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Entity and Identity

Usha Rodrigues

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ENTITY AND IDENTITY

*Usha Rodrigues**

ABSTRACT

The function, indeed the very existence, of nonprofit corporations is undertheorized. Recent literature suggests that only preferential tax treatment adequately accounts for the persistence of the nonprofit form. This explanation is incomplete. Drawing on psychology's social identity theory, this Article posits that the nonprofit form can create a special "warm-glow" identity that cannot be replicated by the for-profit form. For example, a local nonprofit food cooperative sells more than the free-range eggs or organic strawberries that Whole Foods and other for-profits market so effectively. The co-op offers community participation and an investment in local farms, a distinctive ethos that is incompatible with the profit motive. Ascribing a special meaning to the nonprofit form allows us to view afresh a variety of issues regarding the appropriate legal treatment of nonprofits.

* Associate Professor of Law, University of Georgia School of Law. I thank Dan Coenen, Henry Hansmann, Paul Heald, Jill Horwitz, Michelle Morris, Larry Ribstein, participants in colloquia at Illinois, Duke, Emory, and the University of Pittsburgh Law Schools, the 2008 and 2010 Law and Entrepreneurship Retreats, and a Georgia Law brownbag. Exceptional research assistance was provided by Judson Bryant, Sunny Chung, John Crotty, Meredith Lee, Bin Minter, and Eric Stolze.

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INTRODUCTION

The distinction between nonprofit organizations and for-profit firms is blurring before our eyes. Corporate social responsibility, sustainability, and green movements have made doing good an important component of many products offered not only by nonprofits, but also by for-profit firms. Economists call “warm glow” the utility one derives from giving.¹ Increasingly, for-profit corporations sell us warm glow. Consider Starbucks’s description of its Shared Planet initiative:

It’s our commitment to do things that are good to each other and the planet. From the way we buy our coffee, to minimizing our environmental footprint, to being involved in local communities. It’s doing things the way we always have. And it’s using our size for good. And because you support us, Starbucks™ Shared Planet™ is what you are a part of too.²

Whole Foods is another corporation that markets its products and brand as better not only for the consumer, but also for the larger community. From its webpage:

Yes, we are a publicly held company and have to make a profit to survive in the marketplace. But we’ve proven that a company can do good and do well if the doing comes from the heart. Luckily, our success helps us bring about change in the marketplace, which we hope will lead to good things for you and us and the planet.³

Corporate philanthropy has a long and distinguished lineage. Profit-making firms have often received (or claim to have received) reputational benefits from such philanthropic projects as sponsoring World’s Fair exhibits, supporting 5K benefit races, or donating to the Ronald McDonald House. It’s easy to be cynical about corporate efforts to sell consumers warm glow along with their quarter pounders, coffee, and kumquats.⁴ Regardless of actual

¹ M. Todd Henderson & Anup Malani, *Corporate Philanthropy and the Market for Altruism*, 109 COLUM. L. REV. 571, 583 (2009) (internal quotation marks omitted). By contrast, the utility one feels when another’s welfare is improved is “pure altruism.” *Id.* (internal quotation marks omitted).

² *Social Responsibility*, STARBUCKS COFFEE CO. CAN., http://www.starbucks.ca/en-ca/_SocialResponsibility (last visited May 28, 2011).

³ *Values & Actions Overview*, WHOLE FOODS MKT., <http://www.wholefoodsmarket.com/values> (last visited May 28, 2011).

⁴ Indeed, such efforts might be counterproductive, to the extent that consumers spend money on green coffee rather than, for example, donating to an environmental nonprofit that would more directly achieve the end the consumer seeks. James R. Hines Jr. et al., *The Attack on Nonprofit Status: A Charitable Assessment*, 108 MICH. L. REV. 1179, 1191 n.54 (2010).

motives or benefits, however, what seems undebatable is that more and more for-profit corporations are overtly marketing an intangible positive energy as part of the products they sell.

Increased warm-glow marketing from the for-profit sector is part of what is blurring its boundary with the nonprofit sector. But there is more: Nonprofits and for-profits now compete in areas formerly occupied almost exclusively by nonprofits. An example involves microfinance—the provision of credit to low-income individuals not served by traditional financial institutions. The Grameen Bank, a nonprofit that began in Bangladesh, developed a successful microfinance model based on organizing borrowers into groups that take collective responsibility for members' loans.⁵ The Grameen Bank model spawned many nonprofit imitators, but before long, for-profit entities jumped on the microfinance bandwagon as well. Thus Compartamos, which began as a nonprofit Grameen-style bank in 1990 but converted to the for-profit form in 2006, has become one of the largest microfinance institutions in Latin America.⁶ Muhammed Yunus, founder of the Grameen Bank and winner of the 2006 Nobel Peace Prize, thinks for-profits cannot be true microcredit providers: “When you discuss microcredit, don't bring Compartamos into it. . . . Microcredit was created to fight the money lender, not to become the money lender.”⁷ For-profit institutions nonetheless argue that their economies of scale permit them to make more credit available than nonprofit entities can. Citibank⁸ and Deutsche Bank,⁹ to name but two international banks, have dedicated microfinance divisions.

Even as the line between for-profits and nonprofits is blurring, debate swirls about whether nonprofits should continue to enjoy tax-exempt status. For example, the tax-exempt status of nonprofit hospitals has received close scrutiny in recent years by Congress and the public, as “nonprofit” hospitals have been perceived to be increasingly profitable, perhaps more so than their

⁵ See generally *About Us*, GRAMEEN BANK: BANK FOR THE POOR, http://www.grameen-info.org/index.php?option=com_content&task=view&id=792&Itemid=759 (last visited May 28, 2011).

⁶ Keith Epstein & Geri Smith, *Compartamos: From Nonprofit to Profit*, BUSINESSWEEK, Dec. 24, 2007, at 45.

⁷ *Online Extra: Yunus Blasts Compartamos*, BUSINESSWEEK (Dec. 13, 2007, 5:00 PM), http://www.businessweek.com/magazine/content/07_52/b4064045920958.htm.

⁸ *Citi Microfinance*, CITI, <http://www.citibank.com/citi/microfinance> (last visited May 28, 2011).

⁹ *Microfinance: Effective Self-Help for Entrepreneurs in Developing Countries*, DEUTSCHE BANK (Jan. 31, 2011), http://www.db.com/csr/en/social_investments/microfinance.html.

for-profit counterparts.¹⁰ A critical *Wall Street Journal* article observed that at least twenty-five nonprofit hospitals or hospital systems have reported earnings of over \$250 million a year, and one, Ascension Health, reported \$1.2 billion in net income during the 2007 fiscal year and a staggering \$7.4 billion in cash and investments—making this nonprofit more profitable than the Walt Disney Company.¹¹ Soaring executive compensation has also led to skepticism over whether nonprofit hospitals are deserving of tax-exempt status.¹² The former CEO of Chicago’s Northwestern Memorial Hospital, Gary Mecklenberg, received \$16.4 million dollars in 2006, while the hospital spent only \$20.8 million—less than 2% of its revenues and only a small fraction of its tax breaks—on charity care.¹³ Northwestern’s annual tax exemptions are estimated at over \$50 million, not including its tax-exempt capital gains.¹⁴ Accordingly, some argue that the “nonprofit” label is a misnomer that should be replaced by “nontaxable.”¹⁵

It is true that nonprofit hospitals, with their lack of access to the capital markets, have more reason to stockpile cash than for-profit entities. And it is hard to compare salaries across nonprofit and for-profit hospitals; for example, nonprofit salaries may be higher, but incentive compensation tends to be lower.¹⁶ Still, the perceived increased profitability of nonprofit hospitals, and their comparatively minimal expenditures on charity services, has led Congress to question nonprofit hospitals’ tax-exempt status and the propriety of nonprofit tax exemptions generally: “[M]any goods and services provided by tax-exempt organizations are similar, if not identical, to goods and services provided by tax-paying entities. This raises a fairly fundamental question of

¹⁰ See, e.g., John Carreyrou & Barbara Martinez, *Nonprofit Hospitals, Once for the Poor, Strike It Rich*, WALL ST. J., Apr. 4, 2008, at A1 (“Nonprofits, which account for a majority of U.S. hospitals, are faring even better than their for-profit counterparts: 77% of the 2,033 U.S. nonprofit hospitals are in the black, while just 61% of for-profit hospitals are profitable, according to the [American Hospital Directory] data.”).

¹¹ *Id.*

¹² *Id.*

¹³ *Id.*

¹⁴ *Id.* Of course, income is manipulable, and comparisons to for-profit hospitals might well be unfair. Were the income of nonprofit hospitals subject to taxation, it might be diverted into untaxed areas. See Jill R. Horwitz, *Why We Need the Independent Sector: The Behavior, Law, and Ethics of Not-for-Profit Hospitals*, 50 UCLA L. REV. 1345, 1382 n.158 (2003).

¹⁵ Carreyrou & Martinez, *supra* note 10 (“‘Nonprofit is a misnomer—it’s nontaxable,’ says [Chicago for-profit] Sacred Heart Hospital’s [President] Novak. ‘When you’re making hundreds of millions of dollars a year, how can you call yourself a not-for-profit?’”).

¹⁶ Jeffrey P. Ballou & Burton A. Weisbrod, *Managerial Rewards and the Behavior of For-Profit, Governmental, and Nonprofit Organizations: Evidence from the Hospital Industry*, 87 J. PUB. ECON. 1895, 1903–04 (2003).

what makes these organizations unique and, hence, deserving of a tax-exempt status.”¹⁷ Both the House and the Senate have called for reform of the nonprofit sector and have suggested increasing nonprofits’ tax reporting requirements.¹⁸ In 2007, the minority staff on the Senate Finance Committee proposed a requirement that each nonprofit hospital, to be eligible for tax exemptions, maintain and promote a charity care program and devote a minimum percentage of operating expenses to charity care.¹⁹ Some states have gone even further, revoking nonprofit tax-exempt status completely.²⁰

To date the debate over nonprofits—often referred to as tax-exempt organizations, a presumed synonym—has largely been a debate about taxation. Indeed, even when corporate scholars such as Professors Todd Henderson, Anup Malani, and Eric Posner ventured into an examination of nonprofit entities, they did so not to analyze their distinct corporate form, but rather to question the differential tax treatment between nonprofits and for-profits providing the same services.²¹ Except for the seminal work done decades ago by Henry Hansmann,²² corporate governance scholars have largely ceded the nonprofit field to tax-law experts.²³ And yet, nonprofits are generally corporations,²⁴ and as such they should not escape the close attention of corporate scholars. To be sure, nonprofits take an unusual form, and each state has a separate nonprofit corporation statute. Nonetheless, as corporations these entities face the same agency-cost dilemma as their for-profit cousins, and their distinctive characteristics raise basic questions about their legitimacy and their future prospects.²⁵

¹⁷ *Overview of the Tax-Exempt Sector: Hearing Before the H. Comm. on Ways & Means*, 109th Cong. 4 (2005) (statement of Rep. William Marshall Thomas, Chairman, H. Comm. on Ways & Means).

¹⁸ Jill R. Horwitz, *Does Nonprofit Ownership Matter?*, 24 *YALE J. ON REG.* 139, 152 (2007).

¹⁹ ERIKA LUNDER & EDWARD C. LIU, CONG. RESEARCH SERV., RL 34605, TAX-EXEMPT SECTION 501(C)(3) HOSPITALS: COMMUNITY BENEFIT STANDARD AND SCHEDULE H 6 (2008).

²⁰ See Horwitz, *supra* note 18, at 153 (noting that some states have imposed charity care requirements, or threatened to impose charity spending requirements, before a hospital can be tax exempt).

²¹ See, e.g., *supra* note 1; *infra* note 25.

²² See generally Henry B. Hansmann, *The Role of Nonprofit Enterprise*, 89 *YALE L.J.* 835 (1980).

²³ Notable exceptions include Professors Evelyn Brody, Jill R. Horwitz, Dana Brakman Reiser, John G. Simon, and Marion Fremont-Smith.

²⁴ Garry W. Jenkins, *Incorporation Choice, Uniformity, and the Reform of Nonprofit State Law*, 41 *GA. L. REV.* 1113, 1124 (2007). Nonprofits can also be organized as trusts or cooperatives. *Id.* This Article deals primarily with nonprofits taking the corporate form.

²⁵ See Henderson & Malani, *supra* note 1, at 598–600 (arguing that agency costs are lower in for-profit charities than in nonprofit ones); Anup Malani & Eric A. Posner, *The Case for For-Profit Charities*, 93 *VA. L. REV.* 2017, 2031–41 (2007) (describing agency problems in both for-profit and nonprofit charities).

There is another reason to look at nonprofits as more than vehicles for gaming a tax advantage: While all tax-exempt organizations must be nonprofits, not all nonprofits are tax-exempt organizations. The federal tax-exempt status of nonprofit entities formed under state law is determined by the Internal Revenue Service (IRS) under § 501 of the Internal Revenue Code.²⁶ The benefit of exempt status is that the organization pays no federal tax on income it receives from activities related to its central purpose, and usually no state taxes (including property taxes) as well.²⁷ If the nonprofit organization further qualifies as a public charity under § 501(c)(3), donations to the organization are also tax deductible for the donor. While we often think of nonprofits as coextensive with “public charities,” § 501 lists many noncharitable classes of tax-exempt organizations, ranging from civic leagues to social and recreational clubs to cemetery companies.²⁸

While this protected tax status is perhaps the most obvious feature of most nonprofit entities, it is not their defining characteristic. The hallmark of the form is the nondistribution constraint: Simply put, what makes a nonprofit a nonprofit is the inability to distribute profits. The nonprofit corporation thus has no owners in the for-profit sense of residual claimants entitled to the net profits of the firm after creditors have been paid.²⁹ Of course, nonprofits are not forbidden to *make* a profit; indeed, many are highly profitable and some have assets worth billions of dollars.³⁰ Use of the nonprofit form does not prohibit profit making; rather it prohibits the distribution of profits *qua* profits to shareholders, members, or others.

Given the increased blurring of lines between for-profit and nonprofit warm-glow purveyors, one might wonder whether room is left in the modern

²⁶ Charities generally fall under § 501(c)(3) of the Code, but § 501(c) lists twenty-eight categories of tax-exempt organizations. I.R.C. § 501(c) (2006).

²⁷ So if Company *A* (a for-profit) and Company *B* (a nonprofit) each have income of \$100,000, Company *A* will pay a corporate tax rate of 34%, leaving it with \$66,000 in net income. Company *B* will pay no federal taxes and generally no state taxes, and thus will have \$100,000 in net income. It will also avoid state property taxes.

²⁸ See I.R.C. § 501(c)(4), (7), (13) (providing that civic leagues, recreational clubs, and cemetery companies, respectively, can be nonprofits).

²⁹ Kevin E. Davis, *The Role of Nonprofits in the Production of Boilerplate*, 104 MICH. L. REV. 1075, 1089 (2006).

³⁰ Princeton’s endowment was valued at \$12.6 billion on June 30, 2009 (down from \$16.3 billion a year earlier). John Hechinger, *Princeton’s Endowment Declines 23%*, WALL ST. J., Sept. 30, 2009, at C3. Harvard’s endowment stood at \$26 billion on June 30, 2009 (\$36.9 billion a year earlier), and Yale’s was at \$16 billion (from \$22.9 billion a year earlier). John Hechinger, *Harvard, Yale Are Big Losers in ‘The Game’ of Investing*, WALL ST. J., Sept. 11, 2009, at A1.

day for the nonprofit form. Borrowing from the psychological concept of social identity, this Article argues that the nonprofit form *itself* permits the creation of a special kind of warm-glow good—one based on a shared identity. While countless for-profits are in the business of selling consumers identity, this Article posits that nonprofits create a different kind of identity, one that provides a distinctive warm glow that ordinary corporations cannot offer for the very reason that they are for-profit firms. A for-profit entity that proposes to save the dolphins or feed the hungry is incoherent because the knowledge that the firm's owner is ultimately in business to make money will dim the self-same warm glow that a donor seeks in giving to the organization in the first place.

The Article proceeds as follows. Part I describes the landscape of nonprofits and articulates the “nonprofit puzzle”: Corporate governance theory suggests that agency costs should run rampant in nonprofits, but if that is the case, why do people continue to participate in them? Part II surveys existing theories of the firm and the nonprofit, and argues that none of these theories adequately explains the existence of the form. Part III draws on work in the field of psychology to elaborate a social identity theory of the nonprofit.

Building on the important fact that modern nonprofits are a heterogeneous group, Part IV analyzes different categories of nonprofits, using examples to identify cases in which the identity function is (and is not) most salient. In particular, it suggests that there are reasons to accord differing tax treatment to for-profit and nonprofit entities, while also raising the prospect that tax-exempt status should be limited only to those nonprofits that focus on providing warm glow.

Ascribing special meaning to the nonprofit form of business organization offers analytical and practical payoffs, which are the subject of Part V. First, social identity theory solves the nonprofit puzzle described in Part I by articulating controls on agency costs in the nonprofit form. Second, a focus on social identity theory casts new light on proper tax policy, suggesting three contradictory results:

- If society wants to encourage the production of more warm glow via tax policy, it should favor granting tax-exempt status to entities that provide social identity.
- If society, on the other hand, wants to use tax policy to achieve certain social goals as efficiently as possible,

then it might exempt from taxation only those entities providing a socially desirable service that do *not* provide social identity, on the theory that social identity organizations will flourish even without socially expensive tax exemption. Under this view tax exemption is reserved for those for-profit entities that could not survive without it, while for nonprofits working in the same space, social identity is its own reward.

- Finally, social identity theory could help to justify tax equality for for-profits and nonprofits. In particular, a social identity theory of the nonprofit suggests that, *even if taxed on an equal basis* with for-profits, some nonprofits would continue to flourish because the nonprofit form creates something that for-profits doing the same work simply cannot.

Two more implications from the social identity theory transcend the realm of tax policy. First, in 2008 the Vermont legislature created the low-profit limited liability company (L3C), and other states have considered following suit.³¹ Scholars are just beginning to evaluate this nascent form of business organization, and any proper assessment must take into account the role purveying warm glow has in the nonprofit form. Finally, the social identity function offers a new understanding of the differences between for-profit and nonprofit corporations with respect to campaign finance regulation. As lawmakers and judges continue to grapple with campaign finance reform, they should be careful to consider the difference between nonprofit corporations that focus on creating warm glow and those that do not. An identity-based understanding of the nonprofit offers an alternative path to the approaches taken by both the majority and the dissenters in *Citizens United*.³²

I. THE NONPROFIT PUZZLE

The nonprofit sector is a substantial part of the overall U.S. economy. Over 1.4 million nonprofit organizations and groups are registered with the Internal

³¹ Carter G. Bishop, *The Low-Profit LLC (L3C): Program Related Investment by Proxy or Perversion?*, 63 ARK. L. REV. 243, 246–47 & nn.2–3 (2010).

³² *Citizens United v. FEC*, 130 S. Ct. 876 (2010).

Revenue Service.³³ Of those registered entities, just over one-third are required to report more detailed information to the IRS;³⁴ this smaller subset of all nonprofits has nearly \$3.0 trillion in assets.³⁵ These entities make a dramatic contribution to the domestic economy. Estimates for the percentage of gross domestic product (GDP) attributable to the nonprofit sector range from over 7%³⁶ to between 11% and 12%.³⁷ Employing nearly 10% of all workers (just under 13 million people),³⁸ nonprofits pay nearly 8.3% of all salaries and wages earned in the country.³⁹ These entities provide and operate churches, museums, and vast grant-making programs.⁴⁰ In short, nonprofits permeate American life.

For many observers, this picture raises an important set of questions: In a world where for-profits now provide the same products as nonprofits, why do nonprofits continue to thrive? Should they continue to thrive? And, in particular, should they continue to enjoy the preferential tax treatment that provides an incentive for the use of the nonprofit form? In fact, for-profit institutions have entered traditionally nonprofit realms, such as education and health care, and compete side by side with nonprofits in emerging areas such as microfinance and the sale of carbon offsets. This convergence has led critics to question the usefulness of the nonprofit form.⁴¹ This Part explores

³³ KENNARD T. WING ET AL., *THE NONPROFIT ALMANAC 2008*, at 3 tbl.1.1 (2008) (summarizing nonprofit statistics on tax-exempt organizations by Internal Revenue Code section classification).

³⁴ URBAN INST., *THE NONPROFIT SECTOR IN BRIEF: FACTS AND FIGURES FROM THE NONPROFIT ALMANAC 2007*, at 2 (2006), available at http://www.urban.org/UploadedPDF/311373_nonprofit_sector.pdf (observing that nonprofits that collect over \$25,000 in gross receipts are required to file a Form 990 annually with the IRS). Firms must disclose, for example, information on their board members and the members' interrelationships, descriptions of programs, financial information, and tax compliance information. See Julie L. Floch & Sean B. Delany, *Mastering the New Form 990*, in *ADVISING NONPROFIT ORGANIZATIONS 2010*, at 91, 95–96 (PLI Tax Law & Practice, Course Handbook Ser. No. J-905, 2010).

³⁵ URBAN INST., *supra* note 34, at 3 tbl.2 (noting total assets of all IRS-registered-and-reporting nonprofits).

³⁶ *Id.* at 1; see also *Report Quantifies GDP Contributions of Civil Society Sector*, NONPROFIT BUS. ADVISOR, Dec. 2007, at 11, 11 (“[T]he civil society sector . . . accounts, on average, for 5 percent of the GDP in the countries covered and exceeds 7 percent in some countries, such as Canada and the United States.”).

³⁷ U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-07-1084T, *NONPROFIT SECTOR: INCREASING NUMBERS AND KEY ROLE IN DELIVERING FEDERAL SERVICES 4* (2007).

³⁸ INDEP. SECTOR, *NONPROFIT ALMANAC: FACTS AND FINDINGS: EMPLOYMENT IN THE NONPROFIT SECTOR 1* (n.d.), <http://www.austinncc.edu/npa/library/documents/NPOemploymentnatl.pdf> (“Nonprofit employment represents 9.5 percent of total employment in the United States, with total employees numbering 12.5 million.”).

³⁹ URBAN INST., *supra* note 34, at 1.

⁴⁰ *Id.* at 3–5 (listing broad categories of nonprofit organizations).

⁴¹ See, e.g., Henderson & Malani, *supra* note 1; Malani & Posner, *supra* note 25.

the defining characteristics of the nonprofit and flaws in the form that have provoked criticism.

A. *The Peculiar Problem of Agency Costs for the Nonprofit*

Modern skepticism about nonprofit entities begins with the issue of agency costs. Such costs are a concern for all firms, but special problems arise for nonprofits because they do not have shareholders whose profit motive naturally drives them to monitor the actions of managers. At bottom, the “nonprofit puzzle” is this: Why do nonprofits exist at all, given the pervasive risk of agency costs and the dramatically limited means to address them that the nonprofit form provides?

Agency costs exist whenever a principal entrusts power to an agent to act on her behalf. The agent may rent-seek, absorbing profit that should rightly devolve to her principal. She may shirk her duty or slack off. Or she may seek to fulfill her job in good faith, but make choices that her principal would not want her to make. It is hard for the principal to disentangle which losses are attributable to self-interested rent-seeking as opposed to factors outside the agent’s control. Monitoring can reduce agency costs, but monitoring is costly.⁴²

For-profit firms take a variety of approaches to constrain agency costs. A firm with a small number of owner-managers is akin to a parcel of real estate occupied by a few fee-simple holders (as opposed, for example, to rental property). In each case the owners have an incentive to reduce costs and make long-term investments in the property, and have the control and access to make necessary changes. In other words, such owners face few agency costs, and this fact has important practical consequences. For example, owners of partnerships and LLCs can—and often do—contractually constrain agency costs by forcing managers to distribute earnings, leaving them with less residual money to squander.⁴³

Among for-profit forms, then, we might expect agency costs to be highest in large public corporations, where disparate “owners” exercise no direct monitoring. Indeed, in the 1980s Michael Jensen went so far as to pronounce that “the publicly held corporation . . . has outlived its usefulness in many

⁴² Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 310 (1976).

⁴³ Larry E. Ribstein, *Partnership Governance of Large Firms*, 76 U. CHI. L. REV. 289, 291 (2009).

sectors of the economy” and predicted that public stock offerings would be increasingly displaced by capital acquisition via the incurring of public and private debt.⁴⁴ However, corporate law addresses agency-cost dangers by giving shareholders the rights to vote for directors, sell their shares, and sue managers on the corporation’s behalf.⁴⁵ The market for corporate control further disciplines public corporations: If managers do a poor job, a depressed stock price puts the corporation at risk for a takeover that will likely cost managers their jobs.

By ensuring that there are no owners clamoring for a share of profits—and therefore motivated to police the agents—the nonprofit model arguably leads to much greater agency costs than the for-profit model. To unpack these agency costs, we can characterize a would-be donor as a principal. The nonprofit managers are her agents. If she were to give to a for-profit firm, the donor would worry that a portion of each dollar she gave would go straight to the firm’s owners as profits. The nondistribution constraint inherent in nonprofits reduces that possibility, but does so in an imperfect way because donated funds can be diverted to managers through inflated compensation payments and other more subtle means.⁴⁶

The basic difficulty is that the absence of owners means that nonprofits lack individuals within the organizational form who are incentivized to police agency costs. A nonprofit’s participants⁴⁷ generally lack their for-profit counterparts’ powers to vote, sell, or sue. While membership organizations—such as Wikimedia—do allow members to vote for the board,⁴⁸ donors to charitable organizations generally do not have the right to vote for directors. Since nonprofits do not generally distribute shares, and certainly do not trade on a public exchange, there is no market for control. And due to standing

⁴⁴ George S. Geis, *The Space Between Markets and Hierarchies*, 95 VA. L. REV. 99, 113 (2009) (alteration in original) (quoting Michael C. Jensen, *Eclipse of the Public Corporation*, HARV. BUS. REV., Sept.–Oct. 1989, at 61, 61) (internal quotation mark omitted).

⁴⁵ See generally Julian Velasco, *The Fundamental Rights of the Shareholder*, 40 U.C. DAVIS L. REV. 407 (2006) (describing the basic rights of shareholders in corporate entities).

⁴⁶ If the founders (and natural owners) of the firm are also its managers, as is often the case, then the nondistribution constraint does nothing to prevent disguised profit distributions in the form of inflated salary and perquisites. This rent-seeking functionally equates to normal managerial rent-seeking, however, and so is part of that discussion.

⁴⁷ This Article uses the term *participants* to refer to both donors to charitable organizations and members in membership organizations.

⁴⁸ See *infra* Part IV.B.2.

problems, participants cannot even employ the weak mechanism of derivative lawsuits to protect their investments.⁴⁹

All that protects nonprofit participants from agency costs is the nondistribution constraint—a constraint that is easily avoided and weakly enforced. While a nonprofit may not pay out profits qua profits, it can make disguised payouts in the form of

excessive salaries, low-interest loans from the organization, personal services and amenities paid for out of the organization's funds, excessively generous contracts for services provided to the organization by businesses owned by the managers, or the purchase or lease of real estate by the organization from its managers at inflated prices, mortgage interest, or rents.⁵⁰

Indeed, critics of nonprofit hospitals cite large salaries and perquisites, such as retreats at luxury hotels, as examples of spending inappropriate for a charity.⁵¹

Regulatory review of nonprofits is largely nonexistent. While it is true that the IRS evaluates nonprofits initially to determine if they qualify for exempt-organization status⁵² and recently gained the power to impose sanctions on nonprofits that award their executives excessive compensation,⁵³ it rarely invokes this power.⁵⁴ Under the laws of most states, only the attorney general, rather than organization members or donors, may sue for improper use of funds.⁵⁵ But state attorneys general do not conduct regular reviews of

⁴⁹ See Jonathan Klick & Robert H. Sitkoff, *Agency Costs, Charitable Trusts, and Corporate Control: Evidence from Hershey's Kiss-Off*, 108 COLUM. L. REV. 749, 787–88 (2008) (noting the weakness of shareholder litigation as a mechanism for reducing agency costs in the corporate context).

⁵⁰ Hansmann, *supra* note 22, at 875; see also BURTON A. WEISBROD, *THE NONPROFIT ECONOMY* 11 (1988) (“Nonprofits can act as for-profits in disguise by evading the constraint on distribution of profits by dispensing profits in the form of increased wages.”). Nonprofit directors and managers who work for or own for-profit firms can also extract rents by funneling services to those for-profit firms at beneficial rates. See *id.* at 12.

⁵¹ Northwestern Memorial Hospital paid its former CEO \$16.4 million, consisting mainly of deferred compensation and retirement benefits, in 2006. Carreyrou & Martinez, *supra* note 10; Jacob Goldstein, *On Top of Tax Breaks, Nonprofit Hospitals Reap Big Profits*, WALL ST. J. HEALTH BLOG (Apr. 4, 2008, 8:29 AM), <http://blogs.wsj.com/health/2008/04/04/on-top-of-tax-breaks-nonprofit-hospitals-reap-big-profits>.

⁵² See *Application for Recognition of Exemption*, INTERNAL REVENUE SERV., <http://www.irs.gov/charities/article/0,,id=96109,00.html> (last updated Nov. 10, 2010) (explaining the application process and disclosure requirements that must be satisfied before the IRS will recognize exempt status).

⁵³ Malani & Posner, *supra* note 25, at 2038 n.39 (“Although intermediate sanctions were adopted in 1996, the IRS did not win its first case until 2002, and promptly lost that case on appeal.” (citations omitted)).

⁵⁴ *Id.* at 2038.

⁵⁵ Hansmann, *supra* note 22, at 873.

nonprofits and only occasionally launch investigations.⁵⁶ Worse yet, such investigations may well occur only if they are politically expedient.⁵⁷

To be sure, the boards of nonprofits can and often do check abuses by their day-to-day managers. Many board members, however, have little reason to engage in serious policing, especially if they are not major financial supporters of the organization. And when large donors do serve as directors, they may not be representative of the majority of donors, and thus not focused on vindicating more general donor interests.⁵⁸ Indeed, some high-profile donors have resorted to extralegal mechanisms to ensure that their gifts are spent as intended. Warren Buffett, for example, conditioned his staged donation of over \$1 billion per year to the Gates Foundation on the continued active involvement of Bill or Melinda Gates in the organization.⁵⁹ He also required that the total value of the previous year's gift be spent before another gift could be made, to ensure that he could monitor the use of his donations.⁶⁰ John M. Olin, seeking to avoid the liberal drift of the Ford Foundation during the 1960s and 1970s, required that all resources of the Olin Foundation be spent within one generation of his death.⁶¹ These sorts of arrangements, however, are the exception rather than the rule. Most donors to charitable corporations have

⁵⁶ See *id.* at 873–74 (“[I]n most states neither the office of the attorney general nor any other office of the state government devotes any appreciable amount of resources to the oversight of nonprofit firms.”); Horwitz, *supra* note 14, at 1385 (“Few attorneys general, the only authorities with oversight powers, have adequate resources to or interest in overseeing not-for-profits.”).

⁵⁷ See Klick & Sitkoff, *supra* note 49, at 781 (“The state attorney general, however, is a political official, typically elected, with neither a personal financial stake nor, in the usual case, a political stake in the operation of a charitable trust. Most state attorneys general assign few (if any) lawyers to supervision of charities. Unless an alleged breach of trust obtains enough media attention to achieve political salience, actual scrutiny of a charitable trust by the attorney general is unlikely. As a result, it is the politically salient, egregious cases that ‘trigger investigations,’ not ‘reviews of annual reports.’ In the usual case there simply is not enough of a political payoff to the attorney general to warrant the diversion of resources from other initiatives.” (footnotes omitted)).

⁵⁸ George G. Triantis, *Organizations as Internal Capital Markets: The Legal Boundaries of Firms, Collateral, and Trusts in Commercial and Charitable Enterprises*, 117 HARV. L. REV. 1102, 1148 (2004). Membership organizations have more voice in governance, but the other two rights given to corporate shareholders—the power to sell or sue if they are unhappy with the organization’s management—are denied to them.

⁵⁹ Carol J. Loomis, *Warren Buffett Gives It Away*, FORTUNE, July 10, 2006, at 56, 58.

⁶⁰ *Implementing Warren Buffett’s Gift*, BILL & MELINDA GATES FOUND., <http://www.gatesfoundation.org/about/Pages/implementing-warren-buffetts-gift.aspx> (last visited May 28, 2011).

⁶¹ Jon Hanson & David Yosifon, *The Situation: An Introduction to the Situational Character, Critical Realism, Power Economics, and Deep Capture*, 152 U. PA. L. REV. 129, 277 n.523 (2003).

little power to ensure even that specially designated funds are spent according to their wishes.⁶²

B. *Why Nonprofits?*

Given the high agency-cost risks associated with nonprofits and the weak countervailing constraints, why do individuals continue to donate time and money to them? Many scholars have argued that such donations are in fact ill-advised. Jonathan Klick and Robert H. Sitkoff describe “[t]he prevailing scholarly view . . . that agency costs are rampant in charitable trust governance.”⁶³ And all the agency-cost dangers of the charitable trust form apply equally to noncharitable nonprofits because both settings suffer from an absence of owners, weak state-law enforcement mechanisms, and lack of participant standing to sue. So why does anyone participate in any nonprofit venture?

Tax-exempt status is a tempting response. The advantages of being a tax-exempt organization are indeed considerable, particularly for a 501(c)(3) organization, which offers the special benefit of tax-deductible donations.⁶⁴ But the existing tax-exempt status merely raises another question: Why should tax-exempt status be afforded to some, but not other, business organizations—especially to those organizations most susceptible to agency costs? Complaints about special tax treatment have the greatest resonance among those who view nonprofits as merely “for-profits in disguise.”⁶⁵ According to

⁶² Of course, even lacking standing, donors may alert others to the problem. Hines et al., *supra* note 4, at 1206 (“[Donors can] tip off the attorney general, the local press, or the beneficiary of the gift-over.”).

⁶³ Klick & Sitkoff, *supra* note 49, at 782.

⁶⁴ To achieve tax-exempt status, first a corporation must incorporate within one of the fifty states or the District of Columbia under a state’s nonprofit statute. Then it must file a Form 1023 with the federal government, along with an accompanying application for state income tax. Once conferred, 501(c)(3) tax-exempt status allows donors to deduct donations from their federal taxes and state property taxes, and also excuses the donee corporation from paying taxes on any profits (except for unrelated business income). Mutual benefit organizations, such as neighborhood pools, sororities, and trade associations, enjoy tax-exempt organization status, although members’ dues are not tax-deductible contributions. See generally Peter K. Shack, *The Law and Ethics of Fundraising Regulation*, in NOT-FOR-PROFIT ORGANIZATIONS: THE CHALLENGE OF GOVERNANCE IN AN ERA OF RETRENCHMENT 295 (Am. Law Inst.-Am. Bar Ass’n Comm. on Continuing Prof’l Educ., Course of Study Ser. C726, 1992); Joanne Fritz, *Nonprofit Incorporation—An Overview*, ABOUT.COM, <http://nonprofit.about.com/od/nonprofitbasics/a/incorporating.htm> (last visited May 28, 2011).

⁶⁵ WEISBROD, *supra* note 50, at 11. Indeed, one theory postulates that much of the nonprofit sector may be made up of these so-called for-profits in disguise. *Id.* “Acting like profit-maximizing firms, these nonprofits are of dubious legality. They exist only because incomplete enforcement of the constraint against distribution of profit permits them to abuse their nonprofit status.” *Id.* The problem under this view is essentially one of misclassification: the government has mistakenly given beneficial tax treatment to firms that actually work for the profit of the managers and directors. *Id.*

this theory, nonprofits' tax-exempt status distorts the market, favoring less efficient nonprofit warm-glow providers at the expense of their would-be for-profit competitors.

Malani and Posner have built on this critique. They advocate leveling the playing field by exempting for-profit firms from taxation to the extent that they undertake charitable activities.⁶⁶ Their argument is that the for-profit firm structure creates a powerful incentive for lowering administrative costs, an incentive absent in the nonprofit form.⁶⁷ Thus, the for-profit charity may be a more efficient provider of charitable services⁶⁸ and, accordingly, a more attractive purveyor of warm glow. Taxing them equally—that is, not taxing income from charitable services performed by for-profits, and allowing tax deductions on donations to for-profit charities—would allow for-profits to compete on a level playing field.

Malani and Posner make contestable presumptions about efficiency that other scholars have successfully attacked,⁶⁹ but taken on its face, their thesis leaves little space for nonprofits to exist at all. If for-profits provide the same benefits with greater efficiency, the next step after leveling the tax treatment might be to do away with the nonprofit form entirely (or at least allow it to wither into irrelevancy as donors naturally gravitate toward newly tax-advantaged for-profit warm-glow providers). Does the nonprofit form confer anything other than tax-exempt status? This Article suggests that an organization's form—the nonprofit form in particular, but perhaps other forms, as well—can create something valuable in and of itself: a special identity that the for-profit firm simply cannot provide. Before turning to this argument in Parts III and IV, Part II assesses other previously articulated theories advanced in support of the nonprofit form.

⁶⁶ Malani & Posner, *supra* note 25, at 2023.

⁶⁷ *Id.* at 2028–29 & tbl.2.

⁶⁸ *See id.*

⁶⁹ Several scholars have criticized the details of the Malani–Posner proposal, questioning its basic assumptions and the validity of the model. *See, e.g.*, Victor Fleischer, Response, “*For Profit Charity*”: *Not Quite Ready for Prime Time*, 93 VA. L. REV. BRIEF 231, 232 (2008), <http://www.virginialawreview.org/inbrief/2008/01/21/fleischer.pdf> (“Posner and Malani may place too much faith in the ability of Section 501(c)(3) to distinguish between charitable and noncharitable activities.”); Brian Galle, *Keep Charity Charitable*, 88 TEX. L. REV. 1213, 1214–15 (2010) (“By opening philanthropy to potential profiteering, Malani, Posner, and their allies would dilute the power of these perceptions for every firm”); Hines et al., *supra* note 4, at 1183 (“[Malani and Posner’s] policy recommendation . . . is considerably less sound than the current regime of restricting tax benefits to organizations with nonprofit status.”).

II. THEORIES OF NONPROFITS

A. *Theories of the Firm (in a Nutshell)*

In neoclassical economics, market transactions are presumed to be the most efficient, and the existence of firms is therefore perplexing. There are both economic and legal “theories of the firm”—explanations for why firms exist at all. Economic theories look at how firms minimize transaction costs, while legal theories focus on the function of the legal boundary of the firm.⁷⁰ Neither provides a satisfying explanation for the existence of nonprofits.

Ronald Coase’s seminal article, *The Nature of the Firm*, posited that firms exist because at a certain point, despite the cheapness of individual “spot” market transactions, the costs associated with those transactions make it more efficient to produce rather than buy certain products.⁷¹ Uncertainty, the need for long-term commitments, and external forces such as taxes all encourage the formation of a firm, which can shelter transactions from the costs imposed by the marketplace.⁷² Oliver Williamson’s work elaborated on Coase’s original insight by detailing three sorts of transaction costs that the creation of a firm tends to reduce: search and information costs, negotiation costs, and policing and enforcement costs.⁷³ The Coase–Williamson transaction cost story, then, explains the existence of firms generally, but not the existence of nonprofits.

The dominant metaphor for the corporation is the “nexus of contracts”: The firm in this view serves a coordinating function among managers, shareholders, suppliers, and consumers.⁷⁴ Replacing the old models of “corporation as person” or as “license from the state,” the nexus of contracts model emphasizes that firms are a form of private ordering. Like Coase’s theory of the firm, however, the nexus of contracts approach fails to explain

⁷⁰ Agency-cost theories do not explain the firm, but conceptualize the relationship between manager and investor.

⁷¹ R. H. Coase, *The Nature of the Firm*, 4 *ECONOMICA* 386, 388–92 (1937).

⁷² *See id.* at 393.

⁷³ *See generally* Oliver E. Williamson, *Transaction-Cost Economics: The Governance of Contractual Relations*, 22 *J.L. & ECON.* 233 (1979) (arguing that transaction costs are central to the field of economics). In a perfect world, for present purposes defined as one free from transaction costs, “spot” market transactions would always dominate, and there would be no need for internal production of products. But we live in an imperfect world where transaction costs exist, and internal production therefore can be more efficient. Coase, *supra* note 71, at 391.

⁷⁴ Michael Klausner, *The Contractarian Theory of Corporate Law: A Generation Later*, 31 *J. CORP. L.* 779, 779–80 (2006); Brett H. McDonnell, *Professor Bainbridge and the Arrowian Moment: A Review of The New Corporate Governance in Theory and Practice*, 34 *DEL. J. CORP. L.* 139, 153 (2009) (book review).

why firms exist in the forms that they do, other than to posit that the law provides certain default forms that private parties are (or should be) free to modify as they choose. Presumably some contracting parties favor a “corporate” style nexus, while others favor a “nonprofit” nexus. According to this view, firm forms are only conveniences—default contracts that parties can vary as they see fit. The theory does not address why the existing defaults exist, that is, why some contracting parties may be drawn to the nonprofit form.

Responding to the nexus of contracts literature, asset-based theories of the firm suggest that the firm is perhaps more than a nexus of contracts, because organizational forms provide something parties cannot obtain through contract alone. Hansmann and Kraakman identify asset partitioning as the essential role of organizational law.⁷⁵ Most obviously, shareholders cannot effectively contract for limited liability from the debts of the organization.⁷⁶ More profoundly, in their view, it is impossible for shareholders to contract away firm-level liability for the debts of other shareholders.⁷⁷ Only the corporate form can successfully shield firm assets from the reach of shareholders’ creditors.⁷⁸

Margaret Blair and George Triantis have also put forward asset-based theories of the firm. Blair argues that the corporate form permits a lock-in of capital that is absent in the partnership form.⁷⁹ Triantis argues that a firm’s legal boundaries separate internal capital markets, within which a firm’s managers can easily redeploy resources merely by deciding to do so, from external capital markets, where resources can only be moved by means of contracting.⁸⁰ For example, the managers of a candy corporation can easily decide to use the revenue from its lollipop factory to fund the expansion of its chocolate business. But if the corporation is divided into parent chocolate and subsidiary lollipop corporations, the managers’ discretion in reallocating

⁷⁵ See Henry Hansmann & Reinier Kraakman, *The Essential Role of Organizational Law*, 110 YALE L.J. 387, 390 (2000).

⁷⁶ Indeed, some organizational forms, like the general partnership, do not permit this form of what the authors term “defensive asset partitioning.” *Id.* at 395–96.

⁷⁷ *Id.* at 394.

⁷⁸ George Triantis’s works, both alone and with Edward Iacobucci, explore how the need for legal partitioning drives how firms distribute firm assets amongst subsidiaries. See Edward M. Iacobucci & George G. Triantis, *Economic and Legal Boundaries of Firms*, 93 VA. L. REV. 515 (2007); Triantis, *supra* note 58.

⁷⁹ Margaret M. Blair, *Locking in Capital: What Corporate Law Achieved for Business Organizers in the Nineteenth Century*, 51 UCLA L. REV. 387, 389–90 (2003).

⁸⁰ Triantis, *supra* note 58, at 1105.

resources between the parent and subsidiary is constrained by legal obligations that do not exist within a single firm.⁸¹ While asset-based theories cast fresh light on the existence of the corporate form, they do not explain the need for the nonprofit corporation.

B. Theories of the Firm as Applied to Nonprofits

These theories of the firm can be applied to nonprofits, but ultimately they do not explain the need for a separate nonprofit form. For example, while prospective donors and volunteers can in some sense “buy” warm glow⁸² on the spot market, the scope of personal transactions is inherently limited.⁸³ Animal lovers, for example, can feed stray dogs or adopt them. If interested in more systemic solutions, they can pay to spay or neuter individual dogs they encounter. Most of them, however, will donate to the Society for the Prevention of Cruelty to Animals (SPCA). The attractions of the latter option are reduced transaction costs: information costs, search costs, etc. The Coase–Williamson theory of the firm takes us this far, but does not explain why a special nonprofit form of organization (as opposed to the ordinary for-profit form) should be available to providers of these services.⁸⁴ It merely explains the gains that agglomeration offers, which boil down to economies of scale and coordination. As Malani and Posner argue, for-profit firms offer these benefits, with lower administrative costs to boot.⁸⁵

Asset-partitioning theories also fail to explain the existence of nonprofits. Hansmann and Kraakman’s asset-partitioning view of the firm explains why the corporate form exists, and also why limited liability forms (both companies and partnerships) exist: to protect creditors of the firm by shielding them from the debts of investors and, in some cases, to shield investors from the entity’s debts.⁸⁶ Nonprofits generally take the corporate form, and thus shelter their creditors from the nonprofit participants’ debts. The lack of ownership interest in the nonprofit presumably protects participants from the organization’s

⁸¹ *Cf. id.* at 1125–26 (“[There is a] difference in legal obligations between two projects that are managed within a single firm and two projects that lie in distinct but affiliated corporations subject to common control . . .”).

⁸² See *supra* note 1 and accompanying text.

⁸³ Nonprofit employees and members of nonprofit associations can find no substitute for the firm on the spot market.

⁸⁴ See Malani & Posner, *supra* note 25.

⁸⁵ *Id.* at 2022.

⁸⁶ Hansman & Kraakman, *supra* note 75, at 390.

debts—but nonprofits are generally corporations, and therefore already offer this protection to their participants.

Triantis characterizes donors' restricted gifts as a type of asset partitioning, a way to ensure that dedicated assets are not diverted for an unintended purpose.⁸⁷ He relies on trust principles for their enforcement: "If a donor restricts the use of her contribution to a specific purpose, the charity may not reallocate the funds to a different purpose. Moreover, the charity cannot borrow against assets acquired with restricted funds in order to finance a different project."⁸⁸ Problematically, however, donors must generally rely on attorneys general to enforce trust principles,⁸⁹ and they, as we have discussed, are poor policers of nonprofits.⁹⁰ More generally, Triantis uses asset partitioning as a way to explain the treatment of restricted gifts *within* charities; it does not explain the existence of the nonprofit form itself. In sum, asset partitioning may explain some donor behavior but cannot explain what sets the nonprofit form apart.

C. Contract Failure

Henry Hansmann offers by far the most complete theoretical account of the nonprofit form, which he argues exists because of contract failure.⁹¹ His elegant theory accounts for many of the different types of nonprofits. Take, for example, a classic charity. A donor may want to help the poor in Africa. A for-profit entity might do as well (or better) at delivering the service—aid to the African poor—as a nonprofit.⁹² But the donor would worry that, because the corporation's shareholders will clamor for the distribution of profits, the organization would skimp on the promised services in order to give the owners

⁸⁷ Triantis, *supra* note 58, at 1153–54.

⁸⁸ *Id.* at 1150.

⁸⁹ *See id.* at 1152.

⁹⁰ *See supra* notes 55–57 and accompanying text. Yet a growing number of descendants are suing to enforce the provisions of their progenitors' bequests. Two suits involved Brandeis University's alleged failure to honor donor bequests. In one, the University planned to demolish a science building named after a benefactor that had left a substantial sum "for a building, or a portion of a building, to be known as the 'Julius Kalman Memorial,'" and replace it with a building named after a new donor. Tracy Jan, *Brandeis Settles Suit over Name of New Science Building*, BOS. GLOBE, Aug. 20, 2009, http://www.boston.com/news/local/breaking_news/2009/08/brandeis_settle.html; *see also* John Hechinger, *Brandeis Settles Donor Lawsuit over Science Building*, WALL ST. J., Aug. 19, 2009, <http://online.wsj.com/article/SB125071093826043923.html>. Overseers of the Rose Museum, including a descendent of the original donors, filed a similar suit against Brandeis over the closing of that museum. *See* Randy Kennedy, *Lawsuit Seeks to Save Art Museum at Brandeis*, N.Y. TIMES, July 28, 2009, at C2.

⁹¹ *See* Hansmann, *supra* note 22, at 843–45.

⁹² *See* Henderson & Malani, *supra* note 1.

a higher return. The problem arises from the inability of the donor and the intended recipients (the African poor) to contract directly.⁹³ There is no way for the beneficiary to complain to the donor directly about the quality of the service being provided. Given this contract failure, the nondistribution constraint creates a more trustworthy intermediary because, by law, a nonprofit cannot distribute any excess it might divert from the poor.

According to Hansmann, nursing homes and daycare facilities are often nonprofits for related reasons. Firms providing complex private services pose difficulties for purchasers seeking to evaluate the quality of the service being provided: The children and elderly receiving care might not be able to report service skimming to the parents or adult children paying for the service and are often powerless to demand better care.⁹⁴ As delivery of these services through a nonprofit minimizes the danger of service skimming in the first instance, individuals are more willing to entrust the care of a loved one to a nonprofit service provider.⁹⁵ The logical corollary of this theory is that nonprofit service providers would highlight their nonprofit status to consumers as a signal of quality.

There is, however, a problem for Hansmann's theory: A clever empirical study by Anup Malani and Guy David found little evidence that nonprofits actually emphasize their nonprofit status.⁹⁶ According to Malani and David, if contract failure were the true motive for nonprofit formation, nonprofits would signal their status in advertising, effectively telling the market: "You can trust us more, we're nonprofits."⁹⁷ Yet their study of yellow page advertisements and websites revealed that "less than 7.5 percent of nonprofit firms signal their status in yellow pages advertisements, only 25 percent do so on their home pages, and 30 percent do so on their about-us pages. Indeed, over 35 percent never signal their nonprofit status [on their websites]."⁹⁸

This Article later argues that the Malani–David study was flawed because it focused only on service providers: hospitals and daycare providers.⁹⁹ Even so,

⁹³ See Hansmann, *supra* note 22, at 862–63.

⁹⁴ See *id.* at 863–65. Hansmann observes that there is less informational asymmetry in these areas now than formerly, and that historical lag likely accounts for continued nonprofit presence in these areas. HENRY HANSMANN, *THE OWNERSHIP OF ENTERPRISE* 236–37 (1996).

⁹⁵ See Hansmann, *supra* note 22, at 863–65.

⁹⁶ Anup Malani & Guy David, *Does Nonprofit Status Signal Quality?*, 37 *J. LEGAL STUD.* 551, 555 (2008).

⁹⁷ *Id.* at 554–55.

⁹⁸ *Id.* at 555.

⁹⁹ See *infra* Part IV.A.

Malani and David's work makes a valuable contribution. It suggests that, even if contract failure may have sufficiently explained the nonprofit status of hospitals and daycare providers in the past, it no longer does so. Instead, these organizations compete largely on the strength of the services provided: their scope, their reliability, their facilities, and their comparisons with other providers in the market. The Malani–David study by design does not address contract failure in markets where nonprofits and for-profits do not compete on the provision of services.

Hansmann also applied the contract failure analysis to public goods such as a “listener-sponsored radio station”¹⁰⁰—what we will term public radio.¹⁰¹ Hansmann conducts a thought experiment, “silly” as it might seem, imagining a for-profit listener-sponsored radio station.¹⁰² The problem, he argues, is not that the public nature of the good—commercial-free radio—creates a free-rider problem¹⁰³ (although it does). He asserts that people are often willing to pay for free riders.¹⁰⁴ The problem with for-profit radio stations is that they would have an incentive to solicit donations far in excess of what is needed to pay for broadcast and to distribute the excess as profits to the owners. The contract failure here is not that the donor doesn't know the quality of the service being provided (as with the African poor in the earlier example), but rather that she does not know whether, or how much of, her contribution is paying for the service. Nonprofit status provides at least some assurance that profits are not being diverted to the owners' pockets.¹⁰⁵

¹⁰⁰ Hansmann, *supra* note 22, at 550.

¹⁰¹ A note about structure: National Public Radio (NPR) is a private, nonprofit membership organization that partners with separately licensed and operated public radio stations (member stations) “to create a more informed public—one challenged and invigorated by a deeper understanding and appreciation of events, ideas and cultures.” *About NPR: Mission and Vision*, NPR, <http://www.npr.org/about/aboutnpr/mission.html> (last visited May 28, 2011). To do this, NPR “produce[s], acquire[s], and distribute[s] programming that meets the highest standards of public service in journalism and cultural expression; [NPR] represent[s] its members in matters of their mutual interest; and provide[s] satellite interconnection for the entire public radio system.” *Id.* More than 900 independent public radio stations throughout the United States combine local programming with programming from NPR and other sources to provide radio services for their audiences. *About NPR: Stations and Public Media*, NPR, http://www.npr.org/about/aboutnpr/stations_publicmedia.html (last visited May 28, 2011). This Article uses the term *public radio* loosely but recognizes the distinction between NPR and its members—local public radio stations.

¹⁰² Hansmann, *supra* note 22, at 850.

¹⁰³ *Id.* at 849.

¹⁰⁴ *Id.*

¹⁰⁵ In addition, nonprofits address larger market failures such as, for example, in the provision of health care. See Horwitz, *supra* note 14, at 1390, 1405.

Hansmann predicts that

[i]f “pay radio” were to become commercially feasible—that is, if there were some inexpensive means of making receipt of a radio station’s broadcasts conditional upon payment of a periodic charge—then profit-seeking firms also would be able to engage in commercial-free broadcasting simply by charging their listeners directly, as is already happening in the television industry via cable TV. *The result presumably would be a reduction in the willingness of listeners to make voluntary contributions to nonprofit stations, since such stations would no longer be as necessary to fill the need for commercial-free programming. Thus pay radio might be expected to supplant nonprofit listener-supported stations. Such a result would be more efficient, in fact, since the free-rider problem would be eliminated.*¹⁰⁶

The reader may have anticipated where we are going. “Pay radio” has become commercially feasible: SiriusXM provides a subscription-based service that allows its customers to receive myriad radio broadcasts, many of which are commercial free.¹⁰⁷ Yet public radio audiences have increased since the advent of the commercial competitors, and donations had not decreased significantly, at least before the general economic downturn.¹⁰⁸ I suggest the reason for this result is that Hansmann misidentified the good that public radio is selling.

III. SOCIAL IDENTITY THEORY

We have seen how nonprofits are facing pressure to justify their tax-advantaged status and that the risk of agency costs appears high in the nonprofit form due to lack of policing constraints. Yet the form persists.

¹⁰⁶ Hansmann, *supra* note 22, at 854 (emphasis added) (footnote omitted).

¹⁰⁷ SIRIUS satellite radio provides more than 180 digital-quality channels, 71 of which are commercial-free music channels. *What Is SiriusXM?*, SIRIUSXM RADIO, <http://www.siriusxm.com/whatisirsixm> (last visited May 28, 2011).

¹⁰⁸ See Paul Farhi, *Consider This: NPR Achieves Record Ratings*, WASH. POST, Mar. 24, 2009, at C1; Press Release, NPR, NPR Ratings Hit New High: 26.5 Million Weekly Listeners (Mar. 15, 2007), available at <http://www.npr.org/about/press/2007/031507.audience.html>. Although the federal government provides a portion of public radio’s budget, a significant source of income is derived from contributions, sponsorships, and grants. These totals were \$267.8 million (skewed by a bequest of nearly \$200 million from a single donor) in 2004, \$57.6 million in 2005, \$56.2 million in 2006, \$74.2 million in 2007, \$62.5 million in 2008, \$58.3 million in 2009, and \$63.4 million in 2010. See *Public Radio Finances*, NPR, <http://www.npr.org/about/aboutnpr/publicradiofinances.html> (last visited May 28, 2011) (providing direct links to Annual Reports for 2004 and 2005 and audited statements for NPR Consolidated for 2006 and 2007).

Social identity theory, which has roots in the field of psychology, may well explain why nonprofits continue to exist, despite apparently unpoliced agency costs and new sources of competition with for-profits in areas such as commercial-free radio and microfinance. Nonprofits might endure because the nonprofit form has the power to create something that the warm-glow-selling, for-profit firm cannot provide: a particularly valuable kind of warm glow associated with social identity.

A. *Introduction to Social Identity Theory*

Psychologists have been writing about identity and social identity theory for decades.¹⁰⁹ Generally, the theory postulates that one's concept of self is made up both of idiosyncratic traits (personal identity) and membership in various group categories (social identity).¹¹⁰ *Social identity* can be defined as "self-conception as a group member,"¹¹¹ or "the individual's knowledge that he/she belongs to certain social groups together with some emotional and value significance to him/her of the group membership."¹¹² It posits that an individual categorizes the world into units, and that one's sense of self derives largely from the categories in which one belongs.¹¹³

Social identity theory developed out of a desire for an understanding of social conflict at a group level, rather than an individual level,¹¹⁴ but is not so reductionist that it equates the individual with the sum of her group affiliations. It recognizes that personal identifications are often salient: "I am a friend of Suzie," or "I need my morning coffee." But social identifications, such as "I am a Badgers football fan" or "I am a law professor," are prominent, too.¹¹⁵ Social identity grounds itself in "in group" versus "out of group" identification, and several foundational studies have examined how group identifications

¹⁰⁹ See, e.g., Henry Tajfel & John Turner, *An Integrative Theory of Intergroup Conflict*, in *THE SOCIAL PSYCHOLOGY OF INTERGROUP RELATIONS* 33 (William G. Austin & Stephen Worchel eds., 1979); *SOCIAL IDENTITY THEORY* (Dominic Abrams & Michael A. Hogg eds., 1990).

¹¹⁰ Blake E. Ashforth & Fred Mael, *Social Identity Theory and the Organization*, 14 *ACAD. MGMT. REV.* 20, 20–21 (1989). One trait can play both roles, however. One could conceive of oneself merely as "having red hair," or as being a "redhead" with associated traits of fiery temper, impulsiveness, or intelligence.

¹¹¹ Dominic Abrams & Michael A. Hogg, *An Introduction to the Social Identity Approach*, in *SOCIAL IDENTITY THEORY*, *supra* note 109, at 1, 2.

¹¹² *Id.* (quoting Henri Tajfel) (internal quotation marks omitted).

¹¹³ *Id.* at 2–3.

¹¹⁴ See DONALD M. TAYLOR & FATHALI M. MOGHADDAM, *THEORIES OF INTERGROUP RELATIONS* 61–66 (2d ed. 1994); Michael A. Hogg, *Social Identity Theory*, in *CONTEMPORARY SOCIAL PSYCHOLOGICAL THEORIES* 111, 112 (Peter J. Burke ed., 2006).

¹¹⁵ See Abrams & Hogg, *supra* note 112, at 4.

form.¹¹⁶ The key teaching of this work is clear: The knowledge that one is a member of certain groups represents a constitutive part of one's identity.¹¹⁷

B. *Social Identity and the Firm*

Identity theory provides special insight into a theory of a certain kind of firm—the nonprofit.¹¹⁸ While others have focused on why managers or employees behave as they do or why an organization chooses a particular aggregate identity,¹¹⁹ I am interested in why individuals are drawn to

¹¹⁶ For example, the work of Turner, Brown, and Tajfel showed that the mere act of individuals categorizing themselves as group members was sufficient to lead them to display in-group favoritism. See J. C. Turner, R. J. Brown & H. Tajfel, *Social Comparison and Group Interest in Ingroup Favouritism*, 9 EUR. J. SOC. PSYCHOL. 187 (1979). After being categorized into a group membership, individuals seek to achieve positive self-esteem by positively differentiating their in-group from a comparison out-group on some valued dimension. This quest for positive distinctiveness means that people's sense of who they are is defined in terms of "we" rather than "I." See *id.* at 190.

¹¹⁷ See TAYLOR & MOGHADDAM, *supra* note 114, at 83.

¹¹⁸ As Professors Smith and King suggest:

Contracts offer organizations a unique opportunity to express their primary identity requirements: continuity and distinctiveness. Given the importance of a clearly-defined identity for survival, organizations may use contracts to express identity, stating not only what they are but also what they are not. In other words, contracts afford organizations the opportunity to stake out their identity and defend their claims to distinctiveness.

D. Gordon Smith & Brayden G. King, *Contracts as Organizations*, 51 ARIZ. L. REV. 1, 34 (2009) (footnote omitted). This proposal is close to my own argument, but Smith and King use specific organizations, such as a dairy cooperative association, and specific examples, including Pixar's preserving its identity after acquisition by Disney. See *id.* at 34–35.

¹¹⁹ Economists have made use of identity theory and have applied social identity theory's insights to the firm to explore both "identity in organizations" and "identity of organizations." Many academics have looked at "identity in organizations," or the identity of employees within the organization. See, e.g., George A. Akerlof & Rachel E. Kranton, *Identity and the Economics of Organizations*, 19 J. ECON. PERSP. 9 (2005) (using identity theory to model employee behavior); Ashforth & Mael, *supra* note 110, at 22 (exploring how an employee is shaped by her workplace and groups within the workplace); Michael A. Hogg, *Social Identity and Misuse of Power: The Dark Side of Leadership*, 70 BROOK. L. REV. 1239 (2005) (applying social identity theory to explain why successful corporate managers tend toward conformity as a result of the tendency of groups to reinforce their own internal norms); Renee M. Jones, *Law, Norms, and the Breakdown of the Board: Promoting Accountability in Corporate Governance*, 92 IOWA L. REV. 105, 140–41 (2006) (using social identity theory to explain the failure of corporate boards, such as those of Enron or WorldCom, to engage in effective oversight, and describing how their tendency toward conformity leads them toward homogeneity and away from dissent and a willingness to ask questions).

"Identity of organizations," in contrast, focuses on concepts of corporate image and reputation, with the prototypical question being, "Who are we as an organization?" See Stuart Albert & David A. Whetten, *Organizational Identity*, in 7 RESEARCH IN ORGANIZATIONAL BEHAVIOR 263 (L. L. Cummings & Barry M. Staw eds., 1985). Organizations are "social aggregates—collectivities or groups of individuals." David A. Whetten & Alison Mackey, *A Social Actor Conception of Organizational Identity and Its Implications for the Study of Organizational Reputation*, 41 BUS. & SOC'Y 393, 395 (2002). So organizational identity is a set of shared beliefs about the identity of the organization. *Id.* The concept of identity of organizations views firms

participate in a nonprofit organization.¹²⁰ I want to suggest that identity concepts can matter to participants in organizations other than managers and employees—particularly, to investors, donors, or consumers. Indeed, identity concepts often determine the most fundamental question: the form of ownership an organization will take.¹²¹

Because social identity theory comes from social psychology, its chief concern is the interaction between groups, including the origin and effects of discrimination.¹²² The key factors making up social identity are the “distinctiveness of the group’s values and practices in relation to those of comparable groups,” the salience of out-groups, and the prestige of the group in question.¹²³ We will examine these characteristics, but the basic point is a

themselves as social actors “authorized to engage in social intercourse as a collectivity and possessing rights and responsibilities as if the collectivity were a single individual.” *Id.*

¹²⁰ I am not the first to apply identity theory to firms. Prior attempts looked at corporate image, the role identity plays in facilitating information transfer within the firm, and the branding effects of contracts on specific organizations. Professors Kogut and Zander argue for an alternative, information-based theory of firms, based on the decreased barriers to communication and coordination that occur within firms: “[W]e proposed that a firm be understood as a social community specializing in the speed and efficiency in the creation and transfer of knowledge.” Bruce Kogut & Udo Zander, *What Firms Do? Coordination, Identity, and Learning*, 7 *ORG. SCI.* 502, 503 (1996). “This basic dichotomy between self-interest and the longing to belong is the behavioral underpinning to the superiority of firms over markets in resolving a fundamental dilemma: productivity grows with the division of labor but specialization increases the costs of communication and coordination.” *Id.* at 502. Firms exist not merely because of the transaction costs (including communication costs) outside their bounds, but also because the “shared identity” within the firm not only lowers the costs of communication, but also increases them by “establish[ing] explicit and tacit rules of coordination and influenc[ing] the direction of search and learning.” *Id.* at 503. This literature “argues that the chief function of the firm is not to solve hold-up problems but instead to facilitate the flow of the uncodifiable, living knowledge that animates innovation.” Ronald J. Gilson et al., *Contracting for Innovation: Vertical Disintegration and Interfirm Collaboration*, 109 *COLUM. L. REV.* 431, 496–97 (2009).

¹²¹ Still, there are hints in the existing literature that organizational form itself is an exercise in identity creation:

In identity terms, the selection of organizational forms makes up a self-categorization process whereby the organization’s memberships in identity categories or groups are declared. Examples of organizational forms/identity categories include church versus business organizational purpose, public versus private ownership, local versus global domain, and transportation versus utilities industry. The sum of these choices constitutes the founders’ answer to the question “What type of organization/social actor are we forming?”

Whetten & Mackey, *supra* note 119, at 398.

¹²² One account describes social identity theory as a European rejection of the “nice person” model of social psychology dominant in America, typified by statements such as “we like those who support us” or “understanding the point of view of another person promotes cooperation.” TAYLOR & MOGHADDAM, *supra* note 114, at 64–66. “As an alternative to the ‘nice person’ model of humankind, European social psychologists could rely upon an intellectual tradition, influenced by Marx and Freud, that presents a model of self-centered, irrational humankind struggling to improve their position in a conflict-based society.” *Id.* at 80.

¹²³ Ashforth & Mael, *supra* note 110, at 24–25 (emphasis omitted).

simple one: Nonprofits can create and “sell” a particular kind of identity, one in which an individual may participate as employee, donor, or volunteer. This identity is the organization’s chief defense against agency costs: If managers stray too far from the entity’s nonprofit ethos, they will not merely suffer a loss of reputation, or risk sanctions for norm violation, or subject themselves and the entity to a reputational loss; they will injure—perhaps severely—the value of the enterprise itself.

1. Distinctiveness of the Group’s Values and Practices in Relation to Those of Comparable Groups, and the Salience of Out-Groups

What sets nonprofits apart as organizations is their ability to create a distinctive kind of identity. The rhetoric of nonprofits often uses phrases like “giving back to the community,” “serving unmet needs,” or “preserving heritage, land or culture for future generations.”¹²⁴ Trustees for a successful health care system¹²⁵ serve only on a volunteer basis “for the good of patients and the community.”¹²⁶ The Make-A-Wish Foundation “give[s] children with life-threatening medical conditions the chance to be anyone or anything, to go anywhere, to have anything, [and] to meet anyone” by making their wishes become reality.¹²⁷ The American Red Cross’s mission is to “provide relief to victims of disaster and help people prevent, prepare for and respond to emergencies”;¹²⁸ its goal is “preventing and relieving suffering.”¹²⁹ While for-profit companies may adopt “feel-good” marketing, branding, or positional strategies, it is understood that those goals are subsidiary to the profit

¹²⁴ A counterexample that springs readily to mind is the trade association: the NFL, National Association of Broadcasters, Motion Picture Association of America, and the American Bar Association, for example, are nonprofits. As Part IV.C describes, I classify these nonprofits as functioning more like cooperatives. They exist to further the interests of their membership. Identity is still a salient feature of the organization, but the organization exists specifically for the benefit of its members.

¹²⁵ See President Barack Obama, Remarks by the President to a Joint Session of Congress on Health Care (Sept. 9, 2009), available at http://www.whitehouse.gov/the_press_office/Remarks-by-the-President-to-a-Joint-Session-of-Congress-on-Health-Care (“We have long known that some places—like the Intermountain Healthcare in Utah . . . —offer high-quality care at costs below average.”).

¹²⁶ *Annual Report to the Community for 2008: Trustees*, INTERMOUNTAIN HEALTHCARE, <http://intermountainhealthcare.org/about/overview/annualreport2008/Pages/Trustees.aspx> (last visited May 28, 2011).

¹²⁷ MAKE-A-WISH FOUND. OF AM., 2008 ANNUAL REPORT 2 (2009), available at http://www.wish.org/content/download/8413/63676/version/1/file/MAWF_08_AnnualReport.pdf.

¹²⁸ AM. RED CROSS, 2008 ANNUAL REPORT (2009), available at <http://www.redcross.org/www-files/Documents/pdf/corppubs/A501-08.pdf> (quoting the mission statement of the American Red Cross).

¹²⁹ *About Us*, AM. RED CROSS, www.redcross.org/aboutus (last visited May 28, 2011).

imperative.¹³⁰ The core mission of the nonprofit, in contrast, is to maximize the output of some social good.

The salience of out-groups is a difficult principle to apply to the nonprofit form because nonprofits and for-profits seldom compete with each other. Although, as discussed above, nonprofits generally make clear their different status, usually they cannot cite specific examples of for-profits similar enough to them to provide a relevant contrast.¹³¹ This principle is most notable in the cases of hospitals, nursing homes, and educational institutions, where we do see for-profits competing with nonprofits.

2. *Prestige of the Group*

Being a nonprofit means something to its employees because many of them are willing to accept lower salaries in exchange for the “psychic income” of working at a nonprofit.¹³² It also means something to its volunteer members, and to the outside world. Brian Galle posits that there is a special form of warm glow provided by producing a charitable good at a charity, “where peers will know that the employee is making a sacrifice.”¹³³ Members of the organization, both paid and unpaid, identify themselves with the organization and with its nonprofit form. If it were to begin doling out large salaries or lavish perquisites, while an employee’s monetary income might rise, the identity value derived from being part of a nonprofit would fall.¹³⁴

Because of the history of social identity theory, which grew out of a need to understand discrimination, the emphasis on the prestige of one’s group can sound sinister. But the point is merely that individuals wish to belong to

¹³⁰ See Timothy M. Devinney, *Is the Socially Responsible Corporation a Myth? The Good, the Bad, and the Ugly of Corporate Social Responsibility*, ACAD. MGMT. PERSP., May 2009, at 44, 53–54.

¹³¹ REI might be an example of this distinctiveness, but it is a cooperative in form. *About REI*, REI, http://www.rei.com/aboutrei/about_rei.html (last visited May 28, 2011).

¹³² See RON SAUNDERS, CANADIAN POLICY RESEARCH NETWORKS, PASSION AND COMMITMENT UNDER STRESS: HUMAN RESOURCES ISSUES IN CANADA’S NON-PROFIT SECTOR—A SYNTHESIS PAPER (2004), available at http://www.cpm.org/documents/25806_en.pdf; Peter Manzo, *The Real Salary Scandal*, STANFORD SOC. INNOVATION REV., Winter 2004, at 65, 66 (“Ask virtually any nonprofit employee and they’ll tell you they’re underpaid. . . . When people choose a nonprofit career, they forgo opportunities to make much more money in the for-profit sector.”).

¹³³ Galle, *supra* note 69, at 1223.

¹³⁴ See Jeanne Sahadi, *Feeling Underpaid? Try This*, CNNMONEY.COM (July 18, 2003, 1:23 PM), <http://money.cnn.com/2003/07/17/commentary/everyday/sahadi/index.htm> (“Running a humanitarian nonprofit will earn you many multiples less than what even the most incompetent . . . CEO can pull in. But the mission’s the thing for those who devote their careers to helping others.” (emphasis omitted)).

groups that compare favorably with other groups.¹³⁵ For nonprofits, the prestige comes from not being part of the for-profit world. In a sense, nonprofits perceive all for-profit entities to be the out-group against which they define themselves. Being a shareholder in IBM does not convey prestige or identity, beyond potential wealth. But participation in a nonprofit conveys some aspect of identity and “prestige” to those who approve of the values the nonprofit entity espouses. You will probably have some favorable (or unfavorable) impression of those who associate themselves with the American Cancer Society, Feed the Children, the American Red Cross, Habitat for Humanity, Planned Parenthood, the Metropolitan Museum of Art, the Humane Society, the Nature Conservancy, or the National Rifle Association. The identity function of the nonprofit form explains why.

C. *Social Identity Versus Norms or the Expressive Function of Law*

How does social identity theory fit together with modern thinking about law? In recent years, scholars have focused attention on law as both a reflection and source of social norms. Claire Hill, for example, argues that “norms” result in the taking of actions because of what others think, while “identity” results in the taking of actions because of the kind of person one is.¹³⁶ For example, frugality and sacrifice are forms of behavior that the outside world expects of nonprofits; the use of private jets, or first-class air travel, even for high-level executives of major nonprofits, might cause those outside the organization to conclude the nonprofit was not behaving appropriately.¹³⁷ Actions of this sort are at odds with the *identity* of the nonprofit community; put simply, they indicate a desire for gain that contravenes the very nature of the nonprofit form as conceived by its members and employees.

¹³⁵ TAYLOR & MOGHADDAM, *supra* note 114, at 83.

¹³⁶ Claire A. Hill, *The Law and Economics of Identity*, 32 QUEEN'S L.J. 389, 414 (2007) (defining “norms” “as behavioural regularities enforced either externally, by a community, or internally, or both”); *id.* at 399 (defining “identity” as “a person’s sense of self” (quoting George A. Akerlof & Rachel E. Kranton, *Economics and Identity*, 115 Q.J. ECON. 715, 715 (2000)) (internal quotation mark omitted)).

¹³⁷ See, e.g., Del Jones, *Non-Profit Execs Make Millions*, USA TODAY, Sept. 28, 2009, at 5B (“But CEOs of non-profits do not escape public outrage over pay, and some donors are surprised to learn that leadership isn’t voluntary”); Peter St. Onge, *How Much Is Enough?—Nonprofit Leaders Debate Whether Charity Should Begin with Executive Paychecks*, CHARLOTTE OBSERVER, Oct. 19, 2009, at 1A (“[There is a] widely held belief that individuals make a special commitment when they move into a charitable field, and should have a spirit of community sacrifice that also applies to a charity’s CEO. . . . ‘For a charity, trust is the most important thing to have with the public’” (quoting Ken Berger, President of Charity Navigator)).

Social identity theory also bears a close relationship to Cass Sunstein's scholarship regarding the expressive function of law.¹³⁸ Sunstein argues that law can operate as an expressive and effective articulation of values, even if it remains unenforced or underenforced.¹³⁹ In addition, law's expressive function allows it to change social norms.¹⁴⁰ The nondistribution constraint of nonprofits serves to illustrate the point. Even though the nondistribution constraint is virtually unenforced (because it can be evaded so readily via inflated salary, perquisites, and the like), it nevertheless shapes behavior by signaling what is expected. Indeed, the nondistribution constraint is so central to the identity of nonprofits that, according to social identity theory, it qualifies as *constitutive*. To the extent it serves an expressive function, it expresses fundamentally what the organization is about. Without the identity-creation function and the distinctive kind of good it creates, the nonprofit would not exist.

D. Return to Public Radio

The identity function of the nonprofit organizational form explains SiriusXM's nondeleterious effect on public radio. Public radio sells more than just commercial-free radio. Public radio listeners are a part of a community of listeners in a way that SiriusXM listeners are not. True, there are free riders among the public radio audience, but an ethos of donation exists. This ethos is unaffected by the SiriusXM alternative because commercial-free pay radio is not really an alternative to public radio: It cannot provide the identity that listening to and donating to public radio provides.

Donations to the local stations that are affiliates of public radio confer an identity in a way that paying for a SiriusXM subscription does not. An NPR patron thinks of herself as the sort of person who donates to public radio. There is a rhetoric of membership, of listener-supportedness. A donation makes one a "friend" of public radio.¹⁴¹ Identity creation also explains why

¹³⁸ See, e.g., Cass R. Sunstein, *On the Expressive Function of Law*, 144 U. PA. L. REV. 2021 (1996).

¹³⁹ *Id.* at 2032.

¹⁴⁰ *Id.* at 2025.

¹⁴¹ From my local station:

When you become a member of public radio, your contribution is more than a donation . . . more than a gift. You'll be telling us that public radio is valuable and worth supporting. We, in turn, will do our best to make sure you get what you pay for. It's a great deal and one we hope you can't refuse. Call with your pledge donation now.

the rewards (“gifts”) for donation or service frequently are public expressions (tote bags, coffee mugs) of affiliation with the organization. This rhetoric reflects the true nature of the good being sold: identity and membership in a larger community, rather than only the service of commercial-free radio.

Social identity can similarly work to explain why nonprofits continue to exist in the face of the potential for widespread agency costs discussed in Part I. The nonprofit form itself creates a special kind of identity, different in character from that of the for-profit firm. This identity is a species of warm glow antithetical to the profit motive. A more radical formulation of this concept is that certain experiences or feelings are “extramarket.” Markets do not provide us with parental love or patriotic fervor, not because of market failure but because they simply exist outside the market. And nonprofits’ species of warm glow is similarly extramarket.¹⁴²

E. Nonprofit Social Identity

Nonprofits are not the only corporate entities in the identity business. For-profit firms create identities, too. Indeed, the marketing industry centers on making the consumer identify with the goods they buy and consume. Many consumers, for example, think of themselves as Ford (not GM) owners and as Mac (not PC) users. Victor Fleischer has argued that Google’s branding guided how it structured its IPO.¹⁴³ The identity value of some of these goods is created by scarcity—a Birkin bag or a Rolls Royce. But much of it is just creating a belief within the consumer that her identity is closely tied with drinking Coke (or Pepsi), driving a Prius (or Hummer), and using a Kindle (or iPad).

While consumption of goods or services creates most for-profit identity, occasionally a for-profit firm can generate an identity for *investors* as well as consumers. Berkshire Hathaway is a near-perfect, if idiosyncratic, example.¹⁴⁴ In 2009 there were about 35,000 attendees at “Woodstock for Capitalists”—

Become a Friend of WUGA, WUGA, http://wuga.org/support_friend.html (last visited May 28, 2011) (alteration in original).

¹⁴² I thank Jill Horwitz for this insight.

¹⁴³ Victor Fleischer, *Brand New Deal: The Branding Effect of Corporate Deal Structures*, 104 MICH. L. REV. 1581, 1584 (2006).

¹⁴⁴ Another example of a for-profit firm whose identity output extends to past employees is McKinsey & Company. See *Alumni Center*, MCKINSEY & CO., <https://alumni.mckinsey.com/alumni/default/public/struts/all/login.jsp> (last visited May 28, 2011). I am indebted to Jill Horwitz for this example.

Berkshire's annual shareholder meeting;¹⁴⁵ this when the average shareholder meeting is only sparsely attended. Doubtless much of the interest in attending the meeting comes from hearing Berkshire's CEO Warren Buffett, the famed "Oracle of Omaha," speak, and the opportunity to ask him questions. But the carnival-like atmosphere of the meeting, coupled with events including a dinner at Buffett's favorite steak house and even commemorative stamps,¹⁴⁶ bespeaks a different culture from the typical public corporation. There is a culture of community (built in part on a cult of personality) bound up with owning shares in this corporation. Even viewing Berkshire as an extreme case, many for-profit firms are undeniably in the business of identity creation. For-profits like Nike and Apple are adept at convincing us that consuming their goods sets us apart.¹⁴⁷

While for-profits create identity, I am suggesting here that the nonprofit form can create a *different* kind of identity, one bound up with warm glow in a way that for-profit identity cannot be. It is more difficult—arguably impossible—for a for-profit entity to sell an identity of saving wildlife or feeding the hungry in the way that the National Wildlife Foundation or a nonprofit soup kitchen can. Certain goods or experiences are cheapened by the profit motive. By donating money to a local soup kitchen, some people obtain warm glow because they are helping others. Other people enjoy a feeling of identity as someone who helps the needy in their community. A thought experiment helps to explain this phenomenon. Imagine that one can donate to either a for-profit or a nonprofit that provides housing for the homeless. To which of these entities would *you* donate funds? If you (like me) lean toward the nonprofit entity, this is because when the donor is aware that the donation is to a for-profit group, the identity function is lessened and, as a result, the warm glow dims.

¹⁴⁵ See, e.g., Letter from Warren E. Buffett, Chairman of the Bd. of Dirs., Berkshire Hathaway Inc., to Shareholders, Berkshire Hathaway Inc. (Feb. 26, 2010), available at <http://www.berkshirehathaway.com/letters/2009ltr.pdf> ("Our best guess is that 35,000 people attended the annual meeting last year. . . . With our shareholder population much expanded, we expect even more this year."). Meetings are held at the Qwest Center in Omaha, Nebraska, and subsidiaries of Berkshire Hathaway—such as GEICO and Bookworm—offer samples or discounts on their products. *Id.*

¹⁴⁶ See generally BERKSHIRE HATHAWAY INC., BERKSHIRE HATHAWAY ANNUAL SHAREHOLDERS MEETING MAY 1, 2010: VISITOR'S GUIDE (2010), available at <http://www.berkshirehathaway.com/meet01/VisGuide2010.pdf>.

¹⁴⁷ Identity and image are related but different concepts. Identity has to do with constitutive, organizational self-conception, whereas image is what members think outsiders think about the organization, what outsiders actually think about organization, and sometimes what members project or present about the organization to influence what outsiders think. Whetten & Mackey, *supra* note 119, at 400.

As an empirical matter, the question of why donors give to nonprofits is a difficult one. Factors such as empathy, sympathy, fear, guilt, pity, and trust¹⁴⁸ have all been postulated. Field data and laboratory data yield conflicting results on whether altruism (concern for others' welfare) or warm glow motivates donors.¹⁴⁹ Relatively little work has focused on the role of identity in charitable donation—the data comes largely from surveys that ask about motives, eliciting responses such as “to receive tax breaks” or “personal pride,” rather than responses that elicit a perception of shared social identity.¹⁵⁰ Even so, early research suggests that social identity plays a role in the decision of a donor to give.¹⁵¹

Two concepts from behavioral economics, availability bias and framing effects, offer insight as to why for-profits fail to generate a full measure of warm glow. Availability bias refers generally to the idea that people make decisions based on information “that is particularly salient, vivid, or easily ‘available’ to them.”¹⁵² Research has found that simply increasing the salience of privacy concerns—for example, by reassuring people that their privacy will be protected—can paradoxically make people more concerned about the issue, presumably by bringing it to the forefront of their minds.¹⁵³

Numerous studies have also demonstrated the importance of framing effects—that is, the fact that how questions are framed affects individual choices. In the classic study, individuals were told that they had to choose between alternative vaccine programs to combat a disease that would kill 600 people if nothing were done. When confronted with two equivalent choices, one framed in terms of lives lost and the other in terms of lives saved, people prefer the “lives saved” alternative.¹⁵⁴

¹⁴⁸ Adrian Sargeant et al., *Perceptual Determinants of Nonprofit Giving Behavior*, 59 J. BUS. RES. 155, 156 (2006).

¹⁴⁹ Heidi Crumpler & Philip J. Grossman, *An Experimental Test of Warm Glow Giving*, 92 J. PUB. ECON. 1011, 1013–14 (2008).

¹⁵⁰ Glen Riecken & Ugur Yavas, *Monetary Donations to Charitable Organizations: A Case Study*, SERVICES MARKETING Q., Oct. 2007, at 67, 73 tbl.2.

¹⁵¹ Jennifer L. Aaker & Satoshi Akutsu, *Why Do People Give? The Role of Identity in Giving*, 19 J. CONSUMER PSYCHOL. 267, 268–69 (2009).

¹⁵² Jon D. Hanson & Douglas A. Kysar, *Taking Behavioralism Seriously: The Problem of Market Manipulation*, 74 N.Y.U. L. REV. 630, 662 (1999).

¹⁵³ See, e.g., Joseph Bonneau & Sören Preibusch, *The Privacy Jungle: On the Market for Data Protection in Social Networks*, 8 WORKSHOP ON ECON. INFO. SECURITY 29 (2009), available at <http://weis09.infoseccon.net/files/156/paper156.pdf>.

¹⁵⁴ Hanson & Kysar, *supra* note 152, at 644–45 (citing Daniel Kahneman & Amos Tversky, *Choices, Values, and Frames*, 39 AM. PSYCHOL. 341, 343 (1984)).

Put simply, context matters. And—according to the argument made here—the traditional for-profit form creates a background context that is not conducive to the production of an identity in which altruism and warm glow predominate. For-profit charity promoters Malani and Posner argue that rational donors should choose a for-profit firm that can guarantee lower administrative costs over a nonprofit, which at best implies lower overhead through a weakly enforced nondistribution constraint, but also carries the baggage of increased agency costs.¹⁵⁵ They cite as reassurance for donors the fact that a for-profit charity would have to inform potential donors of administrative costs involved, and the profit to be made, and would face penalties under federal and state consumer protection laws for fraudulent misrepresentations.¹⁵⁶ It would also have to apportion fees for third-party monitoring.¹⁵⁷

The picture is not as simple as Malani and Posner suggest. Consumer protection laws would indeed require informing potential donors of the profit being made and the administrative costs incurred. Providing that information is costly in more ways than simply increasing compliance costs. By increasing the salience of the fact that some (perhaps much) of the donation will go not to the cause that the donor seeks to serve, but instead to administrative costs and to serve the profit motives of the owners, the for-profit increases the salience of the profit motive itself. It reduces the donation to a mere monetary exchange, a diminution likely to dim the warm-glow impulses of many a would-be donor.

A nonprofit's form allows it to create enhanced warm glow by downplaying the fact that not all of a donor's money goes to the targets of charitable giving. Malani and Posner might scoff at this as mere illusion,¹⁵⁸ but the identity function also performs real work in the organization. By taking away the profit incentive, the nonprofit form requires the organization to focus on other ends. The creation of a unique identity works to reduce agency costs because a nonprofit organization will be hard-pressed to market a distinctive warm-glow good if agency costs become too obvious. High salaries and other rent-seeking thus occur less often than we might expect in nonprofits

¹⁵⁵ *But see* Galle, *supra* note 69, at 1214–15 (complicating this basic premise); Hines et al., *supra* note 4, at 1183 (same).

¹⁵⁶ Malani & Posner, *supra* note 25, at 2036–37, 2051.

¹⁵⁷ Galle, *supra* note 69, at 1214–15.

¹⁵⁸ Malani & Posner, *supra* note 25, at 2051.

because it is understood that these actions are inconsistent with the organization's central purpose.

This identity is more than morality, although the two concepts do overlap in application. Jill Horwitz argues that what separates charitable nonprofits is the moral (as well as legal) obligation to advance the charitable goals that they have chosen.¹⁵⁹ She emphasizes that these organizations are legally and morally bound to work toward charitable ends in a way that for-profits are not, which makes them appear to donors more likely to fulfill the donors' desired ends. Social identity is broader in reach than Horwitz's theory because it encompasses noncharitable nonprofits as well—membership organizations such as a local runner's club may lack the moral obligations that apply to a charitable hospital. Both might still provide social identity, but the charitable organization's identity will have a distinctly moral cast.

The preceding discussion shows why the nonprofit form creates an identity distinct from for-profits. But how does this special nonprofit social identity come to be? The nonprofit form creates an identity distinct from for-profits by virtue of the central feature of its organizational structure, the nondistribution constraint. While generally not articulated in formal terms to nonprofit participants, the nondistribution constraint translates in practice to the shared idea among employees, donors, volunteers, and patrons that the organization is not "in it for the money" (even if considerable profits are being made and retained). But donors must believe that the nondistribution constraint has bite, that it actually constrains even in the absence of enforcement mechanisms as discussed in Part I.

The unique social identity of nonprofits functions as both the product being "sold" and the mechanism that makes the nondistribution constraint credible by creating a basis for nonprofit participants—donors, employees, and customers—to trust the organization. Larry Ribstein defines *trust* as "the willingness to make oneself vulnerable to another without costly external constraints"¹⁶⁰—after all, if external forces like legal sanctions force individuals to behave, we ultimately trust not the individuals themselves but the efficacy of those sanctions. "Strong form" trust is the most essential version of trust, where the trusted individual (or, as here, nonprofit institution) is "free to breach but 'opportunistic behavior would violate values, principles, and standards of behavior that have been internalized by parties to an

¹⁵⁹ Horwitz, *supra* note 14, at 1386.

¹⁶⁰ Larry E. Ribstein, *Law v. Trust*, 81 B.U. L. REV. 553, 555 (2001).

exchange.”¹⁶¹ In the nonprofit that offers social identity, donors and patrons have a reason for their strong form trust, even in the absence of legal enforcement: social identity. If the organization violates the nondistribution constraint by paying its managers too high a salary, for example, it risks destroying the very social identity that makes it attractive to its employees and customers.

Not all nonprofits are donative organizations: Trade associations and social clubs are nonprofits, too. The special abilities of the nonprofit form to create an identity apply to these organizations no less than to charitable organizations. Imagine a for-profit fraternity. Here, one is paying to be a member of a group constructed solely for the purposes of generating profit. The concept is incoherent because the point of the organization is to provide something intangible. We might well pay to be members of an association, but we will hesitate to do so if we know that part of the price of the ticket is destined to line someone’s pocket.

IV. ENTITY AND IDENTITY

This Article’s hypothesis is that entity form itself permits the creation of a different kind of good. Although the preceding section explored this hypothesis by way of the nonprofit form, its application is not limited to nonprofits. A community’s local food cooperative, for example, may ostensibly compete with Whole Foods. Both offer a range of organic foods and produce, often in bulk, with an emphasis on whole grains and alternative, herbal, or homeopathic treatments. But the cooperative’s product on offer is not merely organic food; it is also investment in the local community and its farmers.¹⁶² The cooperative thus creates and markets a different product, one grounded as much in the local community and democratic governance as in profits.

¹⁶¹ *Id.* at 557 (quoting Jay B. Barney & Mark H. Hansen, *Trustworthiness as a Source of Competitive Advantage*, 15 STRATEGIC MGMT. J. 175, 179 (1994)). Ribstein distinguishes “semi-strong form” trust (where the parties have set up structures to protect themselves, but are still vulnerable to opportunism), and “weak form” trust (where the presence of legal constraints means that a party actually exposes herself to very little risk). *Id.* at 557–58.

¹⁶² The author’s hometown, for example, has such a co-op, whose mission is to “strive[] to embody progressive cultural transformation through socially and environmentally conscious practices as a democratically run, not-for-profit natural foods store.” *About Daily*, DAILY GROCERIES CO-OP, <http://www.dailygroceries.org/about> (last visited May 28, 2011). This Article posits that similar organizations exist in most medium to large cities and in most college towns.

Vast heterogeneity marks nonprofits, which encompass groups as disparate as the National Football League (NFL), Harvard University, Consumers Union (which publishes *Consumer Reports*), the Mayo Clinic, and the World Wildlife Fund. Social identity works differently within different groups, and the following typology of nonprofits helps to show why.

A. *Service Providers*

These firms provide the public with a service and largely compete based on the market for services. Although Hansmann's theory predicts that these will be nonprofits because of contract failure,¹⁶³ Malani and David's study indicates that few, in fact, signal their nonprofit status.¹⁶⁴ Their finding may be limited to service providers, however, as I postulate that the identity function of the nonprofit is doing little to no work in this setting. Parents looking for a daycare today, for example, shop based on the training and certification of the staff, the facilities, references, and perhaps, the availability of video cameras to provide monitoring. Accordingly, signaling nonprofit status may be of little competitive use in this context.

1. *Hospitals*

The existence of both nonprofit and for-profit hospitals in the same market is largely a historical accident. "Voluntary hospitals" were financially supported and operated by the more fortunate and powerful members of society.¹⁶⁵ While the rich founded these early hospitals, the poor were almost exclusively the patients; the wealthy stayed at home and called doctors for house visits.¹⁶⁶ This difference in the delivery of medical care disappeared in the nineteenth and twentieth centuries for a variety of reasons. Advancements

¹⁶³ Hansmann, *supra* note 22.

¹⁶⁴ See *supra* notes 96–98 and accompanying text. Note that this section is aimed solely at addressing Malani and David's use of the lack of nonprofit-hospital signaling to refute Hansmann's hypothesis. It consciously ignores the rich literature comparing nonprofit and for-profit hospitals. For an example, see Jill R. Horwitz & Austin Nichols, *Hospital Ownership and Medical Services: Market Mix, Spillover Effects, and Nonprofit Objectives*, 28 J. HEALTH ECON. 924 (2009) (arguing that a nonprofit hospital's provision of medical services depends on the concentration of for-profits in the area).

¹⁶⁵ Anthony R. Kovner, *Hospitals*, in JONAS AND KOVNER'S HEALTH CARE DELIVERY IN THE UNITED STATES 145, 147 (Anthony R. Kovner & Steven Jonas eds., 7th ed. 2002) (discussing the characteristics of the first types of hospitals in the United States).

¹⁶⁶ MARSHALL W. RAFFEL & CAMILLE K. BARSUKIEWICZ, *THE U.S. HEALTH SYSTEM: ORIGINS AND FUNCTIONS* 120 (5th ed. 2002) ("The success of these hospitals depended on the willingness of the wealthy to help the poor because poor sick people were virtually all of the hospital's patients. It was still preferable to endure illnesses at home, if possible, and the wealthy were better equipped to do this.").

in medicine required more equipment than a traveling doctor could reasonably carry, so hospitals became a necessity to practice evolving medicine.¹⁶⁷ Doctors, adapting to a new era of medicine, responded by founding doctor-owned hospitals operated for profit, especially during the period from 1890 to 1920.¹⁶⁸ Advancements in medicine changed the role of hospitals because more treatments were becoming available; hospitals were no longer simply places for the poor to await impending death.¹⁶⁹ As more individuals moved to cities and lost the support of family and community, hospitals gained importance. Additionally, hospitals began to play an increasingly important role in the training and education of future members of the medical profession.¹⁷⁰

According to the American Hospitals Association, the United States has 2,918 nonprofit hospitals, 998 for-profit hospitals, and 1,092 government hospitals, for a total of 5,008 hospitals nationwide.¹⁷¹ Adjusted to account for different size hospitals, in nonrural areas nonprofits made up approximately 74% of total hospital admissions, for-profit hospitals approximately 11%, and government approximately 15%.¹⁷² The role of these different categories of hospitals and the policy rationales for providing nonprofits with tax exemptions has long been the subject of controversy.¹⁷³ Nonprofit hospitals are required to produce “community benefits” to qualify for beneficial tax treatment and exemptions, but the definition of that phrase is not certain.¹⁷⁴ Empirical studies that have analyzed and compared the three categories of

¹⁶⁷ Kovner, *supra* note 165, at 147 (“Medical care became too complex for physicians to carry their entire armamentarium in their little black bags; special equipment and consultation with other medical specialists became essential.”).

¹⁶⁸ *Id.*

¹⁶⁹ *Id.* (discussing advancements in medicine that contributed to the increasing use of hospitals and a change in patient types).

¹⁷⁰ RAFFEL & BARSUKIEWICZ, *supra* note 166, at 123 (“Hospitals became important centers for disseminating new knowledge and places where all classes of society could benefit from treatment.”).

¹⁷¹ *Fast Facts on US Hospitals*, AM. HOSP. ASS’N (Dec. 7, 2010), <http://www.aha.org/aha/content/2010/pdf/101207fastfacts.pdf> (providing statistics on the numbers and categories of United States hospitals from a 2009 survey to be included in a 2011 report).

¹⁷² Jill R. Horwitz & Austin Nichols, *What Do Nonprofits Maximize? Nonprofit Hospital Service Provision and Market Ownership Mix* 38 tbl.1 (Nat’l Bureau of Econ. Research, Working Paper No. 13246, 2007), available at <http://www.nber.org/papers/w13246>.

¹⁷³ See *supra* Introduction.

¹⁷⁴ CONG. BUDGET OFFICE, PUB. NO. 2707, NONPROFIT HOSPITALS AND THE PROVISION OF COMMUNITY BENEFITS 1 (2006) (“Although nonprofit hospitals must provide community benefits in order to receive tax exemptions, there is little consensus on what constitutes a community benefit or how to measure such benefits.”).

hospitals have faced difficulties such as limited data availability¹⁷⁵ and source information that provides a low level of detail.¹⁷⁶

There have been periodic calls for nonprofit hospitals to provide more community benefits, charity care, or both in exchange for the tax exemption they receive.¹⁷⁷ But seen through the lens of identity, nonprofit hospitals are generally not—at least, not any longer—organizations that provide an identity function that distinguishes them in any meaningful way from their for-profit counterparts. Both forms of hospitals compete in the same markets. Patients and their attending physicians choose one hospital over another not based on nonprofit versus for-profit status, but instead because of the attractiveness and sophistication of the facilities offered. Put simply, in a field where the value of the service provided to consumers dominates decision making, any warm glow associated with the nonprofit form is likely to be of little consequence to patients (but not donors). An exception may be religious hospitals, which may enjoy increased identity benefits because of their particular religious affiliation.

2. Consumers Union

Consumers Union of the United States (CU) is a nonprofit 501(c)(3) consumer watchdog that publishes *Consumer Reports* magazine and other print and web consumer reports.¹⁷⁸ CU tests and evaluates thousands of products every year at its National Testing and Research Center.¹⁷⁹ Beyond its reporting function, CU testifies before Congress and regulatory agencies and files lawsuits on behalf of consumers.¹⁸⁰

¹⁷⁵ U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-05-743T, NONPROFIT, FOR-PROFIT, AND GOVERNMENT HOSPITALS: UNCOMPENSATED CARE AND OTHER COMMUNITY BENEFITS 2 & n.4 (2005) (noting that “[r]eliable, hospital-specific data were not available nationwide” and explaining the rationale for selecting five states for the study: California, Florida, Georgia, Indiana, and Texas (quoting David M. Walker, Comptroller General of the United States)).

¹⁷⁶ Numerous studies comparing nonprofit and for-profit hospitals exist. Mark Schlesinger and Bradford Gray examined roughly seventy-five studies in 2006. See Mark Schlesinger & Bradford H. Gray, *How Nonprofits Matter in American Medicine, and What to Do About It*, 25 HEALTH AFF. W287 (2006), <http://content.healthaffairs.org/content/25/4/W287.full.html>. Still, many studies raise problematic issues about measurability of outputs and comparability of institutions. See Horwitz, *supra* note 14, at 1363.

¹⁷⁷ LUNDER & LIU, *supra* note 19, at 6.

¹⁷⁸ Hoover's Company Records, In-Depth Records of Consumers Union of the United States, Inc. (Jan. 18, 2011), *available at* LexisNexis.

¹⁷⁹ *Id.*

¹⁸⁰ *Id.* Among the purposes of CU set forth in its certificate of incorporation are: the provision of information and counsel on consumers' goods; the provision of aid to efforts to create decent living standards for consumers; the maintenance of labs and the supervision of research to accomplish the goals of the

CU is required, under its certificate of incorporation, to use all of its income to carry out the purposes of the organization.¹⁸¹ CU generates income from the sale of *Consumer Reports* and from noncommercial contributions, grants, and fees.¹⁸² It accepts no advertising, does not permit commercial use of its ratings or comments, and does not accept free samples from manufacturers; rather, the organization buys all of its test samples.¹⁸³ In 2009, CU generated more than \$250 million in revenue and employed over 600 workers.¹⁸⁴

One could argue CU's nonprofit status is necessary for it to credibly commit that it will not be swayed by profit demands into currying favor with paying advertisers by delivering slanted, rather than truly unbiased, opinions. And yet successful for-profit ratings organizations exist across a variety of products—from the magazine *Cook's Illustrated*, which employs the bonding mechanism of refusing paid advertisements, to Robert Parker's influential wine rankings,¹⁸⁵ to ratings agencies like Standard & Poor's—and depend upon reputational capital for success: If their ratings are shown to be inaccurate or biased, their legitimacy, and thus their profitability, will suffer.¹⁸⁶

CU, then, has a bifurcated identity. As a provider of a product-rating service, CU's nonprofit status is largely irrelevant; a desire to preserve its reputational capital would force it to act in unbiased fashion even if it were a for-profit entity because it is essentially selling trustworthiness. Still, CU's lobbying and filing suits on behalf of consumers reveal more of a social identity function, a characteristic that a for-profit could not provide.

B. Donative Organizations

Unlike service-providing nonprofits, nonprofits dependent chiefly on donations emphasize the social identity that membership or donation provides.

corporation; and the preparation and distribution of all materials resulting from the work of the corporation. See Consumers Union of the United States, Inc. Income Tax Return for 2006, Form 990, General Explanation Attachment 5 [hereinafter CU Tax Return], available at <http://www.consumerreports.org/cro/resources/streaming/PDFs/CU-990-2006-copy-for-public-inspection.pdf>.

¹⁸¹ See CU Tax Return, *supra* note 180.

¹⁸² Hoover's Company Records, *supra* note 178.

¹⁸³ *Id.*; Report a Violation to the No Commercial Use Policy, CONSUMERREPORTS.ORG, <http://www.consumerreports.org/cro/aboutus/adviolation/index.htm> (last visited May 28, 2011).

¹⁸⁴ Hoover's Company Records, *supra* note 178.

¹⁸⁵ Thanks to Steven Schwarcz for this example.

¹⁸⁶ Steven L. Schwarcz, *Private Ordering of Public Markets: The Rating Agency Paradox*, 2002 U. ILL. L. REV. 1, 14.

And this identity depends on the nonprofit status of the organization. For-profit organizations dedicated to preserving wildlife, curing cancer, or even promoting and protecting gun ownership in the United States could plausibly be imagined. Given equal tax treatment, each could make a case for being more effective at promoting its particular cause. Increased transparency and outside certification could assure a potential warm-glow consumer that the firm was directing a reasonable proportion of each dollar earned to the desired cause. And yet, warm-glow consumers would favor the Wildlife Conservancy over a for-profit counterpart because giving to the former organization creates a social identity that paying a for-profit entity does not. The same holds true for the American Cancer Society and National Rifle Association. The salience of the profit motive would dim any potential warm glow the for-profit could offer.

1. *The Green Bay Packers*

The Green Bay Packers team is in some sense the ultimate example of an identity-based organization because it is a non-tax-exempt nonprofit organization.¹⁸⁷ That is to say, although the Green Bay Packers corporation is a nonprofit, it is not a tax-exempt organization. Although stock certificates are issued, the stock is largely ceremonial because no profits (i.e., dividends) may be distributed. New shareholders have diluted voting rights, and shareholders may not sell their stock. Thus, shareholders have no possibility of making a profit on their “investment” and receive no tax deduction for their money.¹⁸⁸ Indeed, one could fairly say that being a shareholder of the Green Bay Packers

¹⁸⁷ The Green Bay Packers was incorporated in 1923 as a nonprofit organization and engaged in its first of three stock drives in 1923. *Shareholders*, PACKERS.COM, <http://www.packers.com/community/shareholders.html> (last visited May 28, 2011). In 1935, the team was reorganized as a nonprofit stock corporation under Wisconsin law and issued 300 shares of common stock. *Greenbay Packer Fans: Owners and Shareholders*, ALLGREENBAYPACKERS.COM (June 23, 2010), <http://www.jerseyal.com/GBP/2010/06/23/green-bay-packer-fans-owners-and-shareholders>. Two more stock sales followed (in 1950, and late 1997 through early 1998) to raise the total number of Packer shareholders to over 112,000, holding 4.75 million shares of stock. *Shareholders, supra*.

¹⁸⁸ Lynn Reynolds Hartel, Comment, *Community-Based Ownership of a National Football League Franchise: The Answer to Relocation and Taxpayer Financing of NFL Teams*, 18 LOY. L.A. ENT. L.J. 589, 594 (1998); see also Richard Sandomir, *Packer Fans Embrace Unusual Stock*, N.Y. TIMES, Nov. 21, 1997, at C2 (“[T]he buyer [of Packer stock] will get no dividends, no share price appreciation, no spoils if the team is sold, no securities law protection, no tickets to Lambeau Field, no charitable tax deduction, no merchandise discounts, no financial reports and no option to transfer ownership to anyone but a family member as a gift.”). At the time of the 1997 sale, team counsel Lance Lopes noted fans’ excitement about owning a part of the team and helping to contribute to the capital of the corporation. *Id.* He commented that “naysayers criticize [the stock sale] for the lack of investment and security, but the beauty is we’re not marketing it to them.” *Id.* (internal quotation mark omitted).

entitles one only to be a shareholder of the Green Bay Packers. Cynics would say that it is the NFL's profit sharing that allows a relatively small city like Green Bay to support an NFL franchise. But the point I am making is not about financial viability, but rather that one spends money on a share that holds no management authority and no possibility of a return on investment to create and participate in a social identity.

Each individual trait of Packers ownership supports the proposition that it is really identity that the Packers are selling—the social identity of belonging to an organization closely identified with a legendary history rooted in a small city in Wisconsin.¹⁸⁹ Most shareholders are Green Bay residents,¹⁹⁰

¹⁸⁹ The following passage, written by my colleague Dan Coenen, who grew up in Appleton, Wisconsin, captures something of the magic of the Packers:

What is this sacred thing that is the Green Bay Packers? It is the team of Lambeau and Lombardi, and the great stadium and busy street that will always bear their names. It is the homeplace of Herber, Hutson, and Hornung. And of modern heroes, too—like Lofton, Sharpe, Butler, and Woodson.

The Packers are the team of the underdog—of seventeenth-round pick Bart Starr, undrafted free-agent Willie Wood, former high school coach Mike Holmgren, the once-homeless Donald Driver. The Packers are a team of names that define the very meaning of athletic competition—Johnny “Blood” McNally, Clark Hinkle, Forrest Gregg, Ray Nitschke, Jimmy Taylor, Reggie White, Brett Favre.

The Packers are a team of constancy and tradition. The team that for 90 years has been a pillar of its league. That has played in one city longer than any other NFL franchise. That has won more championships than any other NFL club.

The Packers are the team of the ordinary person—owned by 112,120 fans, whose shares do not have a dime's worth of financial value and never will. It is the team that in 1920 was brought into the NFL by a local meat-canning company. A team that was saved by its community in 1923, when 400 supporters gathered in an Elks Lodge to pitch in \$5000 to keep it afloat. And saved again in 1935, and then again in 1950, with still more purchases of worthless stock made by local citizens, including (or so the story goes) a woman who showed up at the team office with \$25 in quarters collected in a matchbox.

The Packers are the team of small town America. The team that represents on the international stage a city of 100,000 people. The team that operates in what is by far the smallest metropolitan area, with by far the smallest television market, of any NFL, NHL, NBA and MLB club.

The Packers are the Green and Gold. The pride of the Black and Blue Division. The great rival of the Chicago Bears. The antithesis of the Dallas Cowboys. The Packers are the team of Cheeseheads. The team of the Lambeau Leap. The team of bratwursts and beer.

The Packers are the team of TitleTown, USA. The team that won the Ice Bowl and the first Super Bowl. The team that, during the Glory Years of the 1960s, became so mighty that in a single decade it claimed five NFL championships, including three in consecutive seasons. A team that so dominated an era that it produced even the most deserving player not yet inducted into the NFL Hall of Fame—five-time All-Pro, Jerry Kramer, who remains excluded only because so many of his teammates (ten in all) gained entry before him.

The Packers are the team that, even while producing only three winning seasons during all of the 1970s and 1980s, packed its stadium for every game it played. The Packers are the team that

demonstrating a strong sense of place. Stock may not be sold but may be given as gifts,¹⁹¹ emphasizing the noncommercial nature of the “ownership.” Besides the right to elect a board (which carries no say in management of the team itself), shareholders have a veto on moving the Packers outside of Green Bay,¹⁹² underlining the strong sense of identity and connection to place. To protect against one person (or a small group of persons) taking control of the team, the articles of incorporation prohibit any shareholder from owning more than 200,000 shares.¹⁹³ Although shareholders do not receive coveted tickets to Packers games at Lambeau Field, there is an annual Shareholders Day, which is attended by thousands¹⁹⁴ (unlike the often sparsely attended shareholders meeting of a public corporation). What is more, the events of Shareholders Day focus on key elements of the team’s identity—tailgating parties, visits to the Packers Hall of Fame, and the purchase of special shareholder paraphernalia.¹⁹⁵

The Packers organization may present a special case because *all* sports teams in the United States provide strong identity benefits to members of their communities. It might well be that if the Packers were for-profit, their fans would still pay for the privilege of being “owners,” even if they were to derive no financial benefit from that ownership. Nevertheless, Packers fans place in stark relief the point that people are sometimes willing to contribute to an

for six decades has seen its season-ticket waiting list grow so fast that it now numbers 81,112 and includes would-be buyers who have been on it for more than 30 years. The Packers are the team that, according to current projections, will be unable to sell tickets to the fans who apply for them today until, at the earliest, 2074.

The Packers are the team of the “frozen tundra,” with its still-domeless stadium in an era of professional sports comfort and glitz. The team of sub-zero tailgaters, who come to the shrine of their team—and often to away games as well—from every walk of life. The team of fans decked out in hunting boots, snowsuits, and ski-masks. The team of fans who dreamt the night before of a frosted field and the piercing chill of a bitter-cold December Sunday afternoon.

The Packers are of, by and for the people of Wisconsin. They stayed when the Braves left. They always will stay. They are in the very air that the people of their city and their state inhale. They are what those of us who cherish their legacy most hope for ourselves to be—open to dreams, filled with purpose, spirited, resilient, unpretentious and, on our best days, a source to others of meaning, memories, and joy.

Statement of Dan T. Coenen, Professor, Univ. of Ga. Sch. of Law (Apr. 14, 2011) (on file with author).

¹⁹⁰ Hartel, *supra* note 188, at 594.

¹⁹¹ Sandomir, *supra* note 188.

¹⁹² Hartel, *supra* note 188, at 594.

¹⁹³ *Shareholders*, *supra* note 187.

¹⁹⁴ Sandomir, *supra* note 188.

¹⁹⁵ 2008 *Shareholders Meeting*, PACKERS.COM, <http://www.packers.com/media-lounge/photo-gallery/2008-Annual-Shareholders-Meeting/614be167-7dc8-11df-82b7-d3ef363e9531> (last visited May 28, 2011).

organization with no goal other than deriving identity benefits from participating in the organization itself.

A casebook chestnut, *Shlenksy v. Wrigley*,¹⁹⁶ helps reveal the special value that the nonprofit form creates for the Green Bay Packers. Students of corporate law will remember that a minority shareholder, Shlenksy, sued the directors of the Chicago National League Ball Club, Inc., owner of the Chicago Cubs, for failing to install lights in Wrigley Field and institute night baseball games.¹⁹⁷ The case illustrates the power of the business judgment rule: Directors' actions cannot be questioned absent fraud, illegality, or conflict of interest. For our purposes, what is interesting is that Wrigley, who owned 80% of the firm's shares, may have been interested in running the corporation in a way that "protect[ed] values such as tradition and concern for neighbors, even at the expense of short-term profit."¹⁹⁸ While the business judgment rule provides a shield, such goals and motives of majority owners in a for-profit organization are vulnerable to minority shareholder attacks. One cannot run a for-profit corporation as a "semi-eleemosynary institution."¹⁹⁹ In contrast, the nonprofit structure of the Packers ensures that a *Shlenksy*-style suit could never even be brought against the management.

2. *Wikimedia*

The Wikimedia Foundation, Inc. (Wikimedia)²⁰⁰ offers another example of the power of social identity. The reader is doubtless familiar with Wikipedia,

¹⁹⁶ 237 N.E.2d 776 (Ill. App. Ct. 1968).

¹⁹⁷ *Id.* at 778.

¹⁹⁸ Geoffrey Miller, *Narrative and Truth in Judicial Opinions: Corporate Charitable Giving Cases*, 2009 MICH. ST. L. REV. 831, 842–43. Indeed, George Will, upon considering investing in the Cubs, was told by a Cubs shareholder to ignore "price-earnings ratios, return on capital, and a bunch of other hogwash which has no place in a transaction between two true sportsmen." LARRY E. RIBSTEIN & PETER V. LETSOU, *BUSINESS ASSOCIATIONS* 380 (4th ed. 2003) (quoting GEORGE F. WILL, *PURSUIT OF HAPPINESS AND OTHER SOBERING THOUGHTS* 311 (1978)) (internal quotation marks omitted).

¹⁹⁹ *Dodge v. Ford Motor Co.*, 170 N.W. 668, 683 (Mich. 1919).

²⁰⁰ The Wikimedia Foundation, Inc. is a 501(c)(3) tax deductible, nonprofit charity (categorized by the IRS as adult, continuing education) whose mission is "to empower a global volunteer community to collect and develop the world's knowledge and to make it available to everyone for free, for any purpose." *Frequently Asked Questions*, WIKIMEDIA FOUND., http://wikimediafoundation.org/wiki/Frequently_Asked_Questions (last modified May 24, 2011). Wikimedia was incorporated in the state of Florida on June 20, 2003, after which Wikipedia founder Jimmy Wales transferred ownership of all Wikipedia and Nupedia (the original version of Wikipedia) domain names and associated copyrighted materials to Wikimedia. See *Articles of Incorporation of Wikimedia Foundation, Inc.* (June 20, 2003), available at <http://sunbiz.org/pdf/9003936.pdf>; see also Jimmy Wales, *Post to Announcing Wikimedia Foundation*, WIKIMEDIA FOUND. (June 20, 2003, 4:18 PM), <http://lists.wikimedia.org/pipermail/wikipedia-l/2003-June/010743.html> (announcing formation of Wikimedia Foundation).

the main service of Wikimedia.²⁰¹ One may use the services of Wikimedia simply by using Wikipedia in one of several languages.²⁰² Or one may choose to participate even more in the organization, by authoring and editing articles.

Wikimedia's organizational structure manifests the importance of social identity to the character of the organization. Wikimedia is overseen by a board of trustees, which manages the organization and oversees the solicitation and distribution of funds. Wikimedia also employs a small staff, which runs the organization's day-to-day affairs.²⁰³ Different communities support Wikimedia's projects by organizing individual webpages, structuring navigation between pages, resolving conflicts between community members, and creating their own rules and guidelines of behavior.²⁰⁴ Wikimedia's bylaws provide that all community members can participate in the life of the

²⁰¹ Wikipedia's website describes:

Wikipedia is written collaboratively by largely anonymous Internet volunteers

. . . .

Since its creation in 2001, Wikipedia has grown rapidly into one of the largest reference Web sites, attracting nearly 78 million visitors monthly as of January 2010. There are more than 91,000 active contributors working on more than 17,000,000 articles in more than 270 languages. As of today, there are 3,604,800 articles in English. Every day, hundreds of thousands of visitors from around the world collectively make tens of thousands of edits and create thousands of new articles to augment the knowledge held by the Wikipedia encyclopedia.

Wikipedia: About, WIKIPEDIA, <http://en.wikipedia.org/wiki/Wikipedia:About> (last modified May 18, 2011).

²⁰² Wikimedia collaborates with an international network of chapters to provide the infrastructure and organization for the development and maintenance of Wikipedia and other wiki projects. Other collaborative wiki projects include: WIKTIONARY, http://en.wiktionary.org/wiki/Wiktionary:Main_Page (last modified Apr. 26, 2011) (dictionary and thesaurus); WIKIQUOTE, http://en.wikiquote.org/wiki/Main_Page (last modified Mar. 7, 2011) (compendium of quotations from people and creative works in every language); WIKIBOOKS, http://en.wikibooks.org/wiki/Main_Page (last visited May 28, 2011) (free textbooks and manuals that anyone can edit); WIKISOURCE, http://en.wikisource.org/wiki/Main_Page (last modified May 8, 2011) (online library of free content publications collected and maintained by the community); WIKIMEDIA COMMONS, http://commons.wikimedia.org/wiki/Main_Page (last modified Apr. 14, 2011) (free media repository containing millions of media files); WIKISPECIES, http://species.wikimedia.org/wiki/Main_Page (last modified Mar. 28, 2011) (directory of species of all forms of life); WIKINews, http://en.wikinews.org/wiki/Main_Page (last visited May 28, 2011) (free content news provided by volunteers seeking to present reliable, unbiased, and entertaining news); WIKIVERSITY, http://en.wikiversity.org/wiki/Wikiversity:Main_Page (last modified Dec. 4, 2010) (project devoted to the provision of learning resources for levels stretching from preschool to university, including professional training and informal, free learning materials and activities); and META-WIKI, http://meta.wikimedia.org/wiki/Main_Page (last modified May 25, 2011) (Wikimedia project coordination). See generally WIKIMEDIA FOUND., <http://wikimediafoundation.org/wiki/Home> (last modified May 20, 2011).

²⁰³ *Wikimedia Foundation*, WIKIPEDIA, http://wikipedia.org/wiki/Wikimedia_Foundation (last modified May 26, 2011).

²⁰⁴ *The Wikipedia Community*, META-WIKI, http://meta.wikimedia.org/wiki/The_Wikipedia_Community (last modified Jan. 21, 2011).

organization by voting via electronic means if necessary.²⁰⁵ Proxy voting is not allowed.²⁰⁶

Most strikingly, the organization places an especially high premium on participation in the form of authoring or editing pages. Indeed, eligibility to vote for the Wikimedia board is measured by this form of participation in the organization, not by status or even by donation. For example, in order to vote in Wikimedia's 2009 election, users had to have completed at least 600 edits prior to June 1, 2009, and at least 50 edits between January 1 and July 1, 2009.²⁰⁷

What makes Wikimedia remarkable is that its managerial structure rewards those who most closely identify with the organization and who demonstrate that identity not by donating money, but by participating in the warm-glow creation of the organization in a quantifiable way. If Wikimedia were a for-profit organization it could not exist; the knowledge that the owners were profiting from the labor of the volunteers would dampen their editorial zeal and dim the glow of participating in the organization.

3. Foundations

Among the charitable foundations grouped under § 501(c)(3) of the Internal Revenue Code are private or independent foundations and public charities.²⁰⁸ Independent foundations receive substantially all of their contributions from relatively few sources and often rely on investment earnings as their source of ongoing support.²⁰⁹ About 100,000 private foundations exist in the United States, most of which make grants to fund 501(c)(3) public charities.²¹⁰ Total

²⁰⁵ Wikimedia Foundation, Inc., By-Laws, art. IV § 10 (2010), available at http://wikimediafoundation.org/wiki/Wikimedia_Foundation_bylaws.

²⁰⁶ *Id.*

²⁰⁷ *Board Elections: 2009*, WIKIMEDIA FOUND., http://meta.wikimedia.org/wiki/Board_elections/2009/en (last modified May 2, 2011).

²⁰⁸ INTERNAL REVENUE SERV., PUB. 4220, APPLYING FOR 501(C)(3) TAX-EXEMPT STATUS 5 (2009), available at <http://www.irs.gov/pub/irs-pdf/p4220.pdf>; see also *International Grantmaking Basics*, U.S. INT'L GRANTMAKING, <http://www.usig.org/legal/Types-of-gm-orgs.asp> (last visited May 28, 2011) ("U.S. tax law effectively divides charities into two categories: public charities and private foundations. Although treated differently for some regulatory purposes, both public charities and private foundations are exempt from income tax under Section 501(c)(3) of the U.S. Tax Code.").

²⁰⁹ In contrast, public charities must have broad public support. INTERNAL REVENUE SERV., *supra* note 208, at 5 ("Generally, a public charity has a broad base of support while a private foundation has very limited sources of support.").

²¹⁰ *501(c)(3) Private Foundations*, NAT'L CTR. FOR CHARITABLE STATISTICS, <http://nccsdataweb.urban.org/PubApps/nonprofit-overview-segment.php?pf> (last visited May 28, 2011).

revenues of private foundations reporting to the IRS were \$173.8 billion in 2008, and total assets were \$569.9 billion.²¹¹ Prominent examples of private foundations include the Rockefeller Foundation, Ford Foundation, and the Gates Foundation.

Foundations are in a sense the epitome of nonprofits serving an identity function. Wealthy individuals sometimes create foundations for prestige reasons, of course (otherwise they could just give anonymously to the cause of their choice), but it is the specific kind of prestige associated with creating a nonprofit that fulfills the founders' goals. Founders often do remain involved with their foundations' business, investments, and charitable work, as the involvement of Bill and Melinda Gates in the Gates Foundation demonstrates. However, as foundations become more removed from their founders, the foundations' contributions may become less about the identity of the organization.²¹² Some time after their inception, and certainly by the third or fourth decade, many foundations begin to make grants through an institutional process that has relatively little to do with identity formation. In general, then, we can say that the identity function is strong for foundations' founders and likely diminishes as time goes on.

C. Trade Associations and Social Clubs

Associations exist to promote common interests. The point of the association is to allow individuals to interact and benefit from each other so that income is tax exempt,²¹³ although there is no tax benefit to donating. Sometimes the goal of associations is to maximize profits at the member level and not at the entity level. Organizations as diverse as the National Football League²¹⁴ and the U.S. Chamber of Commerce²¹⁵ are examples. Under

²¹¹ *Id.*

²¹² Indeed, as noted above, some founders take drastic steps to ensure that the identity of foundation is not diminished. For a discussion of the Olin Foundation, for instance, see *supra* text accompanying note 61.

²¹³ Under I.R.C. § 501(c)(4), (6), or (7).

²¹⁴ The National Football League (NFL) is an association of thirty-two United States professional football teams. Constitution and Bylaws of the Nat'l Football League, art. III § 1 (2006), available at http://static.nfl.com/static/content/public/static/html/careers/pdf/co_.pdf. The main purpose of the NFL is "[t]o promote and foster the primary business of League members, each member being an owner of a professional football club located in the United States," and the "League is not organized nor to be operated for profit." *Id.* art. II §§ 1(A), 2.

²¹⁵ The IRS describes chambers of commerce as "composed of the merchants and traders of a city," and treats them as "business leagues" under § 501(c)(6). INTERNAL REVENUE SERV., PUB. 557, TAX-EXEMPT STATUS FOR YOUR ORGANIZATION 47 (2010), available at <http://www.irs.gov/pub/irs-pdf/p557.pdf>. For example, the U.S. Chamber of Commerce is a tax-exempt organization under § 501(c)(6). *Frequently Asked*

§ 501(c)(6), they are exempt from federal income taxation, but association fees are not deductible from a member's income.

Fraternities and sororities²¹⁶ are exempt organizations classified as social clubs under § 501(c)(7).²¹⁷ They focus not on making money, but on purely associational value, that is, the utility derived by each member from being in an association with certain other individuals.²¹⁸ These organizations, too, enjoy an exemption from federal taxation on income (with an exception for unrelated business income, which is taxable²¹⁹). Again, conceptually these entities must be nonprofits because (whatever other ends they may serve²²⁰) their focus is social and identity driven. Imagining a for-profit sorority is difficult. The goods the sorority promises its initiates—sisterhood, friendship, and other intangibles—are not considered goods that can or should be purchased. Were a for-profit entity to purport to provide them, the for-profit motive would reduce the sorority's ability to claim any distinctness of identity, except association with those willing to pay a certain amount of money. Cynics might say that sorority membership concerns only exclusivity, networking opportunities, and access to attractive friends or prospective mates. But even assuming that the cynic is correct, the promise of these would be diminished if provided by an entity with a for-profit motive.²²¹ In particular,

Questions, U.S. CHAMBER OF COMMERCE, <http://www.uschamber.com/about/faqs#19> (last visited Apr. 4, 2011).

²¹⁶ The North-American Interfraternity Conference lists the following as benefits offered by fraternity participation: “lifelong friends, leadership opportunities, social and sports activities, academic support and excellence, and networking opportunities.” *FAQs*, FRATERNITYINFO.COM, <http://www.fraternityinfo.com/faqs> (last visited May 28, 2011). Likewise, the National Panhellenic Conference, which supports its twenty-six member international sororities, promises potential sorority members personal and professional support, enhanced academic achievement, and lifelong friends. *Potential New Members*, NAT'L PANHELLENIC CONFERENCE, <http://www.npcwomen.org/undergrads.aspx> (last visited May 28, 2011).

²¹⁷ Mark D. Bauer, *Small Liberal Arts Colleges, Fraternities, and Antitrust: Rethinking* Hamilton College, 53 CATH. U. L. REV. 347, 356–57 (2004); *see also* I.R.C. § 501(c)(7) (2006).

²¹⁸ *See* Henry Hansmann, *Higher Education as an Associative Good*, in FORUM FUTURES 1999, at 11, 11 (Maureen Devlin & Joel Meyerson eds., 1999), available at <http://net.educause.edu/ir/library/pdf/ffp9901.pdf> (describing an associative good as one where “a consumer is interested not just in the quality and price of the firm's products, but also in the personal characteristics of the firm's other customers”).

²¹⁹ “Unrelated business taxable income” is defined in I.R.C. § 512(a).

²²⁰ *See* Robert M. Jarvis, Book Review, 37 J.L. & EDUC. 605, 607 (2008) (reviewing ALAN D. DESANTIS, *INSIDE GREEK U.: FRATERNITIES, SORORITIES, AND THE PURSUIT OF PLEASURE, POWER, AND PRESTIGE* (2007)) (characterizing the organizations' members as concerned primarily with sex).

²²¹ In contrast, viewed only through a tax lens, these organizations have no real existence as a separate entity. One court justified fraternities' exempt status merely on the grounds of avoidance of double taxation:

Congress has determined that in a situation where individuals have banded together to provide recreational facilities on a mutual basis, it would be conceptually erroneous to impose a tax on the organization as a separate entity. The funds exempted are received only from the members

claims of exclusivity or rigorous selection criteria would be less credible because of knowledge on the part of the consumer that the organizer was driven by profit.

D. Religious Organizations

Churches and other religious organizations are among the most dominant forms of nonprofit enterprise in the United States, with a combined annual revenue of approximately \$100.95 billion.²²² Religious belief is a core aspect of social identity, as well as a source of individual well-being.²²³ Like national identity, one's religious beliefs provide a sense of meaning, belonging, and purposeful existence. While formerly church membership was principally driven by which denomination's building happened to be local, believers are now subdividing into smaller and smaller homogeneous groups.²²⁴ That is, there is now a "competitive religious marketplace,"²²⁵ and in at least some locations, religious communities are run more or less like businesses.²²⁶

Even so, one important aspect of religious community is the sense of social belonging.²²⁷ Religion is a characteristic that markedly distinguishes an individual from others and thus is considered highly salient to personal identity.²²⁸ The more salient an identity characteristic, the greater its potential to affect well-being; thus, there is motive to choose a church or religious

and any "profit" which results from overcharging for the use of the facilities still belongs to the same members. No income of the sort usually taxed has been generated; the money has simply been shifted from one pocket to another, both within the same pair of pants.

McGlotten v. Connally, 338 F. Supp. 448, 458 (D.D.C. 1972). While accurate from an economic standpoint, the description fails to adequately capture why fraternities are not merely exempt, but also nonprofit.

²²² CTR. ON PHILANTHROPY AT IND. UNIV., GIVING USA 2010: THE ANNUAL REPORT ON PHILANTHROPY FOR THE YEAR 2009, at 12 fig. (2010), available at http://www.communityfoundationcbr.org/assets/docs/Giving_USA_report_2010.pdf.

²²³ Marta Elliott & R. David Hayward, *Religion and Well-Being in a Church Without a Creed*, 10 MENTAL HEALTH RELIGION & CULTURE 109, 109 (2007).

²²⁴ Vincent J. Miller, *Where Is the Church? Globalization and Catholicity*, 69 THEOLOGICAL STUD. 412, 419, 426 (2008) (noting change from "simple inertia of social space").

²²⁵ Paul Moses, *The Pope in America: The Pope's Challenge*, NEWSDAY (N.Y.), Apr. 13, 2008, at A6.

²²⁶ See generally Nanlai Cao, *Boss Christians: The Business of Religion in the "Wenzhou Model" of Christian Revival*, CHINA J., Jan. 2008, at 63 (noting entrepreneurial model of church formation).

²²⁷ Christian Smith, *Why Christianity Works: An Emotions-Focused Phenomenological Account*, 68 SOC. RELIGION 165, 176 (2007) ("Some Christians literally order their entire schedules and activities around the social and spiritual lives of their churches.").

²²⁸ Tom W. Smith, *Social Identity and Socio-Demographic Structure*, 19 INT'L J. PUB. OPINION RES. 380, 381 (2007) (reporting survey finding religion third most salient identity characteristic, behind family and occupation).

organization with which one identifies strongly.²²⁹ Even members of a church without a creed, such as Unitarian Universalists, derive great strength and comfort from their religion if it is central to their identities.²³⁰

The benefits of religion include spiritual experience, social support, a sense of identity and belonging, and a framework for dealing with existential questions.²³¹ These attributes are simply inconsistent with a profit motive. It is unlikely that a congregant would derive a satisfactory spiritual experience or a sense of deep belonging from a church that sought primarily to make money or to advance the earthly interests of its owners. And it is difficult to imagine that a congregant would feel socially supported by a church that charged market rates for spiritual counseling or participation in group activities. The concept of a for-profit church is incoherent because what churches purport to offer is incompatible with maximizing profits.

E. Hybrids: The University Example

Colleges and universities are nonprofit institutions that have both service-providing and donative characteristics. For prospective students (and their parents, who sometimes foot the bill), universities provide a service that involves both the delivery of education and the provision of credentials. Credentialing is a function both of the degree attained (e.g., Ph.D. versus B.A.) and the level of the institution's reputation (e.g., Harvard University versus a highly localized college). Universities generally market to students based on the excellence of their faculties, the attractiveness of their facilities, and the opportunities they provide graduates. Students compare universities based on these attributes, competitiveness in admissions, and a host of intangibles. The identity character of the institution, while important, seems less salient to this population.

In contrast, when universities market to potential donors—chiefly alumni—social identity becomes highly important. Few organizations in an individual's life shape one's identity as profoundly as one's undergraduate institution. Alumni donors give to their alma maters to participate fully in that identity. Alumni are reminded (some might say hounded) about what their college years

²²⁹ Elliott & Hayward, *supra* note 223, at 111.

²³⁰ *Id.* at 122.

²³¹ *Id.* at 110.

meant to them,²³² and of their almost moral obligation to give back, so as to participate in the life of the school.²³³

To be sure, for-profit educational institutions exist. But contrasting for-profit colleges with their nonprofit counterparts highlights the identity function of the nonprofit form. Just as SiriusXM sells a product different from public radio, for-profit institutions of higher education are selling a kind of good fundamentally different from that offered by nonprofit institutions.

For-profit colleges and universities tend to focus on narrow, practical skills and frequently cast themselves as technical training schools (e.g., ITT Technical Institute²³⁴). Advocates of for-profit education argue these universities are making education more accessible to all types of people. Other proponents value being viewed as customers rather than students because they believe it leads to a more responsive instructional environment. The profit motive also requires that these schools innovate and improve to maintain and increase their customer base. This leads to flexibility for both the university and its customers, allowing convenient learning at a student's own pace.²³⁵

Proponents suggest that for-profit education is a desirable result of competition, leading to the most efficient outcome: highest quality at lowest price.²³⁶ On the other hand, one of the criticisms of for-profit charter schools

²³² Indeed, Hansmann concludes that college tuition represents a loan program with a “voluntary payback”—in the form of alumni donations. Hansmann, *supra* note 22, at 861. Higher education is a good investment, but practical problems keep the loan market from being efficient. Hansmann cites: (1) the moral hazard problem of individuals not working hard enough to pay back the loan; (2) legal restraints on personal servitude that prevent the lender from “foreclosing” on the borrower’s labor; and (3) the long-term nature of a loan that would optimally pay out during a borrower’s peak earning years, which occur sometimes thirty years after the loan’s origin. *Id.* While Hansmann is right that the rhetoric of “giving back” has a moral cast, his implicit loan characterization seems strained. If the relationship were truly an implicit loan, then universities would spend more time and money during an undergraduate’s career emphasizing that tuition does not pay for services, and that there is a duty—albeit a moral duty—to pay for future students.

²³³ *Id.* (“Of course, there is no legally enforceable obligation to pay anything to the school once an individual has graduated, and many alumni give nothing. But the schools constantly remind alumni of their moral obligation, and many alumni do give.”).

²³⁴ From its website: “At ITT Technical Institute[], we are committed to helping men and women develop the skills and knowledge to pursue many opportunities in today’s fastest growing career fields, including electronics, web development, computer programming, computer networking, computer drafting and design, criminal justice, business and health sciences.” ITT TECHNICAL INST., <http://www.itt-tech.edu> (last visited May 28, 2011).

²³⁵ See *For-Profit vs. Nonprofit Online Schools*, ALL ONLINE SCHOOLS, <http://www.allonlineschools.com/online-education-resource-center/online-degrees-101-online-school-differences> (last visited May 28, 2011).

²³⁶ See, e.g., Cynthia D. Hill & David M. Welsch, *For-Profit Versus Not-for-Profit Charter Schools: An Examination of Michigan Student Test Scores*, 17 EDUC. ECON. 147 (2009).

is that they divert funding meant for education to maintain profits.²³⁷ Viewing students as customers also has negatives. Admissions are focused on bringing in dollars, not on selecting students who will actually be able to complete their degrees. As Hansmann points out, students might not be the best judges of quality of education;²³⁸ indeed, some educational benefits might not be obvious to the consumer. This explains why, although for-profit universities like the University of Phoenix,²³⁹ American InterContinental University,²⁴⁰ Chancellor University,²⁴¹ DeVry University,²⁴² and Strayer University²⁴³ have been

²³⁷ *Id.*

²³⁸ Hansmann, *supra* note 22, at 866.

²³⁹ University of Phoenix offers undergraduate and graduate programs in business, education, nursing, technology, and human services. It offers evening classes, flexible scheduling, continuous enrollment, a student-centered environment, practitioner faculty, online classes, an online library, ebooks, and computer simulations. It is the largest private university in North America. It is accredited by the Higher Learning Commission and is a member of the North Central Association. See generally UNIV. OF PHX., <http://www.phoenix.edu> (last visited May 28, 2011). It is controlled by the Apollo Group, Inc., based in Arizona. See generally Apollo Group, Inc., Annual Report (Form 10-K) (Oct. 21, 2010).

²⁴⁰ American InterContinental University, established in 1970, offers Associate's, Bachelor's, and Master's degree programs in Atlanta, Houston, London, Los Angeles, South Florida, and online. It is accredited by the Higher Learning Commission and a member of the North Central Association. It has a twelve-member governing board and is owned by the Career Education Corporation. See generally AM. INTERCONTINENTAL UNIV., <http://www.aiuniv.edu> (last visited May 28, 2011); Career Education Corporation, Annual Report (Form 10-K) (Feb. 22, 2011).

²⁴¹ Chancellor University offers Bachelor's, Associate's, graduate-degree, and certificate programs. It was founded after Michael Clifford bought Myers University out of bankruptcy, turning a nonprofit institution into a for-profit institution. Paul Glader, *The Jack Welch MBA Coming to Web*, WALL ST. J., June 22, 2009, at B1; see also Chancellor University System, LLC, Notice of Exempt Offering of Securities (Temporary Form D) (Mar. 12, 2009). Since this conversion, Jack Welch, Noel Tichy, and George Kidd, Jr. joined the institution. *Jack Welch Hooks Up with Chancellor University of Ohio*, CRAIN'S CLEVELAND BUS. (June 22, 2009, 11:23 AM), <http://www.craigslist.com/article/20090622/FREE/906229963/0/TOC>. It is marketed as an education with 160 years of experience with alumni such as John D. Rockefeller, Harvey Firestone, and Theodore Ernst. See generally CHANCELLOR UNIV., <http://www.chancelloru.edu> (last visited May 28, 2011).

²⁴² DeVry University, accredited by the Higher Learning Commission and a member of the North Central Association, has over ninety locations across the United States and Canada. It is owned and operated by DeVry, Inc. See generally DEVRY UNIV., <http://www.devry.edu> (last visited May 28, 2011). For public filings, see *SEC Filings*, DEVRY UNIV., <http://www.investors.devry.com/phoenix.zhtml?c=93880&p=irol-sec> (last visited May 28, 2011).

²⁴³ Strayer University has eighty-seven campus locations across the United States and also offers classes online. The average age of a Strayer student is thirty-four. It has been educating since 1892 and advertises four qualities: affordability, convenience, quality, and support. "Affordability" means offering a wide range of tuition options and scholarships. "Convenience" means flexible classes, "convenient" campuses, and online classes. "Quality" means accreditation by the Middle States Commission on Higher Education, approval and licensing by state education boards, and offering education programs for veterans, handicapped, and international students. "Support" means its administrative support staff: an admissions office, academic advisors, a business office, a learning resources center, and a career development center. The degrees offered are an Undergraduate Certificate, Undergraduate Diploma, Associate in Arts, Bachelor of Business Administration, Bachelor of Science, Master of Business Administration, Master of Education, Master of Health Services Administration, Master of Public Administration, Master of Science, and Executive Graduate

successful, as measured both in terms of returns for their investors and in enrollment, their courses of study, marketing, and student bodies do not place them in competition with the traditional undergraduate institution. Students do not enroll at DeVry seeking the associative good of interacting with students and alumni of a certain caliber. They enroll in order to learn a vocation.²⁴⁴

Most universities are nonprofits because not seeking profits is central to a traditional university's mission and identity. In seeking tuition revenue, nonprofit schools do compete with regard to such matters as facilities offered, quality of faculty, after-graduation employment rates, and the like. But alumni give to these institutions because of the identity they imbue: education as an unquantifiable good, part of the humanistic tradition from which our higher educational system stems. Having profit-focused owners alters the value of this educational identity. Comparison with for-profit higher education thus highlights the identity function the nonprofit form can provide.

F. Cooperatives

The nonprofit form is not the only one that can create a distinctive identity; cooperatives can as well.²⁴⁵ Although cooperatives get little publicity or scholarly attention, they have been around since our country's founding²⁴⁶ and play a substantial role in our economy. As of 2009, 47,000 cooperatives operated in this country, serving close to 120 million members.²⁴⁷ One hundred cooperatives individually generated at least \$346 million in revenue in 2002, and together the top 100 generated \$119 billion in 2002²⁴⁸ and \$170 billion in 2007.²⁴⁹ Names like Sunkist, Ocean Spray, Land O'Lakes, and REI

Certificate. *See generally About Strayer University*, STRAYER UNIV., <http://www.strayer.edu/about> (last visited May 28, 2011); Strayer Education, Inc., Annual Report (Form 10-K) (Feb. 22, 2011).

²⁴⁴ Katherine Yung, *Dealing in Diplomas*, DALLAS MORNING NEWS, Feb. 29, 2004, at 1D (“[T]he university offers a growing array of year-round bachelor’s, master’s and doctoral degree programs in popular fields such as business, health care, education and information technology. You won’t find geology or political science majors at this school.”).

²⁴⁵ Family-owned businesses and some public corporations, such as Berkshire Hathaway, can create a distinctive identity as well. *See discussion supra* Part III.E.

²⁴⁶ Benjamin Franklin helped found an early fire insurance co-op, the Philadelphia Contributorship for the Insurance of Homes from Loss of Fire, in 1752, and it is still in operation today. CHARLES T. AUTRY & ROLAND F. HALL, *THE LAW OF COOPERATIVES* 12 (2009).

²⁴⁷ *Id.* at 4.

²⁴⁸ KIMBERLY A. ZEULI & ROBERT CROPP, *COOPERATIVES: PRINCIPLES AND PRACTICES IN THE 21ST CENTURY* 3 (2004).

²⁴⁹ AUTRY & HALL, *supra* note 246, at 4.

are familiar to many consumers who might not identify these companies with the granola-hawking food cooperative in their hometown.

Cooperatives,²⁵⁰ unlike nonprofits, are usually for-profit businesses.²⁵¹ Yet they resemble nonprofits in important ways.²⁵² Cooperatives concentrate on maximizing the benefit to the customers and users that control them—in other words, the focus is on *owner* wealth maximization, not wealth maximization at the *entity* level. “[T]his difference in orientation and objectives creates the biggest distinction between cooperatives and other corporations. Cooperative members *may or may not believe that profit maximization is the best goal for their cooperative.*”²⁵³

The point is not to make money at the entity level, but rather to maximize gain to individual users. User power and control is emphasized, and a key characteristic of the form is democratic control, defined as one member/one vote, rather than as one share/one vote. But members are comfortable with a for-profit entity as long as the entity’s understood purpose is maximizing the wealth of the users. Just as it is contradictory for nonprofits to pay outsized bonuses to employees, so it would be incoherent for a cooperative to amass cash at the entity level or to spend capital on fancy offices. While it may be a for-profit entity, it exists to assist and give back to its users, generally in proportion to their use. This focus gives cooperatives a unique identity based in furthering the ends of their owners and users.

²⁵⁰ This section describes the traditional cooperative. Relatively recently, “new generation” cooperatives have emerged, helped by the National Conference of Commissioners on Uniform State Laws (NCCUSL), which developed a uniform law in 2007, the Uniform Limited Cooperative Association Act. These cooperatives require substantial equity investment from members, have contractually fixed delivery rights and obligations, a closed membership (i.e., a limited number of shares), and fewer restrictions on transferability, meaning shares have a market value that fluctuates. *Id.* at 20–22.

²⁵¹ In some ways, cooperatives are not an entity form per se, in that they can be incorporated under general incorporation law, nonprofit law, or LLC law. *Id.* at 37. Some are organized under separate cooperative statutes. Martha W. Jordan, *Are Tenant-Stockholders Entitled to a Charitable Contribution Deduction When a Cooperative Housing Corporation Donates a Preservation Easement?*, 39 U. MEM. L. REV. 515, 520 (2009). Most, however, take the corporate form. *Id.* at 519. Cooperatives may be stock or nonstock in form. ATRY & HALL, *supra* note 246, at 71. Nonstock cooperatives distribute membership certificates but no dividends. *Id.* at 71, 74. For the purposes of this discussion, I treat the forms as indistinguishable.

²⁵² Two common definitions of *cooperatives* are: “an autonomous association of persons united voluntarily to meet their common economic, social, and cultural needs and aspirations through a jointly owned and democratically controlled enterprise,” ZEULI & CROPP, *supra* note 248, at 1 (providing the International Co-operative Alliance definition); and “a user-owned, user-controlled business that distributes benefits on the basis of use,” ATRY & HALL, *supra* note 246, at 8 (providing the USDA definition).

²⁵³ ZEULI & CROPP, *supra* note 248, at 43 (emphasis added).

This Part has provided a typology of nonprofit entities. Service providers such as hospitals or organizations such as Consumers Union compete today largely on the basis of the services they provide. They generally do not provide identity benefits. The nonprofit status of hospitals, in particular, may be a holdover from the past when these organizations did provide an identity function, and religious hospitals may still retain that identity because of the meaning the religious affiliation brings. Donative organizations, in contrast, rely not on the sale of services but rather on outside donations. Organizations as varied as the Green Bay Packers, Wikimedia, and charitable foundations rely on donations, and much of what they “sell”—that is, provide—in exchange is a social identity. Trade associations and clubs similarly traffic heavily in identity; their nonprofit status is crucial to their ability to credibly offer a good that is essentially the pleasure of associating with other like-minded individuals. Because of the centrality of faith to many individuals, religious organizations are perhaps the prototypical identity organization. Imagining a for-profit church crystallizes the importance of the nonprofit form in providing distinct social identity. Universities are both service providers and donative nonprofits. When marketing to students, they emphasize the superior nature of their services, but when marketing to alumni, they emphasize the special identity characteristics—sports teams, religious affiliation, shared experiences—that encourage giving. While for-profit universities do exist, they compete for students solely based on the services they provide because they are not in the identity business. Traditional universities, which are very much about identity creation, cannot take the for-profit form because to do so would undermine their ability to provide a university identity based on shared values or experiences. Finally, the case of cooperatives illustrates that forms other than the nonprofit can create a distinctive identity.

V. IMPLICATIONS

A. *The Solution to the “Nonprofit Puzzle”*

Part I of this Article articulated the nonprofit puzzle. Agency costs should be rampant within nonprofits, given the lack of traditional curbs. But if agency costs were indeed severe it seems unlikely that individuals would participate in nonprofits. The leading theory posits that nonprofits exist because of contract

failure.²⁵⁴ Applying Hansmann's theory, nonprofit hospitals and nursing homes should make their status clear to potential customers to signal why the contract-failure risk is less acute, as compared to their for-profit rivals. Yet empirical research suggests that they do not. Furthermore, Hansmann's contract failure theory fails to address the nonprofit puzzle. He does, however, acknowledge that agency costs undermine the nonprofit form's effectiveness as a response to contract failure, i.e., the inability of the payer to trust that she is getting what she paid for.²⁵⁵ Still, he concludes that, despite limited policing mechanisms, agency costs are probably not widespread in the nonprofit sector due to a vaguely defined social norm mechanism.²⁵⁶

In Hansmann's account, then, the nonprofit form exists because of contract failure, policed by social norms. This Article supplements Hansmann's theory by specifying the mechanism for norm enforcement. Firms that sell a certain kind of warm-glow, social-identity good *must* choose the nonprofit form. The social identity function accounts for the success of the form despite the weakness of legal constraints. It creates a reason to trust the organization that makes the contract-failure theory work. This Article proposes that the mechanism that constrains agency costs is the social identity function of the form itself: If agency costs run too high, then the nonprofit organization cannot market a distinctive warm-glow good. High salaries and other rent-seeking thus occur less often than we might expect in nonprofits because both firm outsiders and firm insiders understand that the organization is premised on a goal separate from the profit motive.²⁵⁷

B. Tax Status

As discussed in the Introduction, the tax exemptions enjoyed by the nonprofit form are under assault. This Article shows that nonprofits have a purpose that transcends providing tax advantage: They can provide social

²⁵⁴ To be fair, Hansmann calls social clubs an exception to the contract failure theory. See Hansmann, *supra* note 22, at 892–94.

²⁵⁵ *Id.* at 896.

²⁵⁶ *Id.* at 875 (“Such broad compliance with a poorly policed constraint is presumably due to adherence to social norms that reinforce the legal restraints on profiteering by conditioning individual behavior even when the legal constraints are unlikely to be enforced.”).

²⁵⁷ Put differently, one could characterize the nonprofit organizational form as a kind of credible commitment device, in that it constitutionally commits the organization to nonprofit ends. Yet, as Part I discussed, the commitment on its own lacks credibility, given the risk of agency costs and lack of policing. What makes the commitment a truly credible one is the identity function nonprofits can create.

identity. The nonprofit form itself contributes meaning that cannot be reduced to mere tax exemption.

Accepting this premise allows us to view the tax-exempt question in a new light. A social identity theory of nonprofits suggests that taxation is irrelevant to the purpose of nonprofits, or at least of certain nonprofits. Suppose that for-profits and nonprofits were taxed equally, as Malani and Posner suggest.²⁵⁸ The social identity theory argues that at least some nonprofits—those that provide an identity function—would continue to exist. Even if the tax code no longer provided a special incentive to donate to a nonprofit provider of health care to the indigent, for example—that is, even if the code provided for an equal deduction for donations to a for-profit that provided the same service, or did not allow a deduction for a donation to either group—some subset of donors would still favor the nonprofit because of the increased identity value that entity provides.

The point also applies to nonprofits that do not enjoy the personal deduction. For example, trade associations or sororities are exempt from taxation at the entity level, but association fees and other donations are not tax deductible to the donor. Even if these organizations had to pay taxes, social identity forces would keep these organizations in the nonprofit sphere.

A social identity theory of nonprofits is thus agnostic on the tax-exemption question. However, the theory may suggest that a binary approach to taxation of nonprofits is inappropriate. As discussed above, nonprofits are heterogeneous, and as a policy matter, some might warrant exempt status more than others. If social identity has value, so that society desires to encourage its production, then perhaps nonprofit organizations that provide identity should be the only ones that qualify for favored tax treatment. Conversely, if identity function is providing enough incentive for these organizations to exist, exempt status might be redundant, and therefore wasteful.

One particular application of social identity theory concerns service providers, such as hospitals and daycares. As we have seen, nonprofit providers of these services differ little from for-profit providers with regard to their provision of social identity to consumers.²⁵⁹ As a result, affording for-profit and nonprofit service providers differing tax treatment may make little sense. To be sure, society might want to encourage the operation of daycares

²⁵⁸ See *supra* notes 66–68 and accompanying text.

²⁵⁹ See discussion *supra* Part IV.A.1.

and hospitals; if that is the case, however, there seems to be little reason to encourage the creation of such institutions only when they take the nonprofit form.

C. *The L3C*

The identity theory of nonprofits also offers insight into a new form. Tax lawyers and their clients are still exploring the implications of a brand new form of entity, the low-profit limited liability company (L3C). L3C statutes have been adopted in eight states (the first, Vermont, only in 2008), and numerous other states are considering them.²⁶⁰ Their history provides a remarkable case study of tax law shaping organizational design.

The motivation behind the L3C form stems from the tax treatment of foundations.²⁶¹ Total revenues of private foundations reporting to the IRS were \$173.8 billion in 2008, and total assets were \$569.9 billion.²⁶² Foundations are in something of a bind: They are required to spend 5% of their assets in order to maintain their exempt status,²⁶³ yet they also want to preserve capital and perhaps even grow it to provide for future needs. The Internal Revenue Code penalizes private foundations that make investments that jeopardize the accomplishment of their exempt purposes, but allows private foundations to make program-related investments (PRIs).²⁶⁴ To qualify: (1) the primary purpose of the investment must be to accomplish a foundation's exempt purpose; (2) no significant purpose of the investment can be the production of income or the appreciation of property; and (3) no purpose of the investment can be to electioneer, and only limited lobbying is permitted.²⁶⁵ PRIs permit foundations to garner some financial return and count toward their 5% annual distribution requirement.²⁶⁶

²⁶⁰ Bishop, *supra* note 31, at 246–47 & nn.2–3; J. William Callison, *LC3s: Useless Gadgets?*, BUS. L. TODAY, Nov.–Dec. 2009, at 55, 55; Daniel S. Kleinberger, *A Myth Deconstructed: The “Emperor’s New Clothes” on the Low-Profit Limited Liability Company*, 35 DEL. J. CORP. L. 879, 880 & nn.1–2 (2010).

²⁶¹ Bishop, *supra* note 31, at 244.

²⁶² 501(c)(3) *Private Foundations*, *supra* note 210.

²⁶³ The tax regulations contain instructions for valuation of the investment assets. For example, a foundation must use the average of the monthly values of publicly traded securities held during the year. BRUCE R. HOPKINS & JODY BLAZEK, *PRIVATE FOUNDATIONS: TAX LAW AND COMPLIANCE* 358 (2d ed. 2003).

²⁶⁴ I.R.C. § 4944 (2006).

²⁶⁵ Treas. Reg. § 53.4944-3(a)(1)(i)–(iii) (1972).

²⁶⁶ I.R.C. § 4942.

The assets against which the five percent is measured include the foundation's investment assets, but not program-related investments or other assets that are used directly in carrying out the foundation's charitable mission. For example, if the foundation owns the building that houses its

The problem with PRIs is that uncertainty surrounds whether a given investment will qualify for the exception. A foundation first must carefully plan a PRI and either hope that its investment will not be challenged or seek a preinvestment private letter ruling from the IRS, a lengthy and costly process.²⁶⁷ Claiming a PRI where none exists renders the foundation vulnerable to “toxic” excise taxes that run from 10% to 25%.²⁶⁸ For this reason, private foundations have generally been reluctant to engage in PRIs.

Recently social entrepreneurs have promoted L3Cs as a way to unlock the potential of PRIs. The future of L3Cs remains uncertain,²⁶⁹ but what is remarkable for the purpose of this Article is that the form was specifically created to track the language of the PRI requirements.²⁷⁰ Notably, the L3C

offices, the value of the building is excluded from the five percent calculation to the extent the building is used directly for charitable activities and related administrative functions.

MINN. COUNCIL ON FOUNDS., WHAT EVERY GRANTMAKER SHOULD KNOW: FREQUENTLY ASKED LEGAL QUESTIONS 46 (2009), available at http://www.mcf.org/system/asset_manager_pdfs/0000/0069/wegsk_1_.pdf; see also David S. Chernoff, *Legal Dimensions of International Grantmaking: Summer 2000: Program Related Investments*, COUNCIL ON FOUNDS., <http://www.cof.org/templates/content.cfm?ItemNumber=1278> (last visited May 28, 2011) (“As an added inducement for foundations to make program-related investments, the Code provides that the amount of the program-related investment reduces the asset base upon which the 5-percent annual distribution requirement is applied. On the other side of the equation, any principal repayment of a program-related investment increases the foundation’s minimum distribution requirement for the year in which the repayment is received.”).

²⁶⁷ Thomas Kelley, *Law and Choice of Entity on the Social Enterprise Frontier*, 84 TUL. L. REV. 337, 356 (2009).

²⁶⁸ Bishop, *supra* note 31, at 252–53.

²⁶⁹ Some view L3Cs as “dangerous” because they are unnecessary and suggest to donors a tax status that they do not (yet) have. Callison, *supra* note 260, at 55–56. Some proposed initiatives read the requirement of significantly furthering the accomplishment of a charitable or educational purpose very broadly, even to encompass publishing Illinois newspapers, bolstering North Carolina’s hard-hit furniture-manufacturing industry, and funding biotech startups. See Mark Fitzgerald, *Prophet Motives: Alternative Ownership Buzz Raises Flagging Hopes*, PEORIA NEWSPAPER GUILD (Ill.) (Mar. 25, 2009), <http://peorianewspaperguild.org/includes/print.php?ID=6293> (noting efforts within newspaper industry to use L3C corporate structure); Heather Peeler, *The L3C: A New Tool for Social Enterprise*, COMMUNITY WEALTH VANGUARD (Aug. 2007), [http://www.communitywealth.com/Newsletter/August 2007/L3C.html](http://www.communitywealth.com/Newsletter/August%2007/L3C.html) (noting use of L3C in North Carolina furniture industry); CHRIS LARSON, AM. CHEM. SOC’Y, L3C—THE NEXT GENERATION OF SMALL BIOTECH? (2008), available at <http://www.americansforcommunitydevelopment.org/downloads/ChrisLarsonNextGenBiotech.pdf> (advocating use of L3C structure in biotech industry). The author reads the charitable purpose in the latter two cases as the creation or preservation of jobs, but most for-profit businesses also strive to create or preserve jobs, at least as a by-product of doing business.

²⁷⁰ Vermont was the first state to authorize creation of the L3C. Bishop, *supra* note 31, at 246. Modeling its language after the PRI requirements, its legislation requires (among other things) that:

(A) The company: (i) significantly furthers the accomplishment of one or more charitable or educational purposes within the meaning of Section 170(c)(2)(B) of the Internal Revenue Code of 1986, 26 U.S.C. § 170(c)(2)(B); and (ii) would not have been formed but for the company’s relationship to the accomplishment of charitable or educational purposes. [And that:] (B) No

cannot be formed for the purpose of producing income or property appreciation (although the mere fact that the organization produces significant income does not mean that it necessarily violates this requirement).²⁷¹

Promoters behind the L3C envision a hybrid organization that permits several different tiers or tranches of investment.²⁷² Assume, for example, the investment is in rehabilitating a historic building that has fallen into neglect, but which could provide attractive office space and banquet facilities if properly repaired. The investment is one that is socially beneficial because of its historic preservation value and also could generate some investment returns, but not enough to make the investment viable on its own.

The idea is that private foundations, interested in availing themselves of PRIs without going through the hassle of determining what qualifies as a PRI, could instead invest in junior tranches that would not receive a significant financial return. Presumably any social enterprise that qualified for L3C status could offer investments that also qualified for the program-related investment exemption.²⁷³ That is, entity form is dictated and calculated to produce a desired tax result to particular investors.

L3C promoters posit that the entity could also create additional tiers of membership.²⁷⁴ An intermediate ownership tier would target socially responsible investors who are looking to help the community and willing to accept a lower than market rate of return.²⁷⁵ Finally, the L3C could create a tier of investment that offers market-rate returns to private investors.²⁷⁶

significant purpose of the company is the production of income or the appreciation of property; provided, however, that the fact that a person produces significant income or capital appreciation shall not, in the absence of other factors, be conclusive evidence of a significant purpose involving the production of income or the appreciation of property.

VT. STAT. ANN. tit. 11, § 3001(27)(A)–(B) (2009); *see also* Kelley, *supra* note 267, at 372–73 (noting that the idea behind L3C was to “closely track” the language of program-related investment requirements set forth in I.R.C. § 4944(c)).

²⁷¹ *See, e.g.*, VT. STAT. ANN. tit. 11, § 3001(27)(B).

²⁷² Kelley, *supra* note 267, at 373.

²⁷³ *Id.*

²⁷⁴ *Id.* at 373–74.

²⁷⁵ *Id.* at 373.

²⁷⁶ *Id.* at 374; *see also* Peeler, *supra* note 269.

Tranche	Return
Senior: banks, venture capital	Market
Middle: socially responsible investors	Somewhat below market
Junior: Private Foundations	1–2%

For now it remains unclear whether the IRS will accept these new entities' claims to qualify for the PRI exemption; in 2008, L3C advocates failed in their attempt to have legislation passed that would amend the Code's PRI definition to match L3C structure.²⁷⁷ Critics call the L3C “incoherent,”²⁷⁸ a “perversion,”²⁷⁹ and a “myth.”²⁸⁰ Social identity theory provides further ground for skepticism about this emerging form.

The L3C raises the intriguing possibility that a single for-profit entity could be different things to different investors. Some may be looking for a market rate of return, while others may seek returns made up of both financial gain and social good. As such, the L3C challenges the traditional conception of entity as a collection of individuals with a common purpose—be it to maximize profit (the for-profit corporation, LLC, or partnership), to maximize wealth at the user level (the cooperative), or to maximize benefits for society or members (the nonprofit).²⁸¹

The L3C as currently envisioned may be too much of a hybrid to claim to provide any identity benefits. While the form's vaunted purpose is to serve social ends, and it is not supposed to have as its purpose the production of income or the appreciation of property, the fact that some of its investors expect market rates of return may keep it from bestowing a sense of unique identity on its investors—and from achieving the very PRI status that supposedly drives it.²⁸² On the other hand, as discussed above in Part IV.B,

²⁷⁷ The Program-Related Investment Promotion Act of 2008 would have amended § 4944(c) to provide a process for foundations to receive a determination that low-profit L3C investments qualify for the program-related investment exemption. Callison, *supra* note 260, at 55–56.

²⁷⁸ Larry Ribstein, *The Nature of the L3C*, TRUTH ON MARKET (June 17, 2010, 6:37 PM), <http://truthonthemarket.com/2010/06/17/the-nature-of-the-l3c>.

²⁷⁹ Bishop, *supra* note 31, at 243.

²⁸⁰ Kleinberger, *supra* note 260.

²⁸¹ Of course, investors at all firms may have heterogeneous motives: Investor *A* might choose to invest in Whole Foods because she thinks she will earn the maximum return for her capital, while Investor *B* might invest because he believes in the firm's commitment to organic food. But the entity as a whole seeks to make money.

²⁸² As Kleinberger points out, typical L3C statutes require that “no significant purpose of the company [be] the production of income or the appreciation of property,” but the venture itself is premised on achieving a

foundations, the market for which the L3C form was specifically crafted, are probably less motivated to invest for reasons of identity than other donors.²⁸³ The L3C planners certainly anticipate that the senior-level investors will be motivated by pursuit of market rates of return rather than any warm glow or identity benefits. (If they were not so motivated, they would, presumably, accept less than a market rate of return.)

The question then becomes whether the middle tranche of socially responsible investors will feel any identity benefits in contributing to a worthy for-profit and receiving a below-market rate of return, or whether instead the knowledge that fellow investors are receiving more than they are will vitiate the warm-glow, social identity possibilities offered by the organization as a whole. Clearly individuals can derive some identity or warm-glow benefits from financial transactions and are willing to sacrifice financial gain to do so. For example, Kiva Microfunds is a nonprofit that facilitates loans to microfinance organizations.²⁸⁴ Its website allows individuals to make interest-free loans to microfinance organizations that in turn make loans to individuals living in poverty.²⁸⁵ While Kiva itself is a nonprofit and fosters feelings of community among its lenders,²⁸⁶ its lenders are not donors: They make loans on the assumption that the principal will be returned to them. They forgo interest on the money that they loan, but the IRS does not view this forgone interest as deductible, nor does Kiva itself.²⁸⁷

The question of whether a slice of an organization can confer identity-based warm glow is an intriguing one. My guess is that it cannot. I

profit. Kleinberger, *supra* note 260, at 908 (emphasis omitted) (quoting 805 ILL. COMP. STAT. ANN. 180/1-26(b)(1) (West Supp. 2010)) (internal quotation marks omitted).

²⁸³ Indeed, this Article has specifically set aside the donative activity of private foundations, which, due to their large size and sophisticated screening mechanisms, do not generally make donations for identity reasons.

²⁸⁴ Sarah B. Lawsky, *Money for Nothing: Charitable Deductions for Microfinance Lenders*, 61 SMU L. REV. 1525, 1526, 1536 (2008).

²⁸⁵ See *How Kiva Works*, KIVA, <http://www.kiva.org/about/how> (last visited May 28, 2011) (explaining how donation and lending processes work).

²⁸⁶ Prospective lenders evaluating a potential loan recipient can view the profiles of other Kiva lenders who have already lent to that individual. To bolster this sense of community, Kiva has employed social networking and “Web 2.0” to develop “a community of passionate lenders.” Lawsky, *supra* note 284, at 1532–33 (“Kiva lenders have their own website, separate from Kiva, which, as the site itself explains, ‘supports Kiva’s mission of “connecting people, through lending, for the sake of alleviating poverty,” by creating a place where Kiva community members can connect with one another.’ Kiva lenders also have their own MySpace page.” (footnote omitted) (quoting *About Kiva Friends*, KIVA FRIENDS, <http://www.kivafriends.org/index.php?action=about> (last visited May 28, 2011))).

²⁸⁷ While donations to the organization itself are tax deductible, the forgone interest on the loans is not. See *generally id.* (arguing that such forgone interest should be deductible).

hypothesize that the knowledge that fellow investors are making a profit would likely taint the social identity value of the investment. It remains too early to know how the L3C will work in practice. To the extent the public believes that some tax implications should flow from identity, it may feel that L3Cs are more or less deserving of qualifying for the PRI exemption.

D. First Amendment Implications of a Social Identity Theory of Nonprofits

The Supreme Court's recent *Citizens United*²⁸⁸ decision reveals the importance of understanding identity's role in business entities. *Citizens United* is a nonprofit corporation that was prevented by the Bipartisan Campaign Reform Act of 2002 (BCRA) from purchasing advertisements for *Hillary: The Movie* by the Federal Election Commission (FEC) in the thirty days prior to the last Democratic primary.²⁸⁹ Prior to *Citizens United*, First Amendment jurisprudence collapsed all corporations—with the exception of certain so-called *MCFL*²⁹⁰ ideological nonprofit corporations—into one category and regulated organizational speech accordingly.²⁹¹ Corporations could not engage in “electioneering communication” within thirty days of a general election unless they were exempted under *MCFL* because they: (1) were “formed for the express purpose of promoting political ideas”; (2) had no shareholders; (3) were not founded by a for-profit corporation or labor union; and (4) did not accept contributions from such entities.²⁹² *Citizens United* did not qualify under *MCFL* because for-profit corporations donated some of the funds used to make the movie.²⁹³

Each of the five opinions in *Citizens United* grapples with the basic fact that the corporate house has many rooms; nonprofits, privately held businesses, and large public companies all take the corporate form. Because the law draws a line between corporate and noncorporate speech, each authoring Justice in *Citizens United* focused attention on those corporations best suited to his argument. For example, Justice Kennedy emphasized that bans on corporate speech apply to nonprofits and small, privately held for-profit corporations,

²⁸⁸ *Citizens United v. FEC*, 130 S. Ct. 876 (2010).

²⁸⁹ *Id.* at 887–88.

²⁹⁰ *FEC v. Mass. Citizens for Life, Inc. (MCFL)*, 479 U.S. 238 (1986).

²⁹¹ *Citizens United*, 130 S. Ct. at 891.

²⁹² *MCFL*, 479 U.S. at 264. The Bipartisan Campaign Reform Act of 2002 (BCRA) placed limits on political advertising thirty days before a general election and applied that restriction to all nonprofits, as well as for-profit corporations. The Court in *McConnell v. FEC* interpreted the BCRA to retain the *MCFL* exemption. *McConnell v. FEC*, 540 U.S. 93, 102–03 (2003).

²⁹³ *Citizens United*, 130 S. Ct. at 891.

specifically invoking the Sierra Club, the National Rifle Association, and the American Civil Liberties Union.²⁹⁴ Making much the same point, Justice Scalia noted the impact on the Republican and Democratic parties.²⁹⁵ Justice Scalia described the speech of the Republican or Democratic Party as “the speech of many individual Americans, who have associated in a common cause, giving the leadership of the party the right to speak on their behalf.”²⁹⁶ He concluded that “[t]he association of individuals in a business corporation is no different.”²⁹⁷ But it is in fact different. Nonprofits can create a social identity in association, which for-profit corporations cannot. In this vein Justice Stevens, writing in dissent, focused on publicly held corporations, with their “large war chests.”²⁹⁸ One of his key arguments, which focused on the protection of investors, only applies to for-profit corporations, and further, only to those for-profits that are publicly traded.²⁹⁹

If nonprofit status can create and convey a distinct social identity, and if we value the freedom of individuals to speak in association, then perhaps there is a middle road between the *MCFL* exemption and opening the floodgates of corporate spending on the electorate. If the First Amendment privileges speech rights and the right to speak in associations, it might also reasonably draw a line between organizations in which the associative or identity function is paramount—mostly nonprofits, but cooperatives and perhaps labor unions as well—and those in which it is not. Put differently, and in the *Citizens United* majority’s terms, government may not discriminate on the basis of the identity of the political speaker—if it is coherent to claim that speaker has an identity in a constitutionally relevant sense. And a constitutionally relevant identity might well be a social identity—an identity with meaning over and above agglomeration to pursue profit.

This interpretation would greatly broaden the reach of the *MCFL* exemption. Perhaps it is proper to subject § 501(c)(3) organizations to campaign-finance restrictions on the theory that they give up their ability to participate in campaigns in exchange for § 501(c)(3) status. But this logic

²⁹⁴ *Id.* at 897.

²⁹⁵ *Id.* at 928 (Scalia, J., concurring).

²⁹⁶ *Id.*

²⁹⁷ *Id.*

²⁹⁸ *Id.* at 966 (Stevens, J., concurring in part and dissenting in part).

²⁹⁹ Generally shareholders in privately held corporations have bargained for board representation or contractual rights that protect their interests. Justice Stevens’s references to most Americans holding stock by means of pension funds and mutual funds and portfolio holdings suggest a focus on public corporations. *Id.* at 978.

would not extend to other § 501 organizations that might still make strong claims for First Amendment protections. This would include not only 501(c)(4) organizations, but also real estate boards, sororities, and trade associations such as the National Football League, the Chamber of Commerce, and labor unions. Although sometimes made up of for-profit entities, at the organizational level these associations still have a coherent nonprofit identity and purpose.

Indeed, Citizens United is itself a nonprofit corporation “dedicated to restoring our government to citizens’ control.”³⁰⁰ It qualifies for tax-exempt status under § 501(c)(4),³⁰¹ which applies to “[c]ivic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare.”³⁰² Section 501(c)(4) organizations, unlike § 501(c)(3) groups, can engage in lobbying or political campaigning.³⁰³ The *Citizens United* majority elected not to hold for Citizens United by the *MCFL* exemption,³⁰⁴ holding instead that the BCRA discriminated based on the identity of the speaker.³⁰⁵ According to the majority, the First Amendment at its root prohibits Congress from punishing citizens or associations of citizens from engaging in political speech—and corporations are just another type of association of citizens.³⁰⁶ Permitting the exemption to extend to all nonprofits—all organizations that truly have “associated in a common cause”—would permit Citizens United to run its advertisements despite the BCRA prohibition.³⁰⁷ The typical for-profit corporation, in contrast, has merely associated for the generic purpose of

³⁰⁰ From the Citizens United website:

Citizens United is an organization dedicated to restoring our government to citizens’ control. Through a combination of education, advocacy, and grass roots organization, Citizens United seeks to reassert the traditional American values of limited government, freedom of enterprise, strong families, and national sovereignty and security. Citizens United’s goal is to restore the founding fathers’ vision of a free nation, guided by the honesty, common sense, and good will of its citizens.

Who We Are, CITIZENS UNITED, <http://www.citizensunited.org/who-we-are.aspx> (last visited May 28, 2011).

³⁰¹ Brief for Appellant at 5, *Citizens United v. FEC*, 130 S. Ct. 876 (2010) (No. 08-205).

³⁰² I.R.C. § 501(c)(4) (2006). The subsection further requires that “no part of the net earnings of such entity inures to the benefit of any private shareholder or individual.” *Id.*

³⁰³ However, while § 501(c)(4) organizations are exempt from federal (and sometimes state) income taxation, donations are not tax deductible to the donor. *See* INTERNAL REVENUE SERV., *supra* note 215, at 46.

³⁰⁴ Citizens United did not qualify outright for the exemption, since it received some donations from for-profit corporations. *See supra* note 293 and accompanying text.

³⁰⁵ *Citizens United*, 130 S. Ct. at 913 (Stevens, J., concurring in part and dissenting in part).

³⁰⁶ *Id.*

³⁰⁷ *Id.* at 928.

making money (and not in any specific region or industry).³⁰⁸ Investment in a for-profit entity does not indicate the same kind of interest in a common cause that participation in the Republican Party or Greenpeace does, because of the lack of organizational identity. Drawing this distinction seems both principled and clean.

CONCLUSION

This Article argues that entity form can itself create meaning, by creating a type of good incompatible with the profit motive. It describes the nonprofit puzzle: Why would a rational person give to nonprofits knowing that agency costs are so poorly constrained? Existing theories of the firm and the nonprofit fail to address this puzzle.

This Article then lays out psychology's social identity theory and articulates a social identity theory of the nonprofit. The nonprofit form can create a unique warm-glow identity that a for-profit cannot, because the salience of the for-profit motive inevitably dims the warm glow that motivates the donor to participate in the organization in the first place. The Article then creates a typology of nonprofits, arguing that service-providing nonprofits like hospitals are generally not in the identity-creation business, while donative nonprofits, trade associations, social clubs, and churches are much more identity driven.

Finally, the Article explores some implications of a social identity theory of the nonprofit. The theory solves the nonprofit agency-cost puzzle and also offers a new vantage point from which to view the tax-exemption question. It suggests that nonprofits would persist even if taxed equally with their for-profit counterparts, also emphasizing that there are some nonprofit organizations for which no for-profit counterpart could exist. Depending on whether we as a society seek to encourage nonprofit identity organizations, we might want to tax them more or less favorably than nonprofits that do not provide an identity function. The social identity theory of nonprofits will also have relevance as we grapple with how to distinguish nonprofits from for-profits in new contexts such as the L3C and campaign finance reform.

³⁰⁸ Indeed, many corporations' charters authorize them to exist "for any lawful purpose." Don Mayer, *Fort's 'Business as Mediating Institution'—A Holistic View of Corporate Governance and Ethics*, 41 AM. BUS. L.J. 595, 608 (2004).