a great opportunity."[183] Overlapping

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175. MELVIN A. EISENBERG, THE STRUCTURE OF THE CORPORATION 139-41, 162-68 (1976); *see also* MYLES L. MACE, DIRECTORS: MYTH AND REALITY 184-90 (1971). Bainbridge reminds us how old this complaint is. Bainbridge, *supra* note 174, at 1062-63 n.145 (citing William O. Douglas, *Directors Who Do Not Direct*, 47 HARV. L. REV. 1305 (1934)).

176. *See* Bainbridge, *supra* note 174, at 1058.

177. *Id.*

178. *See id.* at 1059-61.

179. JAY W. LORSCH WITH ELIZABETH MACIVER, PAWNS OR POTENTATES: THE REALITY OF AMERICA'S CORPORATE BOARDS 17 (1989).

180. *Id.* at 17-18 (citations omitted).

181. *Id.* at 18-19.

182. *Id.* at 27.

183. *Id.*

management and board service, however, result in a guild of outside directors.

How does the board/management power relationship change, if at all, in a nonprofit? Can we predict that the lack of shareholders will effectively increase the power of executives of charitable organizations relative to the board?

Dennis Young, in a book subtitled *A Behavioral Theory of the Nonprofit Sector Based on Entrepreneurship*, developed a theory that entrepreneurs possessing various characteristics sort themselves into appropriate fields and reward structures.[184]

> Screening or self-selection occurs on the basis of differences in structural variables among sectors . . . , such as income potential and intrinsic character of the work to be performed. The differential filtering of motivation into sectors that allow room for managerial discretion determines the ultimate behavior of firms. Thus, for nonprofits, according to Hansmann's and Weisbrod's analyses, the screening process may be expected to produce organizational activity that is less tuned to pecuniary aggrandizement than that of firms in the profit-making part of the economy.[185]

In general, Professor Young finds that the nonprofit sector primarily attracts those he categorizes variously as believers, conserves, poets, searchers, and professional varieties of entrepreneur.[186] Nevertheless, he cautions that a nonprofit board, even more than a proprietary board, might need to keep a close eye on its chief executive, because "output is more difficult to measure and managerial rewards are only loosely related to changes in organizational wealth."[187]

To some, the nonprofit board is a greater force than the for-profit board.[188] However, others suggest that we should reverse the usual

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184. DENNIS R. YOUNG, IF NOT FOR PROFIT, FOR WHAT? (1983); *see also* Jane M. Howell & Peter J. Frost, *A Laboratory Study of Charismatic Leadership*, 43 ORG. BEHAV. & HUM. DECISION PROCESSES 243 (1989).

185. YOUNG, *supra* note 184, at 16-17.

186. *Id.* at 140.

187. *Id.* at 94 (quoting Kenneth W. Clarkson, *Some Implications of Property Rights in Hospital Management*, 15 J.L. & ECON. 363 (1972)).

188. *See, e.g.*, Peter F. Drucker, *What Business Can Learn from Nonprofits*, HARV. BUS. REV., July-Aug. 1989, at 88, 90:

> Many nonprofit boards now have what is still the exception in business—a functioning board. They also have something even rarer: a CEO who is clearly accountable to the board and whose performance is reviewed annually

business hierarchy and place the nonprofit chief executive above the board.[189] Perhaps chief executives often appear more dominating in the nonprofit sector only because nonprofit directors usually exhibit an extreme form of the characteristics already seen in proprietary boards[190] —outside nonprofit directors tend to be time-constrained volunteers,[191] to be chosen for their relationships to certain key constituencies of the

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> by a board committee. And they have what is rarer still: a board whose performance is reviewed annually against preset performance objectives.

See also Byrne, *supra* note 45, at 69 (describing management techniques of various nonprofits):

> Ah, yes, the directors. The bane of many a CEO. Perhaps there is no better example of what the nonprofits have to teach Corporate America. What is often viewed as little more than a necessary evil in corporate executive suites has become a prized source of expertise and a reality check for nonprofit managers.

189. *See* Heimovics & Herman, *supra* note 148, at 307-08, 309 n.13 ("We were unprepared for the fact that both actors and observers in our research found the [nonprofit chief executive] as responsible for all nonprofit organizational outcomes, both successes and failures."). At the very least, the relationship between the executive director and the board consists of "strange loops and tangled hierarchies." Middleton, *supra* note 130, at 149-51. "[B]oard members are part-time volunteers who may serve as trustees for a variety of noneconomic reasons, such as the desires to become more fully integrated into the community, to develop new circles of friends, and to gain status and prestige." *Id.* at 144.

190. *See, e.g.*, *The Invisible Band*, ECONOMIST, Oct. 8, 1994, at 81, 81 (reforms of proprietary boards "depend on non-executives, who are paid a pittance and expected to behave as hard-nosed businessmen, referees, coaches, visionaries and saints, while giving only a few days a year to the job.").

191. *See* Deborah A. De Mott, *Self-Dealing Transactions in Nonprofit Corporations*, 59 BROOK. L. REV. 131, 140 (1993) (discussing the different motives and incentives of directors of nonprofit boards, as compared with those of business corporation directors). Professor De Mott observes that:

> Most nonprofits do not compensate their directors directly. Board members often join because they believe in an organization's mission and contribute to it with financial donations. They depend heavily on organization management to set the board's agenda and provide information to the board. Many large nonprofits also have relatively large boards.

Id. (footnotes omitted). The National Charities Information Bureau adopted standards prohibiting the payment of fees to directors (although participation costs may be paid). *Id.* at 140 n.46. However, "[s]ome actors in this environment reportedly believe that directors who make financial contributions have a reciprocal entitlement to self-deal." *Id.* at 140. Perhaps the obvious solution is to allow nonprofits to pay reasonable fees for services to financially-strapped directors.

nonprofit,[192] and to lack technical proficiency in the "business" of the nonprofit.[193]

B. *Organizational Behavior and Productive Efficiency*

Examining the internal operations of an organization strongly challenges the classic assumption that proprietary businesses seek to maximize profits. In the 1950s the Carnegie School began developing theories of organizational behavior.[194] Herbert Simon's pathbreaking work found that corporate managers tend to engage in "satisficing," that is, managing inputs (physical and human) at merely a satisfactory rate (subject to making a profit) rather than at a profit-maximizing rate.[195] Similarly, Richard Cyert and James March identified the multiple and

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192. *Cf.* Middleton, *supra* note 130, at 141 ("To control any external dependencies, an organization can place on its board representatives of important external groups or constituencies and define as one of the board's functions the task of mediating its relationships with these key elements.").

193. *See, e.g.*, JOHN S. GLASER, THE UNITED WAY SCANDAL 207-08 (1994), describing how William Aramony, president of United Way of America, controlled board meetings:

> [M]aterial presented to the Board had already been reviewed and massaged, either by the officers or by the committee chairmen so as to eliminate any dissension at meetings. Board members who often disagreed or asked embarrassing questions were not given committee assignments and eventually left the board. I never heard any comment about a board meeting other than, "Great meeting, wasn't it?"

See also Middleton, *supra* note 130, at 144 (one nonprofit staff criticized the board's lack of technical expertise, and "[thus], the very characteristics that legitimated the boards' external representation functions created tensions between board and staff."). *But see id.* at 149 (in nonprofits with "noisy" boards, those who also have constituent representatives, "[u]nclear authority relationships between board and management may develop, and the board may encroach on staff's administrative functions.").

194. *See* Harvey Leibenstein, *Organizational or Frictional Equilibria, X-Efficiency, and the Rate of Innovation*, 83 Q.J. ECON. 600, 601 n.2 (1969) [hereinafter Leibenstein, *Innovation*]. My historical account of industrial economics is necessarily abbreviated, and omits discussion of important works by economists including: KENNETH J. ARROW, ESSAYS IN THE THEORY OF RISK-BEARING (1971); CHESTER I. BARNARD, THE FUNCTIONS OF THE EXECUTIVE (1938); JOHN R. COMMONS, INSTITUTIONAL ECONOMICS (1934); and FRANK H. KNIGHT, PH.D., RISK, UNCERTAINTY AND PROFIT (1921); and by legal academics including Archibald Cox, *The Legal Nature of Collective Bargaining Agreements*, 57 MICH. L. REV. 1 (1958) and Karl N. Llewellyn, *What Price Contract? An Essay in Perspective*, 40 YALE L.J. 704 (1931). For a general overview of transaction cost economics, see the prologue to WILLIAMSON, ECONOMIC INSTITUTIONS, *supra* note 15, at 1-12.

195. *See generally* H. Simon, *A Behavioral Model*, *supra* note 94.

conflicting goals a business corporation harbors: they assumed not only "a profit goal[, but also] a sales goal, a market share goal, an inventory goal, and a production goal."[196] Professors Cyert and March observed that primacy for each of these goals is pressed by members of coalitions within the organization, based on their independent aspirations.[197] As a result of these "more or less independent" goals, bargaining must occur among potential coalition members as short-run pressures demand.[198]

Professors Cyert and March further described the concept of "organizational slack"—a cushion of excess labor and unaggressive business practices, built up out of retained profits during fat years to be trimmed or reformed during lean years.[199] As a result of these mechanisms, the corporation has the flexibility to adapt over time as "the decentralization of decision making (and goal attention), the sequential attention to goals, and the adjustment in organizational slack permit the business firm to make decisions with inconsistent goals under many (and perhaps most) conditions."[200] In sum, practices such as crisis management and the adoption of routines "follow from the view of decision making as a political process."[201]

Slightly different from Cyert and March's theory of organizational slack is Harvey Leibenstein's theory of "X-efficiency."[202] This management concept describes the increased inputs that can be produced with a better deployment of given inputs.[203] More commonly, scholars refer to the antonym "X-inefficiency," defined as the degree to which

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196. CYERT & MARCH, *supra* note 56, at 117.

197. *Id.*

198. *Id.* at 43.

199. *Id.* at 36-38; *cf.* ALBERT O. HIRSCHMAN, EXIT, VOICE, AND LOYALTY 15 (1970). Hirschman puts a slightly different slant on slack, viewing it like a human law of thermodynamics:

> [Slack] is *continuously being generated* as a result of some sort of entropy characteristic of human, surplus-producing societies. . . . Firms and other organizations are conceived to be permanently and randomly subject to decline and decay, that is, to a gradual loss of rationality, efficiency, and surplus-producing energy, no matter how well the institutional framework within which they function is designed.

Id.

200. CYERT & MARCH, *supra* note 56, at 43.

201. Powell & DiMaggio, *supra* note 58, at 1, 19.

202. *See* Harvey Leibenstein, *Allocative Efficiency vs. "X-Efficiency"*, 56 AM. ECON. REV. 394 (June 1966) [hereinafter Leibenstein, *Efficiency*]; *see also* Leibenstein, *Innovation*, *supra* note 194; HARVEY LEIBENSTEIN, INSIDE THE FIRM: THE INEFFICIENCIES OF HIERARCHY (1987) [hereinafter LEIBENSTEIN, INSIDE THE FIRM].

203. *See* Leibenstein, *Efficiency*, *supra* note 202.

actual output falls short of maximum output for given inputs.[204] Leibenstein observes: "The simple fact is that neither individuals nor firms work as hard, nor do they search for information as effectively, as they could."[205] He identifies four reasons why given inputs cannot produce predetermined outputs: (1) labor contracts cannot be drafted to cover every possible situation; (2) some factors of production are not marketed; (3) the firm cannot completely specify (or even know) its production function; and (4) competing firms, because of interdependence and uncertainty, find themselves tacitly cooperating in some respects, and imitating each other's techniques.[206] As Professor Leibenstein concludes, "where competitive pressure is light, many people will trade the disutility of greater effort, of search, and the control of other peoples' activities for the utility of feeling less pressure and of better interpersonal relations."[207]

To Professor Leibenstein, some human inputs more readily translate into predictable output than others. Thus, he distinguishes "marginal product" employees, for whom one can easily calculate their value added to output, from "non-marginal product" employees, whose value added might be very costly, difficult, inefficient, or unconventional to calculate.[208] Professor Leibenstein gives as examples not just owners, managers, and supervisory employees, but also some employees with staff jobs, such as accountants, engineers, and secretaries.[209] To Professor Leibenstein, perfect efficiency cannot be achieved because of the costs of innovation. That is, firms that do not innovate their operations have implicitly decided that the costs of making the change to the required level of effort exceed the utility of the potential net gain. Costs are high not just because of one person's unwillingness to change, but also because of group dynamics:

> Some people believe that they will gain by the adoption; others are neutral, while still others may fear that they will lose. . . . Somehow the promoter or promoters have to persuade the members of the group that no one will lose or that there are reapportionments of the gains possible so that potential losers will be compensated, or else the power structure has to be such that

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204. *Id.*

205. *Id.* at 407.

206. *Id.*

207. *Id.* at 413.

208. Leibenstein, *Innovation*, *supra* note 194, at 602.

209. *Id.* at 602-03.

> those who gain can somehow force their decision upon those who lose.[210]

Unless the firm can create appropriate incentives for its employees, innovation will fail. Because "the nature of the employment relation is such that individuals are not given full vested rights in the gains from a change," the group could discount the gains to the point that they fall short of the losses, and thus resist innovation.[211]

Economists continued to refine a model of organizational behavior. Oliver Williamson's pioneering work in the New Industrial Economics, begun in the 1960s, brought new understanding of how internal firm structure can elicit effort through hierarchies and peer-group sanctions.[212] He also identified the downside of hierarchies: information "degrades" as it is passed up the chain, and the top (policy making) level can be far removed from the lowest (detailed information-gathering) layers. Hierarchy both reduces the effectiveness of monitoring and dilutes the "message from the top." Moreover, "the real principals (stockholders) are usually not in a position to state their specific interest, however imperfectly."[213]

In 1977, Alfred Chandler published *The Visible Hand*, in which he emphasized the hegemony of a professional managerial class. Indeed, Professor Chandler characterized the modern business enterprise as "managerial capitalism."[214] Once "modern business enterprise took the place of market mechanisms in coordinating the activities of the economy and allocating its resources, . . . it became the most powerful institution in the American economy and its managers the most influential group of economic decision makers."[215] Reminiscent of Berle and Means's work almost half a century earlier, Professor Chandler observed that the

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210. *Id.* at 614.

211. *Id.* at 615.

212. *See generally* OLIVER E. WILLIAMSON, MARKETS AND HIERARCHIES: ANALYSIS AND ANTITRUST IMPLICATIONS 41-56 (1975).

213. Leibenstein, *Efficiency*, *supra* note 202. While management fashions change with dizzying speed, techniques include management hierarchies, peer-group monitoring, and systems to bifurcate decisions between "management (initiation and implementation) and control (ratification and monitoring)." Fama & Jensen, *Separation of Ownership and Control*, *supra* note 124, at 308, as well as the more recent quality circles, joint worker-management groups, and matrix management.

214. ALFRED D. CHANDLER, JR., THE VISIBLE HAND: THE MANAGERIAL REVOLUTION IN AMERICAN BUSINESS 1 (1977) [hereinafter CHANDLER, THE VISIBLE HAND]; *see also* ALFRED D. CHANDLER, JR., STRATEGY AND STRUCTURE: CHAPTERS IN THE HISTORY OF THE INDUSTRIAL ENTERPRISE (1962).

215. CHANDLER, THE VISIBLE HAND, *supra* note 214, at 1.

increasing size and complexity of the modern business enterprise demanded increasingly professionalized managers, separating management from ownership.[216] As a result of this power shift, "in making administrative decisions, career managers preferred policies that favored the long-term stability and growth of their enterprises to those that maximized current profits."[217] When faced with high profits, managers "preferred to reinvest them in the enterprise rather than pay them out [to shareholders] in dividends."[218] That is to say, the utility function of the business firm *becomes* the utility maximization of the managers—preserving and improving their jobs.

One scholar extends this existential view of firms to the public sector—as well as to the nonprofit sector. All organizations, asserts Barry Bozeman, seek stable growth, autonomy, and control: "The mission of the organization is less important than these basic motivations, and these motivations are only minimally affected by the presence or absence of a profit motive."[219]

Indeed, no one inside the black box of the firm behaves as if work is just a chance to make profits for the firm: "[W]hile companies must serve shareholders' interests, neither their executives nor their employees leap from bed in the morning in order to maximize the risk-adjusted present value of streams of future cash flows."[220] Rather, twentieth-century American workers define themselves, in many ways, in relation to the society they find at the work place.[221]

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216. *Id.* at 1-6.

217. *Id.* at 10.

218. *Id.*

219. BARRY BOZEMAN, ALL ORGANIZATIONS ARE PUBLIC: BRIDGING PUBLIC AND PRIVATE ORGANIZATIONAL THEORIES 149 (1987).

220. Joseph L. Badaracco, Jr., *Business Ethics: Four Spheres of Executive Responsibility*, 34 CAL. MGMT. REV. 64, 72 (1992).

221. *See, e.g.*, RONALD INGLEHART, CULTURE SHIFT IN ADVANCED INDUSTRIAL SOCIETY (1990); DANIEL YANKELOVICH ET AL., THE WORLD AT WORK: AN INTERNATIONAL REPORT ON JOBS, PRODUCTIVITY, AND HUMAN VALUES (1985). Work contains positive utilities that are socially and historically structured,

> whether as expression of an identity (I work or I am a metal worker), a relative performance (I am a good metal worker), social value (It is good to be a metal worker), gender (It is good for a man to be a metal worker), or social status (It is better to be a metal worker than a salesperson).

Friedland & Alford, *supra* note 114, at 232, 234.

For a discussion of the dark side of spending more and more time at work, see JULIET B. SCHOR, THE OVERWORKED AMERICAN: THE UNEXPECTED DECLINE OF LEISURE (1991).

C. *Nonprofit Operations: X-Inefficiencies, Cross-Subsidizing, and Competition*

How different is the nonprofit sector? Once economists turned their attention to non-proprietary enterprises, such as government and nonprofits, they expected to find even greater organizational slack and X-inefficiencies.[222] Management schools recently have begun examining the nonprofit sector,[223] and you can now find books like *Managing the Non-Profit Organization*, by management expert Peter Drucker, on the shelves of local bookstores.[224]

Aside from any possible malfeasance they might commit, charity managers can manage a nonprofit in ways that prevent the nondistribution constraint from operating as its proponents hope. Even without distribution of profits, two types of information asymmetries persist with regard to the "value" a patron is getting from a charity. First, the charity might have high X-inefficiencies, either productive inefficiencies (such as a relaxed work environment) or the cross-subsidization of another "good" (such as charity care by a hospital, or the employment of beneficiaries rather than professional staff). Second, the patron may be faced with more than one competing charity, and the nondistribution constraint provides no way of choosing among them.

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222. *See, e.g.*, Regina E. Herzlinger & William S. Krasker, *Who Profits from Nonprofits?*, HARV. BUS. REV., Jan.-Feb. 1987, at 93, 104 ("[W]e believe nonprofit managers could perform even better if they were freed of the limitations imposed by the nonprofit setting and could operate in a for-profit environment with its clearer incentives and measures of performance."); Weisbrod & Schlesinger, *supra* note 150, at 142-43 (finding greater organizational slack in nonprofit nursing homes than in for-profit nursing homes, except for church-owned and public institutions, whose administrators, perhaps, "are less motivated by financial incentives").

223. *See, e.g.*, Byrne, *supra* note 45, at 67-68 ("To cope with their changing environment, the leaders of nonprofits are steeping themselves in professional management techniques, even attending management sessions at Harvard, Stanford, and Wharton.").

224. PETER F. DRUCKER, MANAGING THE NON-PROFIT ORGANIZATION: PRACTICES AND PRINCIPLES (1990) (includes interviews with nonprofit executives). Incidentally, Drucker uses many examples from the business sector. Publisher John Wiley & Sons produces a series of titles in its "Nonprofit Law, Finance, and Management Series." The list currently stands at 11, including the *Financial and Accounting Guide for Not-for-Profit Organizations* and *Fund-Raising: Evaluating and Managing the Fund Development Process*. See also *supra* note 133 discussing the numerous texts to improve nonprofit governance, published by the Independent Sector and by the National Center for Nonprofit Boards.

According to the standard analysis, efficiency takes a back seat to "mission"[225] in an organization where no shareholders demand profit-maximization,[226] and where goals are deliberately made fuzzy in order to avoid antagonizing conflicting constituencies. Nonproprietary enterprises (whether private or public) operate with a higher degree of slack, or X-inefficiency—avoiding conflict, reducing tension, valuing "fairness,"[227] and making the nonprofit a more pleasant place to work.

One might think that a nonprofit would engage in less opportunistic behavior than a proprietary enterprise. This depends, however, on how one defines "opportunistic."[228] There is no reason for automatically assuming that for-profits will engage in opportunistic behavior and nonprofits will not.[229] Professor Hansmann posits that only a few consumers actually calculate the benefits of dealing with nonprofits, and the rest of the public uses nonprofit status as a signal of trustworthiness.[230] Many economists simply ignore the fact that for-

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225. *See, e.g.*, Byrne, *supra* note 45, at 68 ("'Many of the good people who come up in the nonprofit world generally rise for reasons other than their interest or skill in management,' says John W. Gardner, a professor at Stanford University.").

226. Economists believe that nonprofits are "inherently subject to productive inefficiency (that is, failure to minimize costs) owing to the absence of ownership claims to residual earnings." Hansmann, *Economic Theories of Nonprofit Organization*, *supra* note 17, at 38 (citations omitted).

227. *Cf.* BOZEMAN, *supra* note 219, at 36 (citation omitted), in which the author discusses the issue of efficiency in the public sector:

> [I]f efficiency is the minimization of waste, the relationship of politics to efficiency is not so clear. Politics is less often a source of waste than an additional (that is, noneconomic) set of allocational criteria. Claims of equity, redistribution of resources, and regulation of hazardous practices and products often conflict with efficiency objectives.

228. WEISBROD, *supra* note 18, at 222 n.23 ("The notion that one form of institution might be more trustworthy than another is not part of mainstream thinking in economics, but it may well affect consumer actions.").

229. *See* Weisbrod & Schlesinger, *supra* note 150, at 136 ("[N]onproprietary organizations will be more likely or less likely to misrepresent than proprietary organizations, depending on whether misrepresentation is more or less consistent with nonpecuniary or pecuniary forms of rewards.").

230. Professor Hansmann avers that only through long-run experience with specific providers does the public come to "develop a sense that in certain circumstances it is most appropriate to deal with nonprofits. Undoubtedly for most consumers such attitudes are learned from others rather than based upon conscious reflection." Hansmann, *Role of Nonprofit Enterprise*, *supra* note 7, at 896. It is sufficient for Professor Hansmann that "some subset of patrons has a general notion that when an organization is nonprofit it is somehow committed to operating for some purpose other than profit maximization." *Id.* at 897. He concludes: "In general, social institutions and patterns of behavior may

profits worry a great deal about their reputations. For example, Professors Ben-Ner and Van Hoomissen assume that reputation is a governor of last resort,[231] and when they assert that for-profits will extract consumer surplus, they neglect to mention reputation at all.[232]

Dennis Young reminds us that trustworthiness contains two *independent* components: "[f]ulfillment of promises, that is, delivery of services as advertised, and abstinence from fraud and depreciation of quality as strategies for self-aggrandizement."[233] He quotes Bruce Vladek's influential study of the nursing home industry, which observed that government investigators found no statistical correlation between stealing and poor care. Indeed, investigators found that

> many of the biggest crooks ran moderate to very good nursing homes, while some of those who ran poor nursing homes were more incompetent than dishonest. . . . The most intelligent and farsighted crooks might endeavor to run especially good facilities in order to maintain good relations with regulatory authorities . . . and develop a positive professional reputation.[234]

Even if the nonprofit operates at a high level of productive efficiency, the nonprofit might use the surplus to cross-subsidize activities for which there is no market. For example, a hospital might sell medical services at fair market value (as set by the third-party reimburser and for-profit competitors) and use the surplus to do medical research or community education that no one otherwise pays for.[235] No matter how meritorious the cross-subsidization, how can a donor or patron be sure that *her* money

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represent a reasonable degree of economic rationality even when most of the individuals involved are not self-consciously engaged in intricate processes of economically rational thought." *Id.*

231. Ben-Ner & Van Hoomissen, *supra* note 117, at 34 n.5 (in general), 36-37 (automobile repair).

232. *See id.* at 38.

233. YOUNG, *supra* note 184, at 128.

234. *Id.* (quoting from BRUCE C. VLADEK, UNLOVING CARE: THE NURSING HOME TRAGEDY 186-87 (1980)).

235. There might be less cross-subsidization occurring than we think. *See, e.g.*, Michael Rothschild & Lawrence J. White, *The University in the Marketplace: Some Insights and Some Puzzles*, *in* STUDIES OF SUPPLY AND DEMAND IN HIGHER EDUCATION 11, 11-16 (Charles T. Clotfelter & Michael Rothschild eds., 1993) (expressing skepticism of the old assumption that undergraduate tuition cross-subsidizes graduate education; after all, universities must compete on price with free-standing colleges).

is being used to provide the service that *she* wants?[236] This pattern illustrates that the nondistribution constraint, while perhaps helpful,[237] is not a sufficient bond to align the interests of management with the interests of patrons.[238]

As a separate matter, assuming the public prefers dealing with a nonprofit enterprise to dealing with a for-profit enterprise in certain cases, what happens when there are *two* (or more) nonprofits?[239] The nondistribution constraint account cannot answer the next obvious question: Once more than one nonprofit organization exists to supply the desired trust good or service, how does the information disadvantaged

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236. Even retaining funds to build up a surplus is a form of cross-subsidization. *See, e.g.*, Tuckman & Chang, *supra* note 142, at 85 ("[W]hen nonprofits are free to accumulate large sums of equity without informing the donors of the organizations' actions, . . . a contract failure occurs in the market for donations . . . .").

237. The nondistribution constraint could even be harmful if a profit-sharing or other incentive compensation agreement would attract and motivate more competent management or protect the nonprofit from unwanted risk.

238. Indeed, one commentator, Dean Robert Charles Clark, goes so far as to say that the uses to which a for-profit hospital puts its surplus have more social utility than the uses to which a nonprofit hospital puts its surplus. Even at a positivistic level, a for-profit earns a greater surplus because its profit motive forces it to closely monitor costs, while nonprofit operations suffer from inefficiencies in order to minimize employee conflict. Robert C. Clark, *Does the Nonprofit Form Fit the Hospital Industry?*, 93 HARV. L. REV. 1416, 1459-62 (1980) (discussing Clarkson, *supra* note 187). A for-profit, Dean Clark says, earns a surplus to distribute to its shareholders, but a nonprofit uses its (surreptitiously obtained) surplus to cross-subsidize the provision of medical research and indigent care. *See id.* at 1468. "When a local hospital finances its public goods and its medical services for the poor by overcharging—essentially, collecting taxes—from paying patients and third-party insurers, it acts in an arbitrary and capricious way." *Id.* In effect, to Dean Clark the only acceptable utility that a hospital should be permitted to maximize is the low cost or high quality of services provided to *current paying patients*. *Id.* at 1466-71.

239. I am speaking of two nonprofits that are substitutes for each other. When ideological competition arises, both charities might benefit, as illustrated by Professor Rose-Ackerman:

> [S]uppose that some ideological positions are abhorrent to the donor. He loses utility for every client served by these charities. A devout Baptist might feel worse off the greater the number of children cared for in Roman Catholic day-care centers. He may feel part of a competitive ideological struggle and give more to his favorite Baptist charity, the more clients are served by the Catholic charity.

Susan Rose-Ackerman, *Do Government Grants to Charity Reduce Private Donations?*, *in* THE ECONOMICS OF NONPROFIT INSTITUTIONS, *supra* note 99, at 318, 318. Similarly, "if donors strongly dislike the ideology of charities subsidized by government, they may give more to their own favored charities." *Id.* at 325.

consumer or donor *choose between the nonprofit suppliers*? In order to answer this question, we cannot limit ourselves to the market—because the hypothesis postulates market failure.[240] That is, by assumption information asymmetries prevent the public from judging the quality of the output. But if no one can judge quality—not the insiders, not auditors, not clientele—then by definition no one can earn a (justified) reputation—and no nonprofit could lose it.[241] Does this imply that, in the absence of a monopoly, competition in the nonprofit sector will ultimately be based on price, perhaps at the expense of quality?[242]

Many who believe competition to be healthy in the proprietary sector seem to believe that nonprofit competition wastes charitable resources.[243] Such a belief has a long history. As the newly wealthy mercantile and industrial class devoted funds to philanthropic work in the 19th century, some deplored the "indiscriminate charity" that a diverse nonprofit sector

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240. As George Akerlof notes in describing a market in which buyers cannot distinguish between good quality and bad quality: "The cost of dishonesty . . . lies not only in the amount by which the purchaser is cheated; the cost also must include the loss incurred from driving legitimate business out of existence." Akerlof, *supra* note 118, at 495.

241. *Cf.* WEISBROD, *supra* note 18, at 13 (footnote omitted):

> Whenever any nonprofit is found to have abused its trusted position, the reputation of trustworthy nonprofits also suffers; the value of nonprofit status as a signal that the organization deserves contributions of money or time is debased. Nonprofits that do not act opportunistically, as well as those that do, will find it increasingly difficult to obtain resources and will tend to be driven out of the market. In the end the nonprofit market for trust-type services can disappear.

Weisbrod then describes the debasement process, citing to Akerlof, *supra* note 118. *Id.* at 13-14.

242. *See* Pamela Taulbee, *Outcomes Management: Buying Value and Cutting Costs*, 9 BUS. & HEALTH 28, 28 (Mar. 1991).

243. Dean Clark views the market operations of nonprofit hospitals as so wasteful and duplicative that he proposes government centralization of the whole subsector:

> The great number of nonprofit hospitals and the diversity of their quasi-governmental programs makes extremely difficult, if not impossible, the rational, comprehensive, coordinated planning of health care policy by actual governments. The great complexity and disruption caused by thousands of nonprofit hospitals each pursuing its own vision of the social good, and the great imperfections in the medical care market, combine to create a pressing *need* for a strong, comprehensive, and coordinated governmental policy. . . . Although I accept the argument for decentralization in general, it is inapposite to the health care system, which has become a gargantuan sector of the economy whose growth rate is out of control.

Clark, *supra* note 238, at 1469 (footnote omitted).

produces.[244] Perhaps, with our belief that the nonprofit sector reflects diversity and multiplicity, we also hope that two nonprofit providers in a community are really offering *different services* that in some way respond to the public's demands.[245]

D. *Summary of How Firms Operate*

In this part, we peered inside the black box of firm operations. Because of internal principal-agent problems, we saw that in for-profit firms, a professionalized management often controls the board of directors rather than the other way around. Similar agency problems run down through the corporate hierarchy. Rather than operating to maximize profits, businesses often exhibit organizational slack and productive inefficiencies as a result of compromising competing goals within the organization.

Similar forces operate within the nonprofit firm. Rather than operating to maximize the donor's or client's welfare, nonprofits might use the patron's funds to cross-subsidize other activities, to provide "too much" quality, or simply, once again, to make a comfortable working environment. Because the standard economic account of the nonprofit sector presumes information asymmetry, the theory cannot explain why patrons are satisfied dealing with nonprofits in general or, more practically, how patrons should choose between competing nonprofits.

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244. HALL, *supra* note 127, at 92 (using the 1889 phrase of Andrew Carnegie).

245. Ironically, we can even find a great deal of "competition" and "diversity" in the *public* sector. Our federal system contains many governments; and, within the federal government and among states and their subdivisions, we actually have competing agencies and governments. For a resource-dependent social-service charity—which means most of them—the multiplicity of government programs can lead to conflicts between the demands of grantors, inducing the charity to deliberately blur its goals. This obviously produces difficulties in assessing the effectiveness of the charity's operations. *Cf., e.g.*, Rose-Ackerman, *supra* note 239, at 327-28 n.18 (original source omitted):

> A charity may also have more bargaining power in dealing with one government agency if it also deals with several others. . . . Conflicting quality-control requirements may give managers freedom of action instead of forcing them to specialize. For example, a report on the Jewish Vocational Service in Milwaukee noted that it 'has 13 federal, state and local funding sources, so many, in fact, that auditors appear to be having trouble unscrambling them all'. . . . This pattern of multiple funding sources is common in the provision of social services.

IV. External Constraints: Accountability or Resource Dependence?

"Accountability" is the mechanism by which the agent answers to the principal. In the business sector, managers must account to equity owners. This sections examines the extent to which we can find substitutes for equity owners in the nonprofit sector. In particular, we concentrate on those who donate funds and time to the nonprofit. We see, however, that because of the separation of supply from the *beneficiary's* demand, donors of money and labor can often make poor substitutes for equity ownership. Because benefactors, for reasons of their own, can oversupply some activities and undersupply others, endowing benefactors with the accountability entitlement will not produce the same benefits that we achieve in endowing shareholders with accountability over profits.

This Article cannot, however, answer the normative question: Who are the "principals" to whom society *wants* the charity to answer—in some way greater than the usual demands of resource dependency? If we can identify principals, we can then ask the subsequent question of how to align the interests of the charity with the interests of the principals, be they donors, clients/patrons/customers, government contractors, professional staff, or workers/volunteers. The discussion in the second half of this Part IV considers each of these candidate categories in turn. Before reaching that discussion, though, we must first consider the implications to the charity of living in a complex environment, in which its various constituencies all require response to their often conflicting demands.

To begin on a cautionary note, we must remember that "effectiveness" in satisfying constituents is not necessarily the same thing as "efficiency." Jeffrey Pfeffer and Gerald Salancik give a wonderful illustration of this distinction:

> In the late 1960s, Governor Ronald Reagan of California curtailed the amount of money going to the state university system. He was concerned that state university campuses, particularly Berkeley, were indoctrinating students in radical, left-wing ideas. In response to these political pressures and to forestall further budget cuts, the administrators attempted to demonstrate that they were educating students at an even lower cost per student. Not surprisingly, this argument had little impact on the governor;

> indeed, it missed the point of his criticism. Producing revolutionaries at lower cost was not what the governor wanted . . . .[246]

One academic in the field of nonprofit management identifies four types of accountability.[247] "Compliance accountability" means having to follow requirements imposed by law (such as tax and state filings) and by contract.[248] "Negotiated accountability" comes about through a "negotiation" between the nonprofit and its environment as the charity deals with loosely defined societal values and beliefs and political trends (for example, some hospitals and universities make payments in lieu of local property taxes).[249] "Professional/discretionary accountability" reflects the industry wide performance standards of professionals working for (or volunteering for) the organization.[250] Finally, "anticipatory/positioning accountability" acknowledges that the organization can anticipate future compliance standards, and might even seek "to play a meaningful proactive role in shaping and defining the standards" by lobbying for certain policies and practices.[251]

This Part focuses more on the influences of compliance accountability and professional accountability, leaving the other forms for another day. We first examine the general question of resource dependency, and how

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246. PFEFFER & SALANCIK, *supra* note 43, at 12. For a more recent example of donor clout, see *Fall Out*, ECONOMIST, Feb. 4, 1995, at 78, 78-79 (discussing how the Smithsonian Institution, a nonprofit organization that depends on the federal government for 80% of its support, drastically altered its planned exhibition commemorating the fiftieth anniversary of the atomic bombing of Hiroshima and Nagasaki).

247. Kevin P. Kearns, *The Strategic Management of Accountability in Nonprofit Organizations: An Analytical Framework*, 54 PUB. ADMIN. REV. 185 (1994).

248. *Id.* at 188. The Financial Accounting Standards Board ("FASB") recently issued new rules requiring all nonprofits to report their financial activities with greater conformity; these rules govern financial statements and accounting for contributions received and made. *See* Andrew S. Lang & Wayne Berson, *New Pronouncements Affect Associations' Financial Reporting*, ASS'N MGMT., Jan. 1994, at 37, 37. Charities resent one change requiring them to report all pledges received as revenues; charities would rather wait until collection to avoid the embarrassment of "having either to shake down donors or suffer a write-off." Alison Leigh Cowan, *New Accounting Proposals Create Nonprofit Anxiety*, N.Y. TIMES, July 29, 1990, § 3, at 10.

249. Kearns, *supra* note 247, at 188-89.

250. *Id.* at 189.

251. *Id.* From a different perspective, consider a management article illustrating how a charity that cannot mold to the environment can instead mold the environment to itself: "For example, an adolescent drug treatment agency can seek regulatory legislation to prevent competition from a for-profit drug treatment organization." Heimovics & Herman, *supra* note 148, at 302.

the presence of outside constituents compounds the organization's already existing desire, discussed in Part III, to adopt fuzzy goals. Obviously, multiple, unclear, or even conflicting goals complicate efforts at accountability. In examining certain types of nonprofit resources in more detail, we see the limits of donor, volunteer, and professional oversight. In many cases, nonprofits struggle with many of the same environmental concerns as proprietary businesses do, and external factors influence nonprofit behavior to a greater degree than mere organizational form does.

Perhaps surprisingly, the nonprofit's constituents might not want an active accountability role. Often, sources of support seem to recognize the conflicts under which the nonprofit labors: "Accrediting agencies, boards of trustees, government agencies, and individuals accept ceremonially at face value the credentials, ambiguous goals, and categorical evaluations that are characteristic of ceremonial organizations."[252] To look too closely might upset the accommodation that the parties have reached.[253]

A. *Resource Dependency: Goal Setting and Measuring Success*

Once management experts plunged into the black box of the firm, they sometimes forgot that many factors crucial to the success of the firm exist outside its boundaries.[254] Indeed, the role of management is often symbolic, with managers able to control and influence only a small part of the firm's output.[255] In addition, the output of nonprofits is often hard to measure because quality is often subjective. Finally, the quest of nonprofits to "do good"—the assessment of which involves "societal values about which there may be little or no consensus"—adds another layer of measurement difficulty.[256]

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252. John W. Meyer & Brian Rowan, *Institutionalized Organizations: Formal Structure as Myth and Ceremony*, *in* THE NEW INSTITUTIONALISM, *supra* note 48, at 41, 60.

253. *Id.* (stating that these "external constituents are themselves likely to be corporately organized agents of society. Maintaining categorical relationships with their organizational subunits is more stable and more certain than is relying on inspection and control.").

254. *See* PFEFFER & SALANCIK, *supra* note 43, at 258 ("Somehow, the things to be managed are usually within the organization, assumed to be under its control . . . . When authors get down to the task of describing the running of the organization, the relevance of the environment fades.").

255. *Id.* at 16-19. Professors Pfeffer and Salancik refer to the phenomenon of firing baseball managers as a form of scapegoating, the symbolic method of assigning blame.

256. Rosabeth Moss Kanter & David V. Summers, *Doing Well while Doing Good: Dilemmas of Performance Measurement in Nonprofit Organizations and the Need for a Multiple-Constituency Approach*, *in* THE NONPROFIT SECTOR, *supra* note 17, at 154,

What outside forces *uniquely* influence how the nonprofit is run? After all, business firms also suffer under many of the same constraints, such as the demands of workers, suppliers, creditors, lessors, and customers—and from competition from other firms. Nonprofits, of course, have no source of equity capital, but many do rely, in varying degrees, on donated property and time.[257] It can make a difference if the organization depends on a particular resource, such as a major grant or alumni gift. Under the notion that "he who pays the piper calls the tune," focusing on resource dependency brings together issues of ownership, control and governance, accountability, and subsidy. "Dependency does not just refer to material resources, but includes social relations that involve legitimation, competition, or cooperation."[258]

As discussed in Part III above, organizations often keep goals fuzzy in order to head off conflicting demands for accountability, or to mask differences of opinion, if not power struggles. "Goals are made ambiguous or vacuous, and categorical ends are substituted for technical ends. Hospitals treat, not cure, patients. Schools produce students, not learning. In fact, data on technical performance are eliminated or rendered invisible."[259] Similarly, "in museums one would expect conflict between wealthy lay trustees and ambitious career-minded directors."[260] Similarly, modern hospital systems face "struggles between community-oriented governing boards and super-specialist physicians or between cost-conscious accountants and service-minded caregivers."[261] In attempting to please all, the organization might permit every constituency to believe that its claim has been granted. For example, "if one inquires who decides which curricula will be taught in schools, any number of parties from the various governments down to individual teachers may say that they decide."[262] However, these differences of philosophy are often no more right or wrong than the

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257. *See supra* note 50.

258. Neil Fligstein, *The Structural Transformation of American Industry: An Institutional Account of the Causes of Diversification in the Largest Firms, 1919-1979*, *in* THE NEW INSTITUTIONALISM, *supra* note 48, at 311, 313.

259. Meyer & Rowan, *supra* note 252, at 57.

260. HALL, *supra* note 127, at 210. This conflict provides much material for the high-society story-teller Louis Auchincloss. *See, e.g.*, LOUIS AUCHINCLOSS, *The Foundation Grant*, *in* THE PARTNERS 218 (1974) (in which the curator rails at the board chairman: "Museums are for board members, for prestige, for puffs, for status, are they not? Imagine a man so low as to care enough about a few miserable artifacts as to commit a crime for them, . . . a crime for beauty[!]").

261. HALL, *supra* note 127, at 210.

262. Meyer & Rowan, *supra* note 252, at 56.

decision by a business corporation to reinvest earnings, to the disappointment of those shareholders desiring current dividends.[263]

Management expert Rosabeth Moss Kanter is not troubled by goal conflicts. Indeed, she notes that recent organizational models "have moved away from rationalistic and voluntaristic assumptions about goal consensus, unity of purpose, and the possibility of discovering universal performance standards."[264] As she observes: "Multiple constituencies and multiple environments require multiple measures."[265]

In simpler times, resource dependency presented no institutional conflicts: local charities were funded from one source, the resident church.[266] With the adoption in 1601 of the Statute of Charitable Uses,[267] the British institution of noblesse oblige induced elites to finance private philanthropy—and to control how that philanthropy was conducted.[268] Now, as charities hunt for cash,[269] they encounter conflicts between the expectations of their various income constituents. Charity managers today often indulge in the pipe dream of "independence"

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263. Nonprofits, however, often face common problems related to their constant shortage of operating funds and to the inexperience of volunteers—including, if not most damaging, volunteer board members from the business community. Peter Dobkin Hall spins out a long, involved hypothetical of the "Widget Museum," reflecting the clash of cultures between the nonprofit and business worlds, followed by comment: "When the Widget Museum case was first presented to a group that included nonprofit staffers, trustees, and corporate contributions officers, most of them thought that the unidentified organization was one with which they had been connected in the recent past." HALL, *supra* note 127, at 216 (the "widget museum" hypothetical appears at pages 211-219). He finds that "the rules governing nonprofit behavior become personalized, informal, and folkloric; the signposts demarcating the boundaries between for-profit and nonprofit obligations become effaced; and the stage is set for organizational conflict." *Id.* at 218.

264. Kanter & Summers, *supra* note 256, at 158.

265. *Id.*

266. MARION R. FREMONT-SMITH, FOUNDATIONS AND GOVERNMENT 14-18 (1965) (discussing the charitable activities of the Catholic Church, Islam, and the Church of England).

267. *Id.* at 23.

268. *See* THERESA ODENDAHL, CHARITY BEGINS AT HOME: GENEROSITY AND SELF-INTEREST AMONG THE PHILANTHROPIC ELITE 10 (1990).

269. Cyril F. Chang & Howard P. Tuckman, *Financial Vulnerability and Attrition as Measures of Nonprofit Performance*, *in* THE NONPROFIT SECTOR IN THE MIXED ECONOMY, *supra* note 100, at 163, 168-70, 172 (finding that 40% of nonprofits are vulnerable in at least one of four criteria: inadequate equity, revenue concentration, already low administrative costs, and thin operating margins).

from their donors—of having a sufficient endowment to produce all the income they need.[270]

Having to account for one's actions requires one to think about them harder: to be more analytic, to take longer to reach a decision, and to devote more resources to the process. This effort is both productive and to some degree counterproductive (the "dilution effect").[271] For better or for worse, though, what managers decide depends on who is evaluating their performance, and on what measures.[272] "If decision makers believe that they have identified the option that would be most favorably evaluated by others, they tend to adopt that position."[273] This strategic behavior occurs because accountable decision-makers seek favorable evaluations and low criticism.[274] The process of pleasing changes the

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270. *See, e.g.*, Tuckman & Chang, *supra* note 142, at 79 (citation omitted):

> [F]und accumulations offer decisionmakers a measure of independence from their donors. Nonprofits usually must respond to donor preferences if they wish to obtain gifts and bequests. Those that rely on program service revenues are dependent on the satisfaction of those who purchase the services, while those that seek government grants must meet specific requirements of the grantor. . . . Moreover, in markets where nonprofits compete, large equity balances have strategic value, because they improve competitive position and help to create a barrier against entry by potential competitors.

271. *See* William F. Messier, Jr. & William C. Quilliam, *The Effect of Accountability on Judgment: Development of Hypotheses for Auditing*, 11 AUDITING: J. PRAC. & THEORY 123, 129, 132-33 (Supp. 1992). "The use of analytical processing will be even more pronounced when the decision is *irreversible, significant, complex, ambiguous*, and/or *unstable*." *Id.* at 129 (citation omitted).

272. *See* Robert D. Hayes & James A. Millar, *Measuring Production Efficiency in a Not-For-Profit Setting*, 65 ACCT. REV. 505, 506 (1990).

273. Itamar Simonson & Peter Nye, *The Effect of Accountability on Susceptibility to Decision Errors*, 51 ORG. BEHAV. & HUM. DECISION PROCESSES 416, 417 (1992). *See also* Philip E. Tetlock, *Accountability and the Complexity of Thought*, 45 J. PERSONALITY & SOC. PSYCHOL. 74 (1983) (describing an experiment to measure cognitive effort, in which the subjects were told of their audience's views (as either liberal, conservative, or unknown)). Subjects justifying to a liberal (conservative) audience reported liberal (conservative) attitudes, hoping to win social approval by conforming; but subjects expecting to justify to an audience with unknown views exhibited more multidimensional, self-critical, and complex analytic processing, and still tried to discover an acceptable response. *See also* Simonson & Nye, *supra*, at 418. *See generally* Philip E. Tetlock, *The Impact of Accountability on Judgment and Choice: Toward a Social Contingency Model*, *in* 25 ADVANCES IN EXPERIMENTAL SOCIAL PSYCHOLOGY 331 (Mark P. Zanna ed., 1992).

274. Simonson & Nye, *supra* note 273, at 441; *see also* Canice Prendergast, *A Theory of "Yes Men,"* 83 AM. ECON. REV. 757, 758 (1993) (noting that when workers will be evaluated subjectively, they will "attempt to second-guess the opinions of their monitor and mimic them").

product; in many cases, that is exactly what a business person, schooled in consumer sovereignty, would want to see happen.[275] Even an independent auditor is accountable to his client, subject to the same pressures; the most important aspect of professional judgment by the practicing auditors "was that *the decision could be justified.*"[276]

The demand for measurable goals in the service sector also leads to an "A"-for-effort approach. Substituting "effectiveness criteria" for goals can produce de facto quotas.[277] Moreover, if charities survive and are judged merely by the level of clients they serve, the charities come to have a vested interest in preserving the status quo. John O'Looney discusses the difficulty of building incentives for preventive action into purchase-of-service contracting: "In fact, many observers suggest that private delivery systems have a perverse incentive to maintain problems at some level in order to maintain demand."[278] However, a primary goal of survival can cause nonprofits to "lose sight of other purposes, including their reasons for existing in the first place."[279] Ironically, "[s]ince nonprofits tend to believe in their own functioning, failure to

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275. *See, e.g.*, Grant Wiggens, *Accountability, Testing, and Schools: Toward Local Responsibility and Away from Change by Mandate*, 36 BUS. HORIZONS at 13, 13 (1993) ("Accountability depends on the freedom to succeed or fail based on client satisfaction. . . . A 'command' system failed in all of Eastern Europe in economics; why then is such a system likely to work in education?").

276. Messier & Quilliam, *supra* note 271, at 124 ("Additionally, the researchers found that auditors tend to make a decision early in the judgment process, suggesting that much of the information search . . . is to provide justification for the decision.").

277. Worse, specific goals, rather than serving as minimally acceptable standards, can result in performance dropping to that level. Kanter & Summers, *supra* note 256, at 156.

278. O'Looney, *supra* note 147, at 513. But compare the March of Dimes, which had raised millions in the fight against polio; after the eradication of that disease in the 1950s, the March of Dimes successfully reoriented itself into a campaigner against all birth defects. Founded by President Franklin D. Roosevelt, the National Foundation for Infant Paralysis raised millions to fight the polio epidemics of the 1950s. Its successful small-change campaigns inspired its new name, the March of Dimes Birth Defects Foundation. *See, e.g.*, Molly O'Neill, *Learning to Turn Dimes Into Millions*, N.Y. TIMES, Oct. 17, 1990, at C1; *see generally* Walter W. Powell & Rebecca Friedkin, *Organizational Change in Nonprofit Organizations*, *in* THE NONPROFIT SECTOR, *supra* note 17, at 180, 186-87 (comparing organizations that successfully transformed, such as the March of Dimes and the Young Men's Christian Association, with those that failed, such as the Women's Christian Temperance Union).

279. Kanter & Summers, *supra* note 256, at 158.

achieve goals is taken not as a sign of weakness in the organization but as a sign that efforts should be intensified."[280]

Again, however, for-profit firms similarly suffer from internal and external conflicts. In particular, the growing service subsector of the proprietary economy presents the same challenges of setting quality standards and measuring success.[281] Thus, both proprietary and nonprofit firms must still figure out how to make the most effective use of their resources. The question is whether substituting different constituencies, such as donors or volunteers, for shareholders alters who determines which goals to pursue. To this question we now turn.

B. *Nonprofit Constituents*

In looking at specific types of resource dependency, we begin by examining and contrasting donors, clients/patrons/customers, and governments as bestowers of contracts or grants. We then conclude this section on accountability by examining the oversight provided by professionals and by volunteers.

1. Donors

Recall our hypothetical of Scrooge, endowing a trust to distribute Christmas turkeys to the poor. The law permits a charitable trust to continue in perpetuity as a stark exception to the normal rule prohibiting control over property from the grave. Indeed, in its original usage, the legal term "dead hand" referred to the hand of the trustee, not of the testator, because the trustee cannot exercise discretion.[282] Generally, so long as the trust benefits an indefinite class, the law considers the trust to have a public benefit, no matter how unimportant or narrow the settlor's

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280. *Id.* at 164; *cf.* Donald R. Carlson & George B. Shepherd, *Cartel on Campus: The Economics and Law of Academic Institutions' Financial Aid Price-Fixing*, 71 OR. L. REV. 563, 580 n.46 (1992) (pointing out that after Stanford was accused by the federal government of waste and wrong-doing, its alumni contributions *increased*—perhaps as a show of faith in the alma mater, but perhaps instead on the assumption that government oversight will reduce future X-inefficiency).

281. See *The Manufacturing Myth*, ECONOMIST, Mar. 19, 1994, at 91, 91: "In 1970 27% of America's workers were in manufacturing; by 1993 the figure had fallen to 16%. Meanwhile, services' share had climbed from 66% to 78%." (Presumably these numbers include those who work in the nonprofit sector.). *See also Slow Service?*, ECONOMIST, Mar. 19, 1994, at 92, 92 ("[A] large part of the true increase in the output of many services takes the form of increases in their quality. . . . Because service companies can charge higher prices for higher-quality services, improvements in quality may be misinterpreted as price increases.").

282. LEWIS M. SIMES, PUBLIC POLICY AND THE DEAD HAND 2 (1955).

purpose.[283] That is, the law does not require the grant to be efficient.[284]

Moving beyond the world of a single donor to a charity seeking support from the general public, Avner Ben-Ner and Benedetto Gui argue that it is in the very nature of a nonprofit organization to cede control to "key high-demand stakeholders."[285] For example, Michael Krashinsky describes the "community" that exists between universities and their alumni: "alumni take pride in the athletic and scientific accomplishments of their schools; alumni send their children back to their old schools as a way of continuing an intimate involvement in that community; alumni return for reunions and join alumni clubs in other cities."[286]

Frequently, however, we also find that institutional beliefs clash with economic needs.[287] Today's charity faces competition from myriad other charities, and high fund-raising and administrative costs.[288] At the

283. Consider the Buck trust, which endowed a $447 million trust for the exclusive benefit of Marin County, California, one of the richest counties in the country; its initial trustee unsuccessfully sought court permission to make expenditures throughout the San Francisco Bay area. *See* ODENDAHL, *supra* note 268, at 10.

284. *See, e.g.*, Chang & Tuckman, *supra* note 269, at 166 (describing the social and political impediments to efficient delivery of services through nonprofits).

285. Ben-Ner & Gui, *supra* note 100, at 1, 8 n.5 ("Because the existence of a nonprofit organization is predicated on demand-side stakeholders' revelation of preferences and voluntary price discrimination, any nonprofit entrepreneur must cooperate with key high-demand stakeholders and de facto make them controlling stakeholders.").

286. Michael Krashinsky, *Transaction Costs and a Theory of the Nonprofit Organization*, *in* THE ECONOMICS OF NONPROFIT INSTITUTIONS, *supra* note 99, at 114, 127 (footnote omitted). For a less sanguine view of alumni, whose children in the aggregate are twice as likely to be admitted to Harvard or Yale as unconnected applicants, see John D. Lamb, Note, *The Real Affirmative Action Babies: Legacy Preferences at Harvard and Yale*, 26 COLUM. J.L. & SOC. PROBS. 491, 499, 506 (1993). Harvard defended this preference, in information supplied to the U.S. Office for Civil Rights (OCR), on three grounds: "to 1) encourage alumni volunteer services; 2) encourage alumni financial contributions; and, 3) maintain community relations." *Id.* at 509 (original source omitted). "Additionally, Harvard asserted, and OCR accept[ed], that there are no alternatives to these preferences that could effectively accomplish the same legitimate goals." *Id.* (original source omitted).

287. *See generally* Brody, *supra* note 5.

288. *See* Steinberg, *supra* note 144. See also James M. Buchanan, *Rent Seeking, Noncompensated Transfers, and the Laws of Succession*, 26 J.L. & ECON. 71 (1983), whose discussion of potential heirs' efforts to obtain inheritances could be extended to efforts by charities to compete for donations: "Profit seeking . . . *as a process*, creates value in itself. By contrast, rent seeking is socially inefficient because the process in itself creates no value while utilizing scarce resources. . . . [A]ny value that is to be

same time, the public seems jaded with social problems;[289] uninterested in supporting monolithic organizations ("We all have to remember that people don't support organizations, they support causes."[290]); and uneducated about the fiscal needs of charities (many people express surprise that "managers at nonprofits are paid at all"[291]) and their productive demands ("This is not an amateur undertaking. We try to tell people about the kind of professionalism that's needed."[292]). A public ignorant of cost constraints cannot perform effective oversight.[293]

Where a nonprofit seeks support from the general public, multiple forces of institutional isomorphism (conformity) can transform the enterprise, for both better and worse. Change might be imposed top down, as in the development of the United Charities in the 1930s, which, in the process of standardizing accounting practices, performance evaluation, and reporting mechanisms, also homogenized structure, method, and philosophy.[294] Less deliberately, but just as completely, "neighborhood organizations in urban communities, many of which are committed to participatory democracy, are driven to developing organizational hierarchies in order to gain support from more hierarchically organized donor organizations."[295]

Donor control can be positively correlated with professionalism, discussed below. One study of corporate grant-making in the Twin Cities found a herd mentality in the behavior of corporate-giving officers, who belonged to the same professional associations. Because they tended to evaluate nonprofits similarly, "a system was being created whereby different funders in the community, through their network contacts, could

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transferred without compensation exists independently of the investment in attempts to redirect its disposition." *Id.* at 83.

289. Skolnik, *supra* note 38, at 29.

290. *Id.* at 30 (quoting the public-relations vice president for the American Cancer Society).

291. *Id.*

292. *Id.* (quoting the public-relations vice president for the American Cancer Society).

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

294. DiMaggio & Powell, *The Iron Cage Revisited*, *supra* note 48, at 68. After the United Way of America salary scandal, United Way campaigns suffered serious shortfalls in contributions; as a result several United Way affiliates imposed on charities desiring funding mandatory reporting standards designed to quantify actual impacts and outcomes of services. Bruce Millar, *Allocating United Way Money to Charities: A Painstaking, Often Controversial Process*, 5 CHRON. PHILANTHROPY 27, 27 (Jan. 12, 1993).

295. DiMaggio & Powell, *The Iron Cage Revisited*, *supra* note 48, at 68.

come to some consensus as to which nonprofits should be funded and which should not."[296] Similarly, a historical study of nonprofit auditing suggests that because merchants with business training also likely served religious and political organizations, the audit technology developed in 18th century English companies found its way into the audit practices of "The Society for Propagating the Gospel in Foreign Parts," the most prominent religious-eleemosynary organization of the period.[297]

2. Clients/Patrons/Customers

What's the best law school in the country? Every March, as the latest U.S. News & World Report annual survey makes its way through the halls of the legal academies, you can hear, "What do you mean we're in the third quartile?" or "How can they say we've slipped eight places in one year?"[298] The Clinton Administration proposes issuing "report cards" on hospitals.[299] We already get mortality reports in some cases, although the teaching hospitals claim that their numbers look worse because they treat sicker patients. What else would be tabulated, and with what explanations?

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296. Joseph Galaskiewicz, *Making Corporate Actors Accountable: Institution-Building in Minneapolis-St. Paul*, *in* THE NEW INSTITUTIONALISM, *supra* note 48, at 293, 306. Moreover, this study

> found that nonprofits tended to receive more corporate funding in toto, if a larger number of corporate-giving professionals recognized and thought well of them. This effect was independent of the nonprofits' expenditures, the value of government grants and contracts, and the elite's use and/or service to the nonprofits.

Id. Galaskiewicz was describing a study he conducted with Ronald Burt, which also found that this "interorganization contagion" among corporate officers was stronger for nonprofit organizations providing cultural services; the authors suggested that opinions about culture, being more difficult to judge than health and welfare, depended more on peer views. *See* Joseph Galaskiewicz & Ronald S. Burt, *Interorganization Contagion in Corporate Philanthropy*, 36 ADMIN. SCI. Q. 88, 103-04 (1991).

297. *See, e.g.*, G.A. Swanson & John C. Gardner, *Not-For-Profit Accounting and Auditing in the Early Eighteenth Century: Some Archival Evidence*, 63 ACCT. REV. 436, 444 (1988).

298. *See The Top 25 Law Schools; The Second Tier; The Rest of the Rankings*, U.S NEWS & WORLD REP., Mar. 18, 1996, at 82, 82-86.

299. Hilary Stout & Joe Davidson, *Group of GOP Senators to Unveil Today Their Own Plan to Reform Health Care*, WALL ST. J., Sept. 15, 1993, at A3.

The question of consumer sovereignty in the nonprofit field is a hot topic.[300] One could almost demand accountability to the nonprofit's customers on the ground that the nonprofit exists in the first place to deliver a service that the proprietary sector will not deliver. However, we cannot have it both ways. If there really is information asymmetry, consumers by definition cannot judge the "accounting" in any meaningful way.[301] If, on the other hand, consumers can judge quality, we have just overcome the economic need for a nonprofit sector (at least in this particular industry).

To avoid paternalism, consumer sovereignty should be restricted as little as possible. However, if the nonprofit sector exists because of information asymmetry (that is, the consumer cannot judge the medical, educational, or other benefits), then what can we tell the consumer that will minimize this asymmetry and permit rational choices *between* nonprofits[302] (as well as between nonprofit and for-profit providers)? A voucher is just cash with a stipulation attached that the holder must use it only to buy services from an approved class of providers; the largest voucher programs, such as food stamps and Medicaid, permit the holder

300. *See, e.g.*, Theodore H. Poister & Gary T. Henry, *Citizen Ratings of Public and Private Service Quality: A Comparative Perspective*, 54 PUB. ADMIN. REV. 155 (1994); Lea Aharony & Stephen Strasser, *Patient Satisfaction: What We Know About and What We Still Need to Explore*, 50 MED. CARE REV. 49 (1993); Eugene C. Nelson, et al., *Do Patient Perceptions of Quality Relate to Hospital Financial Performance?*, J. HEALTH CARE MKTG. at 6 (Dec. 1992); Joel Brinkley, *You Bet Your Life. Do You Know the Odds?*, N.Y. TIMES, May 29, 1994, § 4, at 4; Michael L. Millenson, *The Wonder Drug of Information Makes Patients Insiders*, CHI. TRIB., May 11, 1993, § 1, at 1; *Study: Kidney Transplant Can Be $682, or $87,629*, CHI. TRIB., June 24, 1993, § 1, at 16; Ron Winslow, *Health-Care Report Cards Are Getting Low Grades From Some Focus Groups*, WALL ST. J., May 19, 1994, at B1.

301. Several studies of the nursing home industry found that for-profit nursing homes, which charge lower prices, attract residents who have relatives or other monitors, and so do not need to trust a nonprofit to provide higher quality. *See, e.g.*, Weisbrod & Schlesinger, *supra* note 150; Alphonse G. Holtmann & Steven G. Ullmann, *Transaction Costs, Uncertainty, And Not-For-Profit Organizations: The Case of Nursing Homes*, *in* THE NONPROFIT SECTOR IN THE MIXED ECONOMY, *supra* note 100, at 149, 149.

302. *See, e.g.*, Carlson & Shepherd, *supra* note 280, at 587-88 (universities compete on the basis of inefficient, but highly visible, "amenities," such as "elegant dormitories, classrooms, and athletic facilities; fancy food; elaborate recreational opportunities; and extensive medical and counseling services").

to go to a government, private proprietary or private nonprofit provider, with no assistance to consumers in making choices.[303]

Let us return to the threshold question. If the only feature missing from the marketplace is trust, then why not just have nonprofit brokers? For example, if individual consumers find it time-consuming and expensive to research the best hospital, why is it not enough that a nonprofit organization studies, evaluates and ranks (for-profit) hospitals?[304] What public good results from nonprofit *production* as opposed to nonprofit *monitoring*?

Consider the following assertion by Michael Krashinsky, who advocates nonprofit provision as a remedy for the inadequacy of regulatory efforts towards quality production:

> [A] knowledgeable day-care inspector usually can tell quickly whether a center is providing quality care for children. But this judgment is based upon a sensitivity to the dynamics of the relationships between children and care-givers. Since these can hardly be specified in the regulations, the licensing requirements usually focus on physical aspects of the center itself (floor space, bathrooms, windows, etc.) and on the number and training of those providing the care. In areas like this, regulation will not be entirely satisfactory and nonprofit organizations, with all their inefficiencies, become a viable alternative.[305]

Krashinsky's most telling statement is that while quality day-care might not be measurable in terms of inputs, *it is observable*. As a matter of organizational form, why do we need nonprofit day-care centers when we can have private nonprofit inspection of proprietary day-care centers? (Indeed, day-care is only one of many industries in which both business and nonprofit suppliers exist.)

Proprietary organizations might voluntarily seek nonprofit "Good Housekeeping" seals of approval out of competitive self-interest. A

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303. *Cf.* Susan Rose-Ackerman, *Social Services and the Market*, 83 COLUM. L. REV. 1405, 1406, 1420 (1983) ("Proxy shopping"—paying for services for the needy if the provider has a high enough percentage of unsubsidized clients—"can be superior to a voucher plan when the needy are less effective shoppers than are unsubsidized customers.").

304. Of course, there is the Consumers Union, a nonprofit established in 1936 "to provide consumers with information and advice on goods, services, health, and personal finance"; it refuses permission for the product reviews in its magazine, *Consumer Reports*, to "be used in advertising or for any other commercial purpose." *About Consumers Union*, 59 CONSUMER REP. 139 (1994).

305. Krashinsky, *supra* note 286, at 124.

related form of oversight is accreditation. Organizations have some discretion in orienting themselves towards particular types of validating authority: "Organizations must determine with which, if any, external sponsors to connect."[306]

Of course, brokering brings its own problems.[307] An organization seeking accreditation might make major structural sacrifices, perhaps reflecting a power struggle over the accreditation body itself.[308] For example, in order to obtain accreditation by the American Bar Association, a law school must meet several objective standards, not all of which bear on quality of education.[309] Services like the Better Business Bureau and the National Charities Information Bureau, which rate the "worthiness" of donee charities, also adopt objective, and so often unhelpful, standards, such as percentage limits on how much the organization spends on fund-raising.[310]

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306. W. Richard Scott, *Unpacking Institutional Arguments*, *in* THE NEW INSTITUTIONALISM, *supra* note 48, at 164, 176.

307. See generally the 11-article symposium, *Private Accreditation in the Regulatory State*, and in particular, the first article, *Forward: The Place of Private Accrediting Among the Instruments of Government*, edited by Clark C. Havighurst, in 57 LAW & CONTEMP. PROBS. 1 (1994).

308. *See, e.g.*, Steven Morris, *Watchdog Draws Howls*, CHI. TRIB., Feb. 20, 1995, at C1 (describing how hospitals protest the decision by the largest hospital accreditor, the Joint Commission on Accreditation of Healthcare Organizations, to begin selling formerly confidential hospital surveys to patients, their employers, insurers—and their competitors).

309. *See* 1 MSL L. REV. (Winter 1994) (volume devoted to the Massachusetts School of Law's antitrust suit against the A.B.A., whose accreditation is a requirement in most states for a school's graduate to sit for the bar exam); *see also* Edward A. Abrams, *Justice Department Balks at ABA Accrediting Changes*, N.Y. L.J., Jan. 22, 1996, at 1 (reviewing consent decree reached by the Justice Department and the ABA, to be subject to an approval hearing by Judge Richey on June 19, 1996).

310. The National Charities Information Bureau, in rating charities, imposes minimum standards that include an independent board, a clear statement of purpose, detailed budgets, and good cost control—and, for established charities, a 40% limit on fund-raising and other administrative costs. *See* Alison L. Cowan, *The Gadfly Who Audits Philanthropy*, N.Y. TIMES, Oct. 7, 1990, § 3, at 9. For example, the bureau determined that Mothers Against Drunk Driving should have allocated 77% of its receipts to fund-raising, rather than the 35% it allocated (because the organization included information on drunk driving in its fund-raising solicitation, MADD classified much of its mailing costs as program expense). *Id.* The NCIB was formed in 1918 "to help the American public deal with a profusion of war-relief efforts"; in the early 1970's the Better Business Bureau began offering similar services through its Philanthropic Advisory Services. *Id.*

And why should even the brokers be nonprofit?[311] Information is a product that is often marketed by proprietary purveyors; competition accounts for an acceptable level of trustworthiness. Think of newspapers, which (usually) are proprietary. If a proprietary news vendor desires credibility, self-interest dictates disclosing its biases and affiliations; reputation is an important device in overcoming transaction costs.

In the largest industry in which nonprofits dominate—hospitals—consumers happily employ a for-profit broker, namely the doctors themselves. Patients cannot simply check into their local trustworthy nonprofit hospital; rather, they must have a doctor with staff privileges admit them.[312] If it takes a nonprofit motive to earn trust, why has the demand for physician choice dominated the debate over health care cost containment? Why does Medicare, essentially a voucher system, pay for medical services from private (proprietary) doctors? Moreover, a great deal of policing is also conducted by for-profit insurance companies (as third-party payers of employer-sponsored health plans).

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311. Governments can also perform this monitoring role, but apparently the government often does business only with nonprofits because it has trouble judging output! *See* James, *Comments*, *supra* note 99, at 157 ("[G]overnment subsidies can be diverted from their original intent just as private donations can. Thus, requirements tying subsidies to [nonprofit-organization] status may not always be well-founded.").

312. One question recently studied is whether an admitting physician behaves more like an employee or more like a consumer. Lawton R. Burns & Douglas R. Wholey, *Factors Affecting Physician Loyalty and Exit: A Longitudinal Analysis of Physician-Hospital Relationships*, 27 HEALTH SERVS. RES. 1 (1992). Facing the end of the "good old days," with the traditional cost-plus reimbursement pattern of third-party insurers, hospitals want to induce physicians to admit more patients for shorter periods of time at lower treatment costs. "Physician-hospital interdependence has switched from a symbiotic to a competitive basis. . . . In response, hospitals are seeking ways to control or influence their physicians' utilization behavior and to integrate them more closely into hospital affairs." *Id.* at 2 (citation omitted). This might, however, be a mistake. In a county with eight nonfederal hospitals, the study found that most physicians are extremely loyal to one or two hospitals (using the primary hospital between 72% and 95% of the time, and a secondary hospital between 8% and 16% of the time); that the main reason for such loyalty was convenience (primarily proximity of the primary hospital to the doctor's office) and inertia (average termination of only 13.4% of hospital affiliations). *Id.* at 14-16. The authors describe as "both somewhat expected and somewhat surprising" their findings "that physicians utilize hospitals not as loyal employees but as loyal consumers purchasing services on their own (or their patients') behalf." *Id.* at 19. This study leaves us with the unsettling notion that information brokers such as doctors fall prey to habitualization like any other name-brand consumer. If employees cannot provide oversight, and even the most highly educated consumer cannot, nonprofit accountability suffers.

3. Government Contracts/Grants

What are the side effects from government contracting—and government standards—setting the market?[313] The upside is that the activity will be run in a manner specified by a sector accountable to a broad constituency (unlike donors, who tend to be elitist and paternalistic). The greater the government financial stake, the greater the remedy to information asymmetry. The downside, though, is we get only one flavor of certified service. That is, the more the government seeks to impose standards and practices, the less society enjoys the claimed benefits of heterogeneity that are supposed to be the hallmark of the nonprofit sector. For example, John O'Looney observes that "tight-coupling" can be achieved through control of funding streams or budget authority, and through rules specifying technology and standards. However, "[e]ach of these mechanisms tends to change the character of the model and in cases of detailed, comprehensive regulation tends to blur the distinction between public and private provision."[314]

Moreover, if programmatic authority is not also centralized, control effectively devolves to financial officers and accountants.[315] For example, where school funding is tied to attendance data or hospital reimbursement is based on measurable indicators of patient care, "[f]unding decisions do not directly prescribe programmatic and instrumental decisions but create pressures and place constraints on them and, in the limiting case, can virtually determine them."[316]

Not only is the nonprofit subject to review of its government contract performance, but it is also, in many cases, subject to review by government auditors;[317] recall the scandal over Stanford University's

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313. *See generally* SMITH & LIPSKY, *supra* note 149.

314. O'Looney, *supra* note 147, at 516.

315. W. Richard Scott & John W. Meyer, *The Organization of Societal Sectors: Propositions and Early Evidence*, *in* THE NEW INSTITUTIONALISM, *supra* note 48, at 108, 130.

316. *Id.* at 131.

317. Thomas A. Lemmer & Paul E. Pompeo, *"Educating" Lawyers about the Implications of Cost Accounting Standards for Government Contracts and Grants with Educational Institutions*, 21 J.C. & U.L. 111 (1994); *cf.* BOZEMAN, *supra* note 219, at 75 (describing how a Defense Department contractor "now may become an object of attention of congressional watchdogs and may be called upon to testify at congressional and executive budget proceedings.").

government contracting cost allocations.[318] In addition, the federal government often conditions a grant on conformance to government personnel standards. "Universities (including private universities) are particularly vulnerable, because it is legally possible to withhold all federal money from a university because a single department or even a single project has been found in violation of affirmative action guidelines."[319]

Finally, should a nonprofit depend for its funding on a single government contract (or a few), accountability may be high, but security is not. In addition to the normal vicissitudes of its market, such a nonprofit now bears the risk that changes in the political climate might threaten its funding program or even the entire government agency on which it relies.

In sum, the more the nonprofit depends on the public sector, the more the nonprofit metamorphoses into a de facto government enterprise.

4. Managerial and Staff Professionalism

Professionalism exists at the management level as well as at the board level, and the increasing professionalism of lower classes of employees marks the nonprofit sector. In recent years we have witnessed a revolution in the degree to which nonprofits accept, and are demanding, to act in a more "business-like" way, often due to pressures from resources on which the charity depends.[320] Pressure also comes from the ranks of managers themselves, and from educational institutions offering management training.[321] Paul DiMaggio finds the nonprofit sector particularly receptive to administrative professionalism because of "the affinity between the legitimizing accounts of professionals and of

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318. *See Navy, Stanford Settle Dispute Over Charges*, CHI. TRIB., Oct. 19, 1994, § 1, at 18 (recounting that Stanford paid a total of over $3 million in settlement of erroneous overcharges, "including flowers for the president's home"; the Navy found no wrongdoing by the university).

319. BOZEMAN, *supra* note 219, at 102.

320. A professional with seemingly transferable skills from one particular field might impose his profession's norms on the organization. For example, "certain corporate strategies were favored by CEOs with marketing and finance backgrounds because the strategies fit their interests and competencies. . . . [Museum professionals] sought radical changes in museum missions and policies that would tend to enhance their own positions relative to those of their trustees." Powell & DiMaggio, *supra* note 58, at 1, 31. In these cases, "advocates of change drew on institutionalized models and employed highly legitimate and stylized accounts, which we have no reason to doubt they believed, to advance their positions. But the options favored and terms of the debate bore a decided affinity to the interests of the participants." *Id.* at 31.

321. *See* EDUCATING MANAGERS OF NONPROFIT ORGANIZATIONS (Michael O'Neill & Dennis R. Young eds., 1988); *see also* Heimovics & Herman, *supra* note 148, at 295.

nonprofit organizations—both based on claims to expertise, a service ethos, and disinterest in pecuniary gain."[322] However, a professional can experience conflict between her duties to "the profession" and her duties to her organization.[323]

As mentioned in Part III, professionalism creates guilds which supply a common ethos and standards of practice, a superstructure that cuts across firms. According to Peter Dobkin Hall, however, the increasing professionalism of nonprofit managers is viewed by some as "a sort of Trojan horse"; managerial professionalism has tended to shift policy making from the governing board to the staff.[324] Eventually, boundary-spanning activities by the manager can "fundamentally alter the direction of an institution, the composition of its board, and the nature of its membership."[325] If professionalism takes root in a particular field, the state might legitimate the profession with legally required licenses and practices, transforming the organizations operating within the industry.[326]

Managerial training is "professionalized" by becoming increasingly rigorous and more formalized. Moreover, managers carrying out similar activities in different firms not only attended the same schools but also "read the same journals and joined the same associations. They had an approach to their work that was closer to that of lawyers, doctors, and ministers than that of the owners and managers of small traditional

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322. Paul J. DiMaggio, *Constructing an Organizational Field as a Professional Project: U.S. Art Museums, 1920-1940*, *in* THE NEW INSTITUTIONALISM, *supra* note 48, at 267, 288.

323. Compare the case of the in-house lawyer. *See* Grace M. Giesel, *The Ethics or Employment Dilemma of In-House Counsel*, 5 GEO. J. LEGAL ETHICS 535 (1992); Seymour Moskowitz, *Employment-At-Will & Codes of Ethics: The Professional's Dilemma*, 23 VAL. U. L. REV. 33 (1988). A "recent survey indicates that more than 10 percent of all lawyers in the United States are employed in-house by corporations." General Dynamics Corp. v. Superior Court, 876 P.2d 487, 491 (Cal. 1994) (footnote omitted). In this opinion, the California Supreme Court characterized the in-house lawyer as having a dual allegiance, to the client/employer and to the public, under the rules of ethics. The court recognized that this potential conflict exists for outside counsel as well, but "outside lawyers enjoy a measure of professional distance and economic independence that usually serves to lessen the pressure to bend or ignore professional norms." *Id.* at 498. Thus the dilemma is really between the in-house counsel's position as a lawyer and the in-house counsel's position as an employee.

324. HALL, *supra* note 127, at 91.

325. *Id.* at 96; *cf.* Heimovics & Herman, *supra* note 148, at 301 ("[T]he more effective nonprofit chief executives have learned to use their boards as strategic tools to mediate their organizations' environment, an environment that places the nonprofit organization in a highly resource-dependent condition.").

326. Meyer & Rowan, *supra* note 252, at 48.

business enterprises."[327] Even when founders or family members dominated ownership, because of their lack of training they effectively lost control: "As members of the boards of directors they did hold veto power. They could say no, and they could replace the senior managers with other career managers; but they were rarely in a position to propose positive alternative solutions."[328]

In many cases, professionalism homogenizes firms within an industry, and, from the point of view of quality, diminishes the influence of organizational form on the good or service provided.[329] For example, a medical procedure at a nonprofit hospital will tend to resemble the same procedure at a for-profit hospital, because in both cases the medical care is directed by a doctor. Moreover, to the extent professional standards go beyond what might be necessary (think of all those tests doctors order), it reduces the ability of competition to work an efficient deployment of resources, and it reduces the ability of informed consumers to buy less than what professionals want consumers to purchase.

We can cite many examples of the debate over professionalism. Readers might be aware of arguments supporting and opposing teacher certification in the public schools, or, in social work, the struggle between professionalism and grassroots or self-help ("community"-based) standards.[330] We could even say we are seeing the professionalization of professionalism.

> Led by schools of public health, which by the 1960s were attempting to upgrade and standardize hospital administration, the movement has spread to business schools, which have initiated programs in nonprofit management, as well as to the humanities, where courses in museum management, public history, and the administrative aspects of historic preservation are rapidly becoming standard fare.[331]

Finally, a professional identification subordinates loyalty to the particular employing firm; in the aggregate, this reduces the importance of organizational form. Professor Hall observes that professional managers "defined their goals in terms of their professional career

327. CHANDLER, THE VISIBLE HAND, *supra* note 214, at 9.

328. *Id.* at 10.

329. Thus, public law school professors resemble private law school professors, and as a result public law schools resemble private.

330. *See, e.g.*, Yaheskel Hasenfeld & Benjamin Gidron, *Self-Help Groups and Human Service Organizations: An Interorganizational Perspective*, 67 SOC. SERV. REV. 217 (1993).

331. HALL, *supra* note 127, at 94.

interests."[332] On its face, this might not be a bad thing because the sector as a whole can improve as nonprofit managers move on from smaller to larger nonprofits. But we should be particularly concerned about the overlay of professionalism in labor-intensive industries with for-profit providers as well as nonprofits. As described above, this is because the nondistribution constraint only effectively bars returns to capital, not returns to labor. Where compensation can absorb receipts, the laborers (even professionals) might not care whether the enterprise is proprietary or nonprofit.[333]

The public commonly believes that nonprofit employees accept a lower wage in order to work for an organization producing social benefits. However, the studies on this issue generate mixed results.[334] On the one

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332. *Id.* at 96.

333. *See, e.g.*, Holtmann & Idson, *supra* note 119, at 56 ("Because nonprofit nursing homes are such a small part of the purchasers of registered nurses' services, they have little economic incentive to pay other than the market wage for identical nurses—the standard competitive labor market outcome.").

334. Anne E. Preston, *The Nonprofit Worker in a For-Profit World*, 7 J. LAB. ECON. 438, 443 (1989) (the direction of the nonprofit wage differential cannot be predicted, because it results from two opposing forces: the "demand" of managers wanting to pay higher wages, and the supply of workers willing to donate a portion of pecuniary compensation). *Compare* Burton A. Weisbrod, *Nonprofit and Proprietary Sector Behavior: Wage Differentials among Lawyers*, 1 J. LAB. ECON. 246 (1983) (public-interest lawyers deliberately sacrifice income that they could have earned in the private sector in return for nonpecuniary benefits) *with* John H. Goddeeris, *Compensating Differentials and Self-Selection: An Application to Lawyers*, 96 J. POL. ECON. 411 (1988) (no evidence that public interest lawyers could have earned more in the private sector); *see generally* Richard Steinberg, *Labor Economics and the Nonprofit Sector: A Literature Review*, 19 NONPROFIT & VOLUNTARY SECTOR Q. 151 (1990). Dick Netzer cautions us against assuming too much about nonprofit compensation:

> The stereotype is of artists who, on average, earn very little indeed as artists, the "starving artist" stereotype immortalized in *La Boheme*. The only really careful analysis of the question, a study by Filer (1986) using a large sample from the 1980 Census, concluded that "artists do not appear to earn less than other workers of similar training and personal characteristics" (p. 56) and that there is no lifetime earnings penalty attached to the decision to enter the field and stay in it.

Netzer, *supra* note 98, at 192 (citing to Randall K. Filer, *The "Starving Artist"—Myth or Reality? Earnings of Artists in the United States*, 94 J. POL. ECON. 56 (1986)). Many who work in the arts, such as actors and jazz musicians, are not actually employees of any firm, but rather are hired for the run of a particular production. *See* Paul DiMaggio, *Nonprofit Organizations in the Production and Distribution of Culture*, *in* THE NONPROFIT SECTOR, *supra* note 17, at 195, 216 ("Within nonprofit industries, firms tend to employ artists or such aesthetic experts as curators directly, influencing their work through hierarchical authority relations. By contrast, proprietary cultural industries

hand, lower wages might constitute a voluntary "labor donation."[335] But studies in the business sector show that if workers feel they are *inequitably* underpaid, they respond variously by lowering the amount of their output, or, if paid by the piece, the quality; in extreme situations they steal, and, moreover, perceive "their stealing as being honest, [and] also completely fair and justifiable."[336] Commented management professor Sharon Oster, in the context of comparing for-profit and nonprofit outputs, "the unobservability [of outputs] leads one to a choice of theft or sloth by the provider."[337] Finally, patterns of professionalism indicate that people are using nonprofit service as a stepping stone to advancing in business, with the low wages simply an investment in human capital.[338]

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characteristically deal with artists by means of contract. . . .").

The wages/lifestyle trade-off also, of course, exists between proprietary firms. *See, e.g.*, LEIBENSTEIN, INSIDE THE FIRM, *supra* note 202, at 242:

> It is possible to conceive of an organization that produces a maximum output, or near-maximum output, but is not a maximum welfare organization. Pressure for production may be so strong that some employees may prefer less pressure, less output, and lower wages and working conditions, but they may be caught up in a set of conventions, vertical relations, and short-run incentives that do not allow them to *individually* choose a less pressured working environment.

335. Besides the demands of donors and other sources of funds, the *employees* themselves can demand low wages as the tradeoff for doing good. *See, e.g.*, Eric J. Wieffering, *The Nonprofit Paycheck: Some Reformers Complain that Nonprofit CEOs Make Too Much, But That Doesn't Square with the Marketplace*, CORP. REP. MINN., Nov. 1993, 1, at 68, *available in* LEXIS, News Library, ASAPII file ("Hospital executives . . . have an easier time defending their pay internally because just about everybody connected with a hospital, from surgeon to orderly, knows that hospitals are nonprofit in name only . . . . Executives at human service nonprofit agencies, or membership or cultural organizations, are more likely to have a hard time justifying their salaries internally than externally."); Alain C. Enthoven, *Pricing Health Care: How Employers Boost Health Care Costs*, WALL ST. J., Jan. 24, 1992, at A14.

336. Jerald Greenberg, *Stealing in the Name of Justice: Informational and Interpersonal Moderators of Theft Reactions to Underpayment Inequity*, 54 ORGANIZATIONAL BEHAV. & HUM. DECISION PROCESSES 81, 97 (1993) (experiment in which college students, promised $5 for a task, were later told they would be paid $3; when left to help themselves to their pay under circumstances suggesting impossibility of detection, students tended to make up the difference, but stole less if the wage reduction was communicated in a credible and sensitive way).

337. Sharon Oster *in* Sharon Oster & Estelle James, *Comments*, *supra* note 99, at 152-53.

338. YOUNG, *supra* note 184.

5. Labor and Volunteers

Take two charities, one run well and one run badly, offering the same social service. The one run badly (Charity B) "wastes" its resources, and so is unable to produce the same quality and level of services as Charity A (and, perhaps, is losing money overall). Who best observes this performance? Charity B's employees and volunteers, who then might decide to leave and work for Charity A. Indeed, Charity A benefits too, because there now exists labor competing to be hired, and so Charity A can either cut wages or obtain better workers.

Labor (whether paid or volunteer) can decide that Hospital A is "better" than Hospital B as measured by many different criteria: more stable, more responsive to the community, more whatever it is that the worker values. Note that voting with your feet depends on what you value: If you want only high pay and Hospital B pays more than Hospital A, you will stay (assuming you believe that Hospital B can survive at this rate); you might, alternatively, want to work where the hospital serves a large charitable class. Thus, whether labor mobility serves as an effective check on charitable waste of resources depends on what its employees/volunteers value. In any event, we can presume that labor (particularly executive labor) is best informed about the nonprofit's operations.[339]

My hypothetical assumes that labor (paid or volunteer) is perfectly mobile. If it is not, then labor movement provides an imperfect signal as to nonprofit quality. In fact, labor economists believe that a worker has a higher value in the "internal labor market" (where she currently works) than in the external labor market.[340] The danger in relying on labor as a monitoring device is that the worker has something very real at stake unrelated to the organization—the paycheck (or résumé value or other benefit). As Albert Hirschman observed long ago, those who cannot exit from a situation will start to convince themselves that things are not as bad as they seem.[341]

To economist Richard Steinberg, volunteers of labor might make better monitors than financial donors: "Unlike money, time donations

339. *Cf.* Preston, *supra* note 334, at 449 ("[W]orkers less closely tied to social benefit provision in the organization are less likely to donate wages to nonprofit firms. . . . [T]here is no significant wage loss for clerical workers.").

340. *See, e.g.*, PETER B. DOERINGER & MICHAEL J. PIORE, INTERNAL LABOR MARKETS AND MANPOWER ANALYSIS (1971).

341. HIRSCHMAN, *supra* note 199, at 93 (noting that where there are "[h]igh fees for entering an organization and stiff penalties for exit," the member "may have a considerable stake in *self-deception*, that is, in fighting the realization that the organization he belongs to . . . [is] deteriorating").

provide the donor with training, skill certification, social opportunities, control over nonprofit output, and information about the quality and efficiency of the recipient charity."[342]

On the other hand, as we saw with money donors, the very power permitted volunteers might make them unreliable quality signalers. "You often can't order low-paid staff and volunteers to do their jobs; you have to persuade them through consensus."[343] In many cases, charities are reluctant to review the performance of their volunteers.[344] Peter Drucker, though, sees the opposite trend in the increasing professionalization of volunteers: "[T]his new breed requires, indeed, demands, . . . training, training, and more training. . . . They expect to be consulted and to participate in making decisions that affect their work and the work of the organization as a whole. . . . [A] good many nonprofits have developed career ladders for their volunteers."[345] In this case, however, the more the volunteers invest in organization-specific human capital, the more they risk the "lock-in" of paid workers.

D. *Summary of Nonprofit Accountability*

In this part, we found that nonprofit "accountability" is a difficult question. Accountable to whom? For what?[346] While nonprofits as suppliers of goods and services must respond to their customers, and as employers must respond to their professional staff and employees, the

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342. Richard Steinberg, *Does Government Spending Crowd Out Donations?*, *in* THE NONPROFIT SECTOR IN THE MIXED ECONOMY, *supra* note 100, at 99, 114. Steinberg also argues because a time-volunteer can observe the marginal impact of her contribution, volunteers should be equally willing to donate time to a *for-profit* enterprise. But volunteer time cannot be guaranteed to have the full marginal impact—the volunteer still doesn't necessarily know if her input crowds out other good activities, and simply gives the organization a cushion to waste. *See* Hansmann, *Economic Theories of Nonprofit Organization*, supra note 17, at 36 (Professor Hansmann's example of cash donations to listener-sponsored radio).

343. John Byrne, *Finding Your Niche in Nonprofits*, BUS. WK., May 21, 1990, at 170.

344. Holly Hall, *Evaluating Volunteers: It May Be Tricky, but It Can Pay Off*, 5 CHRON. PHILANTHROPY 30 (1993).

345. Drucker, *supra* note 188, at 92.

346. *See* Laura B. Chisolm, *Accountability of Nonprofit Organizations and Those Who Control Them: The Legal Framework*, 6 NONPROFIT MGMT. & LEADERSHIP 141, 143 (1995). This special issue, entitled "Dilemmas of Nonprofit Accountability," also contains Ronald E. Fry, *Accountability in Organizational Life: Problem or Opportunity for Nonprofits?*, at 181; and the following articles on *Accountability and Nonprofit Organizations*: David C. Hammack, *A Historical Perspective*, at 127; William T. Bogart, *An Economic Perspective*, at 157, and Robert P. Lawry, *An Ethical Perspective*, at 171.

same types of resource dependency affect for-profit firms. Accordingly, we also examined whether nonprofits are accountable to their donors and volunteers, in a way similar to the way businesses are accountable to shareholders. As a threshold matter, we must recall that many nonprofits rely only to a small degree on donations, and fewer still rely on a single or small group of donors. Effectively, then, nonprofits generally are as untethered to their donors as large for-profit firms are to their shareholders. Nor, as a legal matter, do donors maintain control over contributed amounts. However, as a practical matter, nonprofits that do depend on future donations must satisfy (or appear to be satisfying) this key resource. Finally, as a normative matter, nonprofit accountability to donors might not be the most socially useful arrangement because of the separation of donor from beneficiary, and because of general public ignorance of the needs of nonprofits.

V. Conclusion

A nonprofit organization is a firm. But it is, by law, a firm without claimants to residual profits. This Article examined the economic consequences to an organization of having to operate under such a "nondistribution constraint."

The standard economic account of the nonprofit sector credits the nondistribution constraint with overcoming public reluctance to make donations or to obtain services in light of information asymmetry. In short, nonprofit status serves as a bond of trustworthiness where the donor or patron cannot judge the quality of the result.

Unfortunately, though, the nondistribution constraint cannot guarantee that the nonprofit operates better or worse than a proprietary enterprise in overcoming information asymmetries. The absence of shareholders demanding profits enables the organization to relax into productive inefficiencies, or to cross-subsidize activities the patron would not want to pay for (could she only observe them). Such inefficiencies or cross-subsidization might "cost" more than the profits the enterprise might otherwise distribute to shareholders if it operated in a proprietary form. Moreover, in an industry with more than one nonprofit, the nondistribution constraint cannot help patrons choose between competing nonprofits.

In comparing the organization and operations of nonprofits in light of how proprietary businesses function, we learned that the two sectors are much more similar than conventionally believed. Firms, whether nonprofit or proprietary (or even public), are subject to many of the same economic forces, such as resource dependency, institutional isomorphism, and organizational slack. We also saw that even in the absence of shareholders somebody still has to run the enterprise: to decide what objectives to pursue, and how; to manage its financial and human

resources; and to span the boundaries of the organization in interacting with the key constituencies, other organizations, and the public. While nonprofits have no shareholders privileged with rights of accountability, we saw that in most of the business sector shareholders have long lost effective control over firm management. In short, management in *both* sectors has decisional authority, whether de facto, as in the proprietary sector, or de jure, as in the nonprofit sector.

In many ways, the formal legal and economic differences between nonprofit organizations and proprietary firms are more of degree than of kind. Does this mean that the law should be amended to treat nonprofits more like business corporations, and that tax and other subsidies should be repealed? Perhaps, but we should hesitate to design changes *based solely on the implications from economics*. Rather, the economic account of organizational form provides only one aspect of the story. Other influences on nonprofit organizations, and the people who deal with them, come from a variety of historical, political, psychological, religious, sociological, and legal institutions. From these perspectives, the differences between the sectors currently are often very real, although intersectoral interpenetration blurs the boundaries.[347] The challenge to the nonprofit sector is reconciling these other institutional influences with conflicting economic goals, and convincing the public that nonprofit organizations continue to remain deservingly "different." Should the public cease to view enterprises in terms of their organizational form, we would likely see subsidies tailored more towards worthy outputs by all enterprises, owned and unowned. Society might conclude, for example, that transforming monolithic tax exemption into targeted output subsidies makes more efficient and fair use of collective resources.

347. *See* Brody, *supra* note 5.