UNIVERSITÀ DEGLI STUDI DI ROMA "LA SAPIENZA"

TESI DI DOTTORATO IN DIRITTO COMMERCIALE COMPARATO E UNIFORME

SCUOLA DI DOTTORATO IN DIRITTO DELL'ECONOMIA E DELL'IMPRESA

XXII CICLO

THE AGENCY PROBLEM IN NON-PROFIT CORPORATIONS: A COMPARATIVE LAW AND ECONOMICS STUDY OF US AND ITALIAN SYSTEMS

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INTRODUCTION

INTRODUCTION

The origins of the non-profit sector are strictly connected with the power and the influence of the Roman Catholic Church. In fact, since the early middle age (III-IV century), people used to donate personal resources on behalf of ecclesiastical and secular institutions/individuals with the belief that those actions would have purified one's soul.

On one hand, such benevolence could well be considered as a *strictly religious charity* in the sense that the purpose of the donation was basically represented by the need to satisfy an inward spiritual feeling. It is true, the Canon law clearly established that one quarter of the resources of the Church had to be employed for the relief of the poor and the sick. Yet this was just an internal rule so that nobody could advance complaints about the disloyal administration of the funds.

On the other hand, such benevolence could also be considered as an *extended religious charity* in the sense that the purpose of the donation was not only represented by the need to satisfy an inward spiritual feeling but also by the concrete desire to give a contribution for the relief of the disadvantaged people.

The difference between the *strictly religious* and the *extended charity* could be detached through the way with which the benevolence was accomplished. In the first case, the benevolence was accomplished through a material transfer of the resources, that is through an *executed contract* while in the second case the benevolence was accomplished through an *inter vivos* or *mortis causa* act which contained specific provisions about the charitable employment of the resources.

The problems generated by such *executory* contract were already and promptly caught by the Codex Theodosianus and Justinaneus which introduced the rule according to which whoever had had an interest in the fair management of the funds would have been allowed to sue the administrator.

The *extended religious charity* experienced a sharp increase when in the XIII century a papal bull promised salvation to all those who had bequeathed their properties for *pious causes*.

It is true, in England the donations on behalf of the Church lasted until the XVI century, that is when the suspects on the disloyal behavior of the ecclesiastic administration led to a Reformation and, as a consequence, to a secularization of the public services.

Whereas the donations continued to be accomplished, the donee began to be rather represented by a lay individual or institution, so that from an *extended religious charity* one assisted to a shift into a sociological charity. In other words, people continued to make donations more with the specific purpose of giving a contribution for the relief of the needy people than with the one of satisfying an internal and spiritual call.

Despite this change in terms of donee, the problems related to the fair administration of funds did not disappear. A very important role concerning the correction of such abuses was exerted by the Court of Chancery and by the Charity Commissions.

As regards the first, it is extremely important to underscore that it introduced the institute of trust, that is a legal device which proved perfectly suitable to accomplish charitable donations. In particular, thank to this institute it was possible to render the donee accountable in relation to his administration as well as to ensure perpetuity to charitable funds by separating them from the personal properties of the trustee.

As regards the second, they were introduced by the 1601 Statute of Charitable Uses in order to fill the vacuum left by the Court of Chancery which meanwhile had become too formal and expensive to be resorted.

The Statute of Charitable Uses was actually flanked by other Acts, known as the Poor Laws. These were more concerned with establishing a “public” welfare system of charities through a system of taxation.

The combination of private charities with public ones promoted by the above mentioned Acts represented the peculiar aspect of the non-profit sector of the Middle Age England.

After a period defined as “dark age of philanthropy” that characterized the XVIII century, in England the need of the private contributions for the provision of public services became urgent. Thus, in the XIX century, the Government intensified the controls over the old charities and, in 1850, established a permanent charity commission whose structure would have lasted until the current days. The penetration of the public authorities into the administration of the private charities conferred to these organizations a strong political

dimension. Charities in fact were not longer conceived as institutions providing simple assistance, but as institutions whose role was that of giving a contribution to the accomplishment of the equality of people.

In the US, the public approach to the non-profit sector lasted only until the end of the XVIII century, that is when the American Revolution disestablished the tax system and, hence, reduced the great part of the financial resource of non-profit institutions.

The US non-profit organizations were initially established with the same purposes of those established in the Old-Country, that is they represented a sociological charity. Yet, after 1873 other kinds of non-profit organization began to be formed.

In particular, certain non-profit organizations were established by those rich entrepreneurs who understood that the belonging to an elite class was not a birth's right. For these reasons they established and funded institutions with the aim of replacing the government in the provision of public services and of ensuring a substantial equality among people. Thus, while also in the US the non-profit sector assumed a political role, differently from England the US non-profit organizations maintained a private dimension. No charity commissions were in fact established even if the Attorney General – so a public office – remained responsible for the control of the organizations.

After 1960, the US non-profit sector experienced a significant proliferation of organizations whose role from political commenced to become economic. Entrepreneurs would have rather established *ex-novo* non-profit corporations for these could ensure a better outcome than business ones, while the directors of the old non-profit structures would have hired business professionals for ensuring the survival of the firms themselves.

Meanwhile, since the XIX century the complexity of these organizations had required them to be incorporated.

The marketization and the incorporation of non-profit organizations had led to new dimensions of the agency problems. In fact, from the very traditional problems related to disloyal behaviors of administrators, problems related to the economic choices adopted by the management began to be considered. It is true the incorporation of the non-profit structure would have added a new principal – or new principals – to the donors/trustees relationship.

For the law, the relevance of this new principal – or these new principals – and of its – their – interest(s) would have depended on the particular dimension conferred to the legal concept of corporation.

For the lawyer who is currently concerned with the study of the agency problems in non-profit corporations, the identification of the legal concept of non-profit corporation would have proven rather difficult for two reasons.

The first is that there are three different theories that have been trying to define the legal concept of corporation. The second is that these theories have originally been developed taking into consideration the activity of business corporations. Therefore, in order to find out which are the principals of a non-profit corporation and what kind of interests they pursue, it would be first of all necessary to analyze those theories issued for business corporation and hence verify how these could be applied to the non-profit activity.

To begin with, the institutional scholars deem the corporation as a public structure whose interests are represented by those of the shareholders, of the corporation as legal entity and by of all the other stakeholders.

On the contrary, the contractarian scholars deem the corporation as a private structure whose interests are exclusively represented by those of the shareholders.

Finally, for the new-institutionalism scholars, the corporation is a sort of public-private hybrid form. According to them, the problem is not to identify the interests involved. In fact, they assume that the interests of corporation, shareholders and other stakeholders deserve protection. Rather, they are concerned with establishing to which extent the pursuing of shareholders interests is to be limited by the need to consider other interests. To resolve this question, new institutionalism scholars propose a model that focus the attention on the procedural rules to be observed in occasion of the decision making process.

The lawyer would find that the institutional theory findings well reflect the dimension of the non-profit corporation for two reasons. The first is represented by the absence of shareholders while the second by the non-discussable public dimension of the organizational charitable purposes which traditionally involve both the accomplishment of high quality/big quantity output and the respect of social, altruistic and ethic values in the adoption of organizational decisions.

Moreover, the institutional approach to the non-profit corporation assumes that the interests of the p*atrons*, of the corporation and of the other stakeholders coincide and, as a consequence, the role of the non-profit sector is that of supporting the market with structures which do not overlook the ethical, altruistic and social values of the community.

Instead, the lawyer would find that the contractarian theory findings reflect the dimension of the non-profit corporation only in part. Their shortcoming is represented by the fact that they focus the attention only on the output of the firm. According to these scholars, either donors and consumers of a non-profit corporation are attracted exclusively by the higher quality and bigger quantity of the products/services provided and ensured by the non-distribution constraint. According to them, the role of the non-profit sector would be therefore that of supporting the market with structures that offer better goods than those offered by the business counterparts.

This means that the contractarian theory of the non-profit corporation denies that the interests of the p*atrons* are the same of the corporation and of other stakeholders and argues that only the interests of the former deserve to be protected by the law.

The new-institutionalism approach to the non-profit corporation would assume that the interests of the donors, corporation and other stakeholders deserve to be protected by law. Yet, the attention would be focused on the fact that these interests might not correspond. The respect of the procedural rules in occasion of the decision making process shall ensure that the interests involved in a certain non-profit corporation have been protected. According to this stream of thought, moreover, patrons would be allowed to bring suits directly against the management, for the relationship between them is represented by an incomplete contract.

It is true, the analysis of the legal nature of the non-profit corporation, of its role and of the interests involved discloses crucial information about the concept of non-profit performance.

While for institutionalist scholars the non-profit performance must be measured according to the efficacy, for contractarians it must be measured against parameters of efficiency.

The contrast efficiency-efficacy represents an agency cost which is peculiar to non-profit corporations. Yet, it is not the only one. As seen earlier, similarly to business

corporations, also non-profit corporations are exposed to the agency costs arising from opportunistic behaviors. Actually, the costs related to opportunism characterize all the agency relationships. These costs involve misappropriation of funds and self-dealing transactions whose accomplishment is facilitated by the information asymmetry occurring between the principal and the agent. Theoretically, non-profit corporations are more exposed to opportunistic behaviors of directors for these structures are *unowned*.

The costs related to the constrast efficiency-efficacy are actually due to the conflict of cultures which characterize the non-profit board of directors. When after the '60 non-profit organizations became direct competitors of business corporations, the board of directors felt the exigency of hiring business professionals.

Although they speeded up the financial conditions of non-profit structures, their decisions might not reflect the values on which the corporation had been established. This problem would have actually occurred also for the non-profit corporations that had been recently established by entrepreneurs. Even if these had chosen the non-profit form for market reasons – better outcome than a for-profit –, still they would have attracted donations for altruistic, ethical and social values that the very nature of the non-profit structure was expected to promote.

An example of economic choices that would have not reflected the intrinsic values of a non-profit corporation is represented by the choice of taking short-term oriented decisions rather than long-term ones. It is clear how a short-term decision while ensuring a momentary high level of output, it would potentially threat the future of the organization and, hence, all the public services it provides.

In the light of the *marketization* of the non-profit sector, therefore, the interests of the corporations, of the community and of the p*atrons* – assumed that these financed the non-profit corporation while driven by altruistic, ethical and social motivations rather than output bent ones – would be jeopardized if judges and legislative power considered the non-profit corporation as a structure which is closer to a business corporation rather than to a charitable trust. In fact, should this be the approach, the non-profit directors would be accountable only in those cases for which the violation of the duty of loyalty or duty of care brought an economic loss to the corporation.

As regards the violation of the duty of care, the US courts have confirmed the application of the business judgment rule also to the non-profit corporations. This would mean that it would be quite hard to challenge a managerial decision that has preferred the efficiency in detriment of efficacy by arguing that the directors violated their duty of care, that is their duty to have the competence required for a non-profit office.

That decision might better be challenged by advancing a breach of the duty of loyalty, arguing that the decision would betray the altruistic, ethical and social values of the corporation.

It is clear that the discussion on the enforcement of non-profit directors' fiduciary duties from the Attorney General suggests the unsuccessful functionality of the internal control, that is the impossibility as well as the unwillingness of non-executive directors to exert control on the business oriented managers. The passivity of the non-profit board of directors is in fact considered as a duplication of the agency costs due to opportunistic and incompetent/negligent behaviors.

Other than the Attorney General, however, US Courts have acknowledged to p*atrons* the right to bring suit against directors' misbehaviors. On one hand, the donation has been considered as an *executory* contract whose implied terms are contained in the by-laws of the non-profit organization. On the other hand, the Courts have even acknowledged the right to bring suits against management for breach of fiduciary duties to peculiar classes of beneficiaries (consumers).

Although the Italian and US non-profit sector origins date back to the donations accomplished in the early middle age for religious purposes, the respective development has been influenced by different circumstances.

In particular, and obviously, the US non-profit development has been influenced by the English Old-country. The major difference between England, US and Italy is represented by the fact in the former countries two circumstances created the basis for developing a strong private non-profit sector: the institute of trust created by the Court of Chancery and the Reformation.

The Roman law that applied in Italy until 1865 and the 1865 Civil Code did not envisage, in fact, a legal institute through which it was possible render certain properties or goods bounded to a perpetual burden. Only with the decision of the 1942 Civil Code it was

finally introduced the concept of foundation which, although different in nature from that of trust, was capable to produce somehow the same effects.

Moreover, a sort of Reformation occurred in Italy just after the Unification with the Crispi Government. This means that until the end of the XIX the charitable activities were basically carried out by the Church, continuing the tradition that had been commenced in the early middle age.

The sort of Reformation, the introduction of the legal institute of foundation and the crisis of the welfare state happened during the 70's, all represented factors that could boost the non-profit sector.

The Italian governments involved non-profit organizations in the provision of public services establishing a significant number of private-public partnerships.

To render more trustworthy the non-profit organization, in 2006 the Italian legislator introduced a new firm model known as "*impresa sociale*". This Act is extremely important for the study and the resolution of agency problems in Italian non-profit firms as it renders applicable the theories of corporations also to the entities disciplined in *Libro* II of the Civil Code.

Of course, the remedies provided by the Italian legal order against corporate directors misbehaviors' are exactly not based on the distinction fiduciary duties and other duties. On one side this implies that the breach of trust performed by an Italian director is hardly challengeable if it does not bring any loss to the firm and that remedy shall be always represented by the recover of damages. On the other side, a negligent decision adopted by a foundation director shall be measured against the discipline of the "*mandato*", that envisage pretty low standards. Therefore, as regards the violation of duty of care, Italian directors would be exposed to similar responsibilities of the US colleagues.

As concerns the external controls, differently from the US latest tendency, it seems rather difficult for Italian donators to sue non-profit directors unless the relevant relationship is considered as *mandato* contract pursuant a *donazione indiretta*.

CHAPTER I

RESEARCH METHOD

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§1. History and Comparison

The comparatistic method imposes to the scholar a historical analysis of the legal institution that she is investigating on. "Comparison involves history" [Gorla, 1964] and "history involves comparison" [Maitland, 1911] are very well known *dicta* for every good comparative lawyer.

In particular, the necessity of the historical investigation had already proven clear when

> "the studiosous of roman law extended their interests to other ancient laws, through a deeper research on the whole vastness of law, of the "*ius privatum*", of the "*ius publicum*", of the "*iura civilia*" and of the "*ius gentium*"; considering the history of the several Greek laws and the common idea of a superior law to all of them; of the laws and eastern legal culture that employed the cuneiform writing…, of the mediterranean basin in the antiquity…" [Wegner *in* Zweigert and Kotz, 1998].

The most difficult task is represented by the identification of the historical moment from which the study must be set forth. This is due to the fact that every historical moment is always the result or the effect of something that has happened before so that is very hard to individuate a watershed.

Thus, when the object of the research has been already dug in literature, the new generation of scholars might take advantage of the efforts accomplished by their precedessors. For instance, if this research had aimed at studying joint stock companies, it would have been quite fair and simple to elect the 17th century as the crucial historical moment. In fact, in that period, for the first time corporations characterized by free transferable shares were constituted[1].

[1] The Indian East Company was constituted in 1602.

As regards non-profit corporations, it seems that it is much more complicated to identify a prototype to which researchers may refer to for outlining a historical analysis.
That is not much because non-profit corporations have been overlooked by literature – although they have received far less attention than business corporations[2] – but because it is first of all very hard to establish which is their distinguishing element.

It is true, non-profit corporation can be distinguished according to their purposes or according to the *nondistribution constraint* (NDC).

Both these elements have historically been expressed through organizational schemes that not necessarily presented the corporate form.

To put it clearer: the distinguishing element of joint stock corporations is the free transferability of shares[3]. Scholars concerned with these institutions and with the relevant evolution have had to establish when and through which structures that element had emerged in the market. As mentioned earlier, clauses regarding the transferability of the shares appeared during the 17th century through the legal form of corporation.

One of the two distinguishing element of non-profit corporations is the NDC. This can be defined as the limit on the distribution of the *surplus* on behalf of whoever exerts control over the entity [directors, managers, employees] and the prescription that any *surplus* must be reinvested for the organization's targets or somehow towards its interests [Tamburrini, 2009]. Scholars concerned with non-profit corporations and with the relevant evolution are expected to identify when and through which forms the NDC has been introduced in non-profit corporations. As quoted earlier, the *NDC* has not been expressed only by corporate forms, rather another legal/economic scheme known as *use* or trust has been involved.

The same can be said as regards the second distinguishing element of non-profit corporations, that is the charitable purposes. These purposes have not been pursued only by corporate forms, rather the incorporation is a practice that began to be diffused only during the XIX century. Before that, the legal/economic scheme employed was the trust.

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[2] "... less highly developed statutory treatment, fewer judicial interpretations, greater dependency on admnistrative fiat..., paucity of creative writin by academicians" [Lesher, 1967]. "...the law historically has given non profit organizations, like Cinderellasm the hand-me-down of their half-siblins, the business corporations [Henn and Boyd, in Zoppini, 1999]

[3] The free transferability of shares may be limited by the articles of association.

This means that while the transferability of shares represents the distinguishing element of the joint stock corporations, the NDC represents not only the distinguishing element of the non-profit corporations but also the distinguishing element of the charitable trusts as well as the charitable purposes represent an element of the charitable trust and of the non-profit corporation.

Therefore, the question becomes to establish if for the purposes of this research it is necessary to study both the forms or instead it is enough to focus just on the corporate one.

For representing an evolution or a more articulated version of the charitable trust, the non-profit corporation has been borrowing from it the basic principles concerning the rules of governance.

This explains why it is necessary to study which were the rules of law when non-profit organizations were organized as charitable trusts. In particular, such analysis is crucial to find out which were the interests involved and how the law protected them against managerial misconduct and what the managerial misconduct itself consisted in.

Other scholars likely concerned with non-profit sector, but driven by research questions which were different from the study of the agency problem, decided to start their analysis from further perspectives.

For example, as regards law and economic literature, Hansmann [1989] opted to take into account the moment within which the non-profit sector began to operate through the corporate form even if, according to him, non-profit corporations had been existing for more than a millennium. The Hansmann choice was justified by the fact that his intention was not to understand which were the interests involved in the non-profit corporations, in fact, in his opinion, the current role of non-profit enterprise assumed that only the interests of the patrons in a high quality / great quantity service/good deserved a legal protection. The target of Hansmann was not to discuss the interests involved, rather to devise legal strategies to protect those of the p*atrons*.

As concerns socio-political literature, Dowie [2002] began his study of non-profit organizations since the ancient times:

> "in ancient Persia the practice of establishing small trust funds called vaqfs (pronounced waffs) for charitable purposes has existed for a thousand years or more. In pre-revolutionary France there were also numerous large foundations; they were eliminated after 1789, however,

> by a regime that repudiated plutocracy and envisioned a state far better able to serve the interests of charity",

while Hammack [1984] whose interest was focused only on the American non-profit, preferred to refer to the late middle age: "very few independent, non-governmental, non-profit organizations were to be found in the American colonies"

Still regarding socio-political literature, Roelofs [2003] found the best moment to develop his discussion in the modern age: "the great foundations arose in the early twentieth century when the new millionaires sought a systematic way to dispose of their fortunes".

The noteworthy consideration of literature which is not specifically legal or economic might sound weird for a comparative law work. Yet, the non-profit sector is by definition a multi-disciplinary subject and study of the agency problem requires a deep understanding of the role that non-profit institutions – in the forms of charitable trusts and corporations – have played in certain economic, sociological and political circumstances.

This justifies the fact that many of the books and articles employed for developing this discussion have been taken into the libraries of Faculty of Art, Social Sciences and History.

In this monographic work, the discussion shall be set forth through the presentation of two Acts – The Statute of Charitable Uses and the Poor Law – enacted by Queen Elizabeth I in 1601.

The choice of that particular historical moment is due to several reasons.

To begin with, they represent the first instance of normative acts expressly directed to institutions characterized by the NDC and by charitable purposes.

Secondly, although by a different extent, they deal with the core issue of this work, that is the agency problem.

Finally, their prolixity provides fundamental hints about the functioning of the non-profit sector. More accurately, the analysis of these Acts does not represent only an occasion to establish an initial date for an onward observation of the non-profit sector role. In fact, it also represents an occasion to understand what non-profit sector had been until that moment. In particular, it is assumed that when law intervenes then it means that a determinate social-economic phenomenon has reached an extension for which it is no longer possible to control the relevant problems only relying on the basis of spontaneous behaviors of the people involved. Therefore, if legislation is a result of a process, then the analysis of

the first legislation concerning the non-profit sector may reveal to the studious when that process has begun, that is to say, it may reveal when the non-profit sector has begun to exert a significant role in the economy and what that role consisted in.

CHAPTER II

BACKGROUND

CHAPTER II

BACKGROUND

§1. OLD-COUNTRY AND POOR LAWS 1601

§1.1 STRICTLY AND EXTENDED RELIGIOUS CHARITY

In the course of time, the concept of non-profit sector has expressed several social, economic and legal meanings.

For sure, in the very beginning of its development, the non-profit sector could be identified in charity activities.

If charity can "be popularly defined as the habit, desire, or act of relieving the physical, mental, moral, or spiritual needs of one's fellows"[4] [Ryan, 1908] then, in the **Early Middle Age**, that is the era of the persecution (I to V century) the non-profit sector was basically represented by a "*strictly religious charity*". By "*strictly religious charity*" one means charity practices mostly founded on a religious base.

This was the reality not only of the British territory, but of all the Roman Empire.

The "habits, desires and acts of relieving" were to be realized by the transfer of personal resources – money, movable goods, immovable –; from a legal perspective, it was possible to detach three different ways to accomplish such transactions.

In particular, people used to donate through:

a) material almsgivings, consisting in natural products such as oblations or *collectae* and in money contributions from rich people left on the altars for the Church.

[4] The Christian definition of charity is provided by Ryan [1908]: "As a virtue, charity is that habit or power which disposes us to love God above all creatures for Himself, and to love ourselves and our neighbours for the sake of God. When this power or habit is directly infused into the soul by God, the virtue is supernatural; when it is acquired through repeated personal acts, it is natural. If, in the last sentence but one, for the words, "power or habit which disposes us to" we substitute the words, "act by which we", the definition will fit the *act* of charity. Such an act will be supernatural if it proceeds from the infused virtue of charity, and if its motive (God lovable because of His infinite perfections) is apprehended through revelation; if either of these conditions is wanting the act is only natural. Thus, when a person with the virtue of charity in his soul assists a needy neighbour on account of the words of Christ, "as long as you did it to one of these my least brethren, you did it to me", or simply because his Christian training tells him that the one in need is a child of God, the act is one of supernatural charity. It is likewise meritorious of eternal life. The same act performed by one who had never heard of the Christian revelation, and from the same motive of love of God, would be one of natural charity. When charity towards the neighbour is based upon love of God, it belongs to the same virtue (natural or supernatural according to circumstances) as charity towards God. However, it is not necessary that acts of brotherly love should rest upon this high motive in order to deserve a place under the head of charity. It is enough that they be prompted by consideration of the individual's dignity, qualities, or needs. Even when motivated by some purely extrinsic end, as popular approval or the ultimate injury of the recipient, they are in essence acts of charity".

Church revenues were therefore divided into four parts, of which one went to the bishop, another to the clergy, a third to the maintenance of worship, and the fourth to the relief of distress[5].

b) wills;

c) *inter vivos* acts.

Among the three mentioned ways, the one described in point a) was the most practiced. This explains why the definition of "*strictly religious charity*" has been adopted to describe the non-profit sector of the Early Middle Age. In fact, there seems to be no that by leaving almsgiving on the altar of the church people did not mean anything else than atoning their own sins (that is these contributions were made not to reach a certain external purpose, but to satisfy an inward feeling). Of course people had to know the canon rule according to which the quart part of their resources was expected to be dedicated for *pious causes*, still the historical and social context, characterized by a strong influence of the Church, would suggest that donors would have reached full satisfaction just with the material delivery of the goods. Therefore, *strictly religious charity* represented acts of benevolence whose (inward) motivation was much more important than the (external) purpose they were expected to pursue.

Actually, also wills and *inter vivos* act could give room for a *strict religious charity*. Yet, while for material almsgiving it was hard to establish if the donors were only meant to satisfy an inward motivation or if they did gifts counting on the canon law rule according to which part of their resources would have been distributed for charity purposes, for *inter vivos* and *mortis causa* acts such assessment would have been easier for these were sometimes supported by documents-evidences that might expressly disclose the intentions of the donors. Thus, in case donations were realized through oral agreement and oral wills, the assessment of the intentions of the donors would have been as hard as in case of material almsgivings.

Now, as regards the hypothesis of donations supported by documents, the donors could either make *simple* donations or they could envisage in their acts (wills or contracts) that the object of the donation had to be employed in a certain manner. This certain manner

[5] It shall be seen how Actually, during the late middle age, and in particular after the reformation, almsgivings were delivered directly in the hands of the beneficiaries, such as poor, idles, etc. .

still could present a religious element, such as repairing a chapel, or saying masses for the soul etc. or a religious/social element such as feeding the poor, healing the sick etc. Contributions to the poor were in fact considered as religious acts [TWD, 1862]

In the first case, if the donations were made to the Church (as it used to happen), then they represented *strictly religious charity*; that is the donors would have satisfied their inward feeling just for the fact of having donated.

If these mere donations – so donations without any burden – were made to secular individual or institution, they obviously could not be considered *in re ipsa* as charities for the nature of secular donees, differently from the nature of the Church donee, did not involve an activity qualifiable as religious or religious social activity or an activity somehow reflecting the above mentioned charity definition provided by Ryan [1908].

However, donations to secular individual or entities, might well involve charity.

In fact, in the second case, that is donations made for specific purposes other than inward motivations, the benevolence represented an *extended religious charity*. Also in this case the donations could be accomplished on behalf of secular individual or institution, yet the specification of the donor for which the resources had to be employed for charitable purposes conferred to the donations themselves a charity dimension.

In particular, the dimension of *extended religious charity* was a benevolence meant to satisfy an inward feeling as well as to satisfy an external need. The interest of the donor was represented not only by his motivation – inward feeling – to donate, but also by the accomplishment of the task indicated by himself. Actually, within the category of *extended religious charity* had to fall also the donations to the Church for which the donor required personal religious services, such as praying for his soul, his funeral etc. This conventional approach had to be explained on the basis of the fact that these donations, differently from the "mere" donations, underscored the importance of the purpose which, for it presented a religious dimension, had to be considered charitable even if it did not aim at "relieving the physical, mental, moral, or spiritual needs of one's fellows".

The practise of *extended charity* was already important in the Early Middle Age. There are evidences, in fact, that demonstrate that in many instances the donor provided the same gift for the support of the indigent and for the forgiveness of his sins [TWD, 1862]. As

it shall be seen, the *extended religious charity* became undoubtedly predominant in the Late Middle Age in occasion of a Decree of Pope Gregory[6].

The difference between *strictly* and *extended charity* is crucial when considered within an analysis of the (legal) discipline of the non-profit sector. The two different dimensions of charity express two different roles of the non-profit sector and, therefore, two different perspective of legal interests involved.

In the *strictly religious charity*, the motivation to make benevolence was more important than the purpose of the benevolence itself or the purpose might even not exist at all. Therefore, the law was only supposed to protect the interest in the accomplishment of the transaction. While there was no problem in case of material delivery (case a)), there could be some legal issues concerning case b) and case c). For example, a donor might be motivated to make benevolence to atone his sins and at the same time he wanted to donate for pious causes. Yet, instead of giving his resources directly to the Church[7], he could provide that his heirs or his donees would have had to do so. The *pious cause* was represented by the choice of the Church as final administrator of the funds. In cases like these, the *strictly religious charity* dimension of the non-profit sector implied that the law was not expected to protect the interest of the donor in a "fair" administration from the Church of the donated resources. On the contrary, the law was expected to compel the heirs or the donees to give the resources to the Church as established by the donor.

In the *extended religious charity*, the purpose to make benevolence reached the same importance – or becomes even more important – of the motivation. Other than envisaging the donee, the donor specified for which *pious causes* the funds had to be employed. The specification added another interest that deserved to be protected by the law – other than the one represented by the accomplishment of the transaction.

So, how did the law of the Empire dealt with these donations? Did it consider them as *strictly religious charity* or as *extended religious charity*? The fact that there were many instances where the donor provided the same gift for the support of the indigent and for the

[6] See p. 27

[7] The Church was the main recipient of the donations as well as the main organization charged with administration of charity funds. Moreover, in those cases where the Church was not the recipient, it still would have played a supervisory role. In fact, Often people made donations to Hospitals which were in the matter of facts regarded as ecclesiatical matters.

forgiveness of his sins did not automatically mean that the law would have protected the purpose other than the motivation.

And actually law did not protect that interest until the unceasing increase of *extended religious charity* within the Roman Emperor urged a legislative intervention. This occurred and aimed at:

a) providing peculiar rules in favor of legacies to pious causes;

b) establishing rules for the administration of the charity.

In particular, in the time of Valentinian and Marcian, A. C. 452, the Codex Theodosianus provided that legacies in favor of the poor should be maintained, even though the legatees were not designated. This provision strengthened even more the position of the Church in charity matters, for having been established that whereas the testator did indicate uncertain persons (did not indicate at all) as administrator of charitable funds, the Church, in the person of the Bishop, would have taken the control over the charities.

For example, it might well happen that a testator envisaged in his will that the resources had to be employed for a religious or social-religious purpose. If he failed to indicate who was charged with such commitment, the provision had to be declared void. The intervention of the law avoided that resources of public utility could be wasted – or remained in the hand of the heirs – and, above all, promoted the interest/intention of the donor in the accomplishment of the pious opera.

The fact itself that the Church entered in possess of the devised resources did not actually mean that they would have been employed according to the donor's desires. The favor legacies was not sufficient to guarantee the proper administration of the funds. It was only sufficient to ensure that the funds would have flown into the hands of an administrator (the Church) supposed to comply with the pious/religious requirements of the donor.

Therefore, law had to deal with two different problems. The first was represented by the donor's choice to elect an administrator who was not the Church, while the second was the direct administration of the Church. Did the Roman law dealt these two administrators in different ways?

In the first case, the Code provided that the bishop superintended the management, being required to have a watchful eye over the charitable funds, to praise them when they fulfilled their duty, to chide and remove those who were negligent, and, in such case, to

appoint other trustees, who had the true fear of God in their hearts, and the final day of judgment in their eye [TWD, 1862].

As regards the administration of the Church, either when directly chosen by the donor or when intervened for lack of designation of certain person, the Roman law established that the Bishop was not independent from the State, to which he had to present reports about the administration of certain charitable funds as for example the redemption of captives.

But the most striking and surprising rule, which applied either to the Church and to the secular individual or entity, was represented by the acknowledgement of the right to bring suits on behalf of every citizen – without distinction – interested in the fulfillment of the charitable intentions of the donor. This scheme disclosed either the public nature of charity and the outstanding actuality of an ancient legal order that had already been able to detach and to "*statutorize*" the economic interest in the fair administration of the funds[8].

These rules provided by the Codex Theodosianus and Iustinianeus came in force in the same period of the proliferation of monasteries (V-VI century).

These were ecclesiastical orders chartered by the Church and run by the monks, that is ecclesiastic figures who professed the Catholic religion through a very peculiar life-style consisting basically in the observation of a strict discipline directed to the highest elevation of human spirit and to the maintenance of this as far as possible from worldly temptations.

The importance of such Church agencies was demonstrated by their actual involvement in providing fundamental social services through the conduction of hospitals and schools. The attainment of a lofty reputation ensured to monasteries valuable gifts of land and gold.

The funds for charity experienced a sharp rise during the XIII century when a Decree issued by Pope Gregory promised salvation to all the people that had bequeathed in their wills part of their wealth to the support of *pious causes*. Moreover, to ensure the salvation of those who died intestate (that is without leaving any will), the Church obtained the right to administrate their property and to distribute a portion to *pious causes*.

[8] "This remarkable passage from the Code, shows that the great principle of the *public nature of a charity*, was judicially recognized to the same extent as at present, although no officer like the attorney-general was employed to represent the public, in a proceeding to establish the public right" [TWD, 1862].

It is true, that did not mean that the *decuius* had to grant her funds to Ecclesiastical institutions (Church or monasteries) for obtaining salvation. In fact, the funds could be entrusted also to secular individuals or institutions. In other words, what ensured salvation was actually the provision that those funds had to be utilized for *pious causes* and not the subjective element (ecclesiastic or laic) of the trustee.

As seen, the expression *pious causes* in turn did involve a very large category. Some of them were definitely religious, such as gifts for saying masses, foundation of chantries etc, other were disposed for the construction of bridges, roads, hospitals, etc. Just the wideness of this category justified the definition of *extended religious charity*.

Other than wills' provisions, by the way, donations continued to be accomplished through *inter vivos* acts. These were normally realized by the wealthier class either in the form of a direct contact with the beneficiaries – as for example giving food or clothes out in occasion of banquets and celebrations – and in the form of a direct almsgiving on behalf of the Church. The Church, in fact, used to insist in convincing the richer people that the "superfluity" of goods, belonged to the poor and was common wealth to be shared in times of need [Sweet, 1958 in Clark 2002], such like the **Late Middle Age** period (XIII century).

The papal Decree other than entailing an increase of charitable funds, implied the arise of agency problems in charity. It is true, the existence of agency problems had already been demonstrated by the provisions contained in the Theodosianus and Justinianeus codes that dealt with the designation of uncertain persons and with the administration of funds. Yet, differently from the era of persecutions, the *executory* type donations – especially those envisaged by the wills – were much more in number than those of *executed* one, that is those represented by the material delivery of resources on the alter or anywhere else.

Executory donations involved a certain gratuitous activity from the donee so that this could not be interested in doing. The increase of these conflict of interests implied therefore a likely increase of problems agency.

Moreover, the difference between executed and *executory* donations was very crucial from a legal point of view, as in common law the former were considered contracts whereas the latter not.

The interest in the execution of the donation belonged either to the *decuius* and to the class of beneficiaries and to all those that could have an interest in relation of the donation

scheme. Of course, the donation contained in the will could well not provide for any class of beneficiary or any indication on the ways of administration, being simply a donation on behalf of the Church. On one side, this could be considered as *strictly religious charity*. On the other side, many years were passed by since the time when people did donations just in order to atone their own sins; after the XI century, almost all the donations to ecclesiastical institutions, even if it was not explicitly specified, were aimed at contributing to the charity activity expected to be carried out by the institutions themselves. In other words, the role of the non-profit sector was by now represented by the *extended religious charity*.

When concerned with questions related to the fair employment of the devised funds it has to be remarked that since the Reign of Henry III, the Church, in person of the Bishops, enjoyed exclusive jurisdiction over the testaments of personality. In the exertion of such function, and continuing a tradition initiated by the Roman Codes of the early Middle Age, the Bishops were bent to show a very elastic attitude towards clauses and terms involving charity. In fact, although these were not correctly constructed by the testator, they still were not declared void for being too indefinite. This attitude of the ecclesiastical courts undoubtedly facilitated the collection of resources destined to charity.

Now, if the testator indicated an ecclesiastic institution as the executor or administrator of the funds, hypothesis of maladministration could hardly be challenged as the Ecclesiastical Courts would have not decided against their own interests.

A secular individual or institution would have therefore been much more accountable for his/her administration. Yet, the remedies offered by Ecclesiastical Courts were not deemed very efficient by those interested in the fair administration of the *decuius* funds. There were also complains about the high fees and the delay of the litigations.

For these reasons, people began to address their petitions to the Court of Chancery[9] that remained concurrent with that of the Bishop.

Such choice represented a very crucial point for the discipline of charitable legacies.

In fact, the Court of Chancery was the only judiciary body that could enforce the *uses* or *trusts*, that is those legal devices through which bequests and donations were realized.

[9] This was possible because of the extra-ordinary character of this Court. In fact, its origins are connected with the cases within which the Common Law presented too formalistic aspects to protect a party's interest. Thus, petitions were addressed to the Crown pleading for a decision taken "for the love of God and in the way of charity". Slowly such petitions began to be addressed to the Lord Chancellor whose repeated proceedings led to the institution of a separate court, the Court of Chancery.

Put it differently, just the Lord Chancellor could compel the executor indicated by the testator to respect the provisions of the bequest. The Ecclesiastical Courts could not do it as before the canon law the executor was the legal owner and, as such, he/she enjoyed full disposal. The Bishop could only make the feoffee account to him.

The employment of the trust/use legal device for charitable purposes has to be discussed more accurately.

To begin with, this institute originated in a practice adopted during the era of crusades (XI-XII century). Such practice was afterwards legally acknowledged by the Court of Equity, that became to be an established judicial institution since the XIV century.

At the time of crusades, land ownership in England was based on the feudal system. When a landowner left England to fight in the Crusades, he needed someone to run his estate in his absence, often to pay and receive feudal dues. To achieve this, he would convey ownership of his lands to a friend, on the understanding that the ownership would be conveyed back on his return. However, crusaders would often return to find the legal owners' refusal to hand over the property.

Unfortunately for the crusader, English law did not recognize his claim. As far as the courts were concerned, the land belonged to the trustee, who was under no obligation to return it. The crusader had no legal claim.

The disgruntled crusader would then petition the king, who would refer the matter to his Lord Chancellor. The Lord Chancellor could do what was “just” and “equitable”, and had the power to decide a case according to his conscience. At this time, the principle of equity was born.

The Lord Chancellor would consider it unjust that the legal owner could deny the claims of the crusader (the “true”) owner. Therefore, he would find in favor of the returning crusader. Over time, it became known that the Lord Chancellor’s court (the Court of Chancery) would continually recognize the claim of a returning crusader. The legal owner would hold the land for the benefit of the original owner, and would be compelled to convey it back to him when requested. The crusader was the “beneficiary” and the friend the “trustee”.

With the judicial acknowledgment of the equitable and just interest of the settlor (who was at the same time beneficiary), the landholders devised to adopt the institute of "use" to avoid to pay taxes.

In particular, the majority of these taxes were appropriated by the Crown when the landholder died. Thus, by placing his property in the name of another person, charged with administering it on behalf of the landholder himself, his heirs would not have been jeopardized in occasion of his death.

As seen, the risk of a bad behavior of the trustee (*feoffee*) – for example after the death of the landholder he could refuse to transfer the land to the heirs – could not be averted before the common law courts. These, in fact, did not envisage a *writ* for such petitions and, moreover, the common law courts involved too formalistic procedures that rendered hard to demonstrate the agreements between the *settlor* and the *feoffee* [Zweigert and Kotz, 1998].

Most importantly, not only the Court of Chancery acknowledged the agreement between the *settlor* and the *feoffee* but also offered typical equity remedies as for example the specific performance.

In other words, even if the Common Law courts had conferred legal validity to the agreement between *settlor* and *feoffee*, that is even if the Common Law courts had considered the mentioned agreement as a contract, then the remedy that they would have offered was only the recover of damages.

It is clear that a recover of damages in case of misbehavior of a person who had been chosen for trust questions could not content the *settlor*, who was definitely better and more completely protected by a specific performance, that is by the power of the Court of Chancery to enforce the obligation.

Had the institute of trust not be devised and developed in the described way within the English Courts and English legislative bodies, charitable bequests and donations would probably have continued to be realized through Roman and Canon law institutes which, as seen earlier, would have not guaranteed the protection of the interest in the administration of the donated funds.

The circumstances related to need of the shift of jurisdiction demonstrated even more that already in the second early stage, the non-profit sector, expressed by *extended*

religious charity initiatives, was affected by what neo-classical economists define as problems of agency and that these concerned above all funds granted *mortis causa*.

Moreover it has to be remarked that before the Chancellor, charity still did not deserve a separate legal discipline (as it happened before the Ecclesiastic Court), rather it had to be considered within the wider law of trust. It is true, the fact that the legal proceedings were initiated by private individual who had an interest in the fair administration of the fund, reflected the private dimension of the non-profit sector and its relationship with the trust discipline. No attempt was made to enforce a charitable use through an information brought by the Attorney General on behalf of the Crown.

The affirmation of the Court of Chancery over testament of personality increased the accountability of the Church and monasteries in relation to the administration of charitable legacies. This is true above all after 1529 when for the first time a lay man, Thomas More, served as Lord Chancellor.

Anyways, the ecclesiastical matrix of the Court of Chancery favored the maintenance of the elastic attitude towards vague and indefinite clauses mentioned in the acts establishing charitable trusts.

Moreover, the charitable trusts became even more frequent because of the enactment of the Statute of Uses in 1535 [Tudor, 1995]. Although this statute was strongly wanted by Henry VIII to stop landholders' constitution of trusts to avoid to pay inheritance taxes, it actually did not slow down the adoption of such legal device.

In fact, as Jordan [1958] explained, the preamble of the Act recited at length the abuses and national disadvantages flowing from the employment of uses, while the text of the Act cured the tax payment problem simply by confirming that the legal estate belonged to the *cestui que use* (the person who had the use).

So the Statute did not forbid the uses, as Henry VIII actually would have preferred, it just stated that the equity owner was treated as a "normal" legal owner (and not as beneficial owner) and as such he would have bore all the responsibilities connected with the land; in other words the statute ensured Henry VIII that someone would have paid the taxes.

Now, the consequence of conceiving the *feoffee* as the legal owner implied that possible cases would have been dealt with before the Common Law courts. Yet, it remained possible to separate the beneficial interest from the legal title and therefore, the competence

of the Court of Chancery resisted. In fact, it was held that when the trust was active, when real and active duties were vested in the trustee in relation to the beneficiary, the act did not prohibit, as was the construction of the statute when a use was established for a term of years [Jordan, 1958; p. 111].

Put it differently, as the scope of the Statute was just that of striking cunning landholders, if the trustee were not simply a *prestanome* but was actually a person charged with doing something that the *settlor* needed, then the use would have been dealt as conferring equitable interests and the Court of Chancery would have decided possible cases.

Therefore, the old principles continued to be in force under a different perspective represented by the conception according to which equity cares "*to the intent rather than the form*" [Stalteri, 2002].

In the same period Henry VIII broke up with the Catholic Church (1529-1536) and initiated a process of Reformation aimed at vanishing the existing ecclesiastic privileges. The distrust against the Church was due to several reasons, both personal of Henry VIII himself and political.

To begin with, the king instituted a royal commission charged with reporting the conditions of Monasteries that in the meantime had gradually lost their good reputation; "The commissioners reported about one-third of the houses to be fairly well conducted, some of them models of excellent management and pure living; but the other two-thirds were charged with looseness beyond description. The number of inmates in some cloisters was kept below the required number, that there might be more money to divide among the monks. The number of servants sometimes exceeded that of the monks. Abbots bought and sold land in a fraudulent manner; gifts for hospitality were misapplied; licentiousness, gaming and drinking prevailed extensively. Crime and absolution for gold went hand in hand. One friar was said to have been the proud father of an illegitimate family of children, but he had in his possession a forged license from the pope, who permitted his wandering, "considering his frailty." Froude, in commenting upon the report, says: "If I were to tell the truth, I should have first to warn all modest eyes to close the book and read no farther."" [Wishart, 2006]

The report led the Parliament to order the suppression of all the monasteries. Although such Act could not be considered as legislation concerning charity, in the matter of facts it involved charity for monasteries being institutions strongly involved in providing social/public services.

Other than demonstrating a negative attitude against the Church as administrator of charity funds, the Tudor Government (1485-1603) intervened also to exclude religious

purposes from the (legal) conception of charity. This normative better reflected the Ryan [1908] definition of charity which, since that the adoption of the normative itself, more and more lost its religious dimension on behalf of a socio-economic one. Thus, while *strictly religious charity* had basically lost its importance, the *extended religious charity* resisted only to the extent to which certain donations were still motivated by religious feelings.

In particular, with the adoption of 23 Henry VIII cap. 10, in 1532, the government disciplined the endowment of chantries. It provided that all feoffments made, *inter alia*, "to uses and intents to have obittes perpetuall, or a conintuall service of a Priste for ever" were declared void, being much prejudicial to the King […] and land so conveyed was to escheat[10] to the mesne lord.

In 1545, another normative intervention established that the endowments of chantries had to be appropriated to the Crown[11]. King Henry VIII had to convince people that the funds would have been used for charity purposes.

As on the death (1545) of Henry VIII the right of the Crown to appropriate chantries had lapsed, in 1547 Edward VI proceeded to restore it[12]. Yet, the King gave much more importance to the religious aspects than to the questions related to maladministration.

Such kind of legislative activity conferred to the agency problems of charity a new perspective that concerned at least three aspects.

The first was related to the interests of donors. These were no longer free to choose for which purposes their property had to be used so that the private dimension of charity became restrained. The circumstance by which property devised for religious purposes had to be transferred to the Crown implied a strong public intrusion in charitable doings. It is clear that Tudor Government was meant to take advantage of the private benevolence for facing the critical economic and social conditions of their times. In practice, the interests of the donors became compulsorily connected with those social duties expected to be executed by the State.

[10] Escheat is a common law doctrine that operates to ensure that property is not left in limbo and ownerless. It originally referred to a number of situations where a legal interest in land was destroyed by operation of law, so that the ownership of the land reverted to the immediately superior feudal lord. Most common-law jurisdictions have abolished the concept of feudal tenure of property, and so the concept of escheat has lost something of its meaning. Even in England and Wales, where escheat still operates as a doctrine of land law, there are unlikely to be any feudal lords to take property on an escheat, so that in practice the recipient of an escheated property is The Crown. Wikipedia, http://en.wikipedia.org/wiki/Escheat

[11] 37 Henry VIII cap. 4.

[12] Statute I, Edward VI cap. 14.

The second aspect concerned the shift in the administration of the funds. The suspects over Church administration of charitable legacies, translated into the mentioned three normative Acts and the fact that after the Reformation "the objects of charity were to become more secular as the majority of Englishmen reflected less on the fate of their souls and became more concerned with the worldly needs of their fellow men" [Jordan 1958, in Jones 1969], marked an important step towards the preference of a secular charity. The connection between the first and the second aspect was represented by the fact that the interests of people in public services was not only a consequence of the statutory prohibition to dedicate funds to religious scopes, but also a consequence of an inward change of their preferences.

The third aspect also regarded the shift into the administration of charitable funds. The mentioned statutory provisions already suggested the participation of the King into the supplying of charity. Yet, this involvement was not only limited to the appropriation of the properties devised for religious purposes, but was also promoted by specific statutory legislations.

As seen, the dissolution of the monasteries was followed, other than by legislative provisions aimed at disciplining private charities, even by others concerned with establishing public units for poor relief.

These Acts were extremely important since they consecrated charity on a two-fold dimension: public and private. The Welfare State was the result of this public-private partnership initiated by the Tudors (1483-1603).

In particular,

> "by the Act of 1536 (Henry VIII c. 25), the churchwardens were to raise charitable contributions for the relief of the poor within their area, thus being the first to be made statutorily responsible for the poor. The voluntary nature was largely transformed into indirect compulsions in 1552 by the next Act (5 & & Edw. VI. C), which also order the appointment for each parish of two collectors". Compulsory measures were definitely adopted in 1563 (by 5 Eliz., c. 3), although the contributions were still termed "charitable alms". With the codifying Act of 1572 (14 Eliz., c. 5) , we have the first statutory appointment of "overseers" who were to be associated with the "collectors" in each parish. An important development was shown by the Act of 1576 (18 Eliz., c. 3) which directed the justices of the peace to " appoint and order stocks of wool, hemp, flax, iron or other stuff", in order that the able bodied poor should be set to work there on

(The stock thus produced could then be sold and the profits used to purchase supplies for the direct relief of indigent).

> Nearly a generation then passed with only minor changes in the Poor Law, until the great scarcity of corn in 1594-1598, causing the price at one period to be nearly trebled, resulted in disturbances and general distress. This led to the consolidation of the legislation of the previous half-century by the Act of 1597 (39 Eliz., c. 3); though incorporating little fresh matter, it aimed at a drastic enforcement of the Poor Law throughout the country. The Act of 1601 (43 Eliz. C. 2) was practically a re-enactment (with trifling alterations) of the temporary Statute of 1597 and still forms the basis of our English Poor Law.

(In fact, the 1601 Act – 43 Eliz. C. 2 – extended the tax base by adding categories of people obliged to pay).

> That the machinery provided in 1597-1601 was shortly afterwards put into operation in the more populous parishes is generally regarded as probable, though it must remain largely hypothetical until the parish records in many counties have been catalogued. It is more likely that the majority of rural parishes, then very small population, did not need a compulsory poor rate until a generation later at least; and it is almost certain that the number of country parishes which had adopted a definite scheme of relief before 1597 were very few [Emmison, 1931]".

To present schematically the organization of the parish in relation to poor relief, one may illustrate as follows:

a) the Churchwardens were elected at the Vestry meeting each Easter and appointed for one year. The Vestry was what would today usually be called a parochial church council. By 1536 Churchwardens began responsible to collect resources for poor relief. In practice, their job consisted in establishing the amount of the poor rate, who had to pay the rate and, therefore, keeping and organizing the registers of the parish-church they worked for.
b) the Justices of the Peace was an office whose origins dated back to 1195. Richard I in that year commissioned certain knights to preserve the peace in unruly areas. They were responsible to the King for ensuring that the law was upheld. They preserved the "King's Peace", and were known as Keepers of the Peace. The title Justices of the Peace derives from 1361, in the reign of Edward III. An Act of 1327 had referred to "good and lawful men" to be still appointed by the Crown in every county in the land to "guard the Peace".

As concerns poor relief system, the justices of the peace had to appoint the overseers of the poor and play a supervisory role on the job of the latter;

c) the Overseers of the Poor were actually instituted only in 1597. In fact, the above mentioned Act of 1572 required each parish to appoint an Alms Collector, and a Supervisor of Rogues and Vagabonds; these two offices were only later combined into that of Overseer of the Poor.

   Basically, the Overseers of the Poor were nothing but Churchwardens charged with the administration of the poor law system. So the difference consisted in the fact that the former had a specific competence.

§1.3 THE SOCIOLOGICAL CHARITY

The changes related to the interests to be pursued – from *strictly* and *extended religious* interests to sociologic interests – and to the subject charged with the administration of charitable funds – from the Church to laic and public individuals or institutions – shaped new dimensions of the agency problems.

On the private side of charity, it has been seen how both the distrust in Church administration of charitable funds and the awareness that salvation did not depend on the bequests left to Church for *pious causes* led people to put their properties into secular hands. Anyways, it must be added that, although the intentions continued therefore to be those of granting relief to needy people, already since XIV century it was developed the idea that an indiscriminate charity would have brought more problems than resolving the existing ones.

Complaints on this regard referred to the fact that there was a significant number of able-bodies who used to take advantage of charity notwithstanding their proper condition to work and, therefore, proper condition to look after themselves.

Now, apart from the discussion on the abuses of the beneficiaries, the shift into secular hands did not resolve problems of agency whereas also lay executors used to not behave according to the wishes expressed either by the testator and by living donor. In the sixteenth century, in fact, "a process of separation between donor and donee entered English dealings with the poor" [Fishman, 2005]. In other words, it has to be underscored that the majority of *inter vivos* charity was not longer characterized by a direct almsgiving (to the Church or the beneficiaries), but as well as in case of wills' provisions, it began to be realized through *executory* donations. This of course implied that the interest of the donor had a stronger voice as he/she could actively complaint for questions concerning administrations of the funds while this could not happen in *mortis causa* charity.

Whether the trust – that as seen earlier was the legal scheme adopted for charity initiatives of more significant value – was established by an *inter vivos* or a *mortis causa* act, the Court of Chancery did not prove able to look after maladministration of charitable funds. It is true, its efficiency had lasted only for few years when it was distinguished by a speedy and simple procedure. After that, pleading progressively became more verbose and delaying

motions. The most complicated problem regarded the right to bring suit before the Court of Chancery. Differently from private trust, in fact, the charitable trust did (and does) not involve a definite class of beneficiaries. Representative actions were often challenged by defendants who objected that the representatives were not "apt parties".

Exigency of certainty and justice[13] in relation to charity demanded a specific normative intervention that would have established an efficient procedure. Moreover, the urgency of a discipline was justified by the fact that England was experiencing very difficult economic situations and private charity was needed as the State was not able to provide and guarantee the basic social-public services. In fact, taxation for poor relief was vehemently resisted because it was taxation and, as seen above, only in 1563 charitable contributions were made compulsory.

Thus, in 1597, the 39 Elizabeth I c.6 was decided. This provision other than being considered as the first of the Acts that would have formed the Poor Law, solved problem related to the right to stand; indeed, the control over charity was referred to the Crown which became "enabled to initiate and sustain a thorough investigation of charitable uses" [Jones, 1969].

The procedure implied that the Court of Chancery would have issued a commission that would have carried out inquisitions with the support of a jury and of the parish officers.

This Act was soon repealed for it was too imprecise and, even more important, for it did not provide the right for the interested people (that is, the people interested in the fair administration of the charity) to challenge the members of the jury who might be personally interested in the funds. The right to challenge jurors was in fact guaranteed by article XXIX of the Great Charter[14]. The abrogation took place through the adoption in 1601 of the Statute of Charitable Uses.

[13] That is the fundamental functions of law.

[14] "No Freeman shall be taken or imprisoned, or be disseised of his Freehold, or Liberties, or free Customs, or be outlawed, or exiled, or any other wise destroyed; nor will We not pass upon him, nor condemn him, but by lawful judgment of his Peers, or by the Law of the land. We will sell to no man, we will not deny or defer to any man either Justice or Right".

As regards the agency problems concerning the public side of charity it has firstly to be observed how before 1597-1601 only few parishes had adopted the scheme of poor relief envisaged by XVI century legislation[15].

For being resources obtained from compulsory taxation – and not therefore voluntary contribution or voluntary investment as in the case of business corporations – the analysis of the relationship between property owners (tax payer, p*atrons*, principals) and parishes (public managers, agents) conducted through the agency theory assumptions, must be integrated by some observations.

In brief, to explain the differences between the agency problems occurring in private firms – whether non-profit or profit seeking – and public administration, one may set out from the opinion of Luby [2009] according to which:

> elected officials (the agent), acting through their financial managers, make policy choices to divert the resources of the taxpayers (the principal) for personal gain. In this context, personal gain refers to the elected official increasing his/her reelection chances through the use of an upfront refinancing savings structure thus reducing the necessity of having to make potentially unpopular policy choices such as raising taxes or cutting government services.

Thus, the elected officials in the Tudor period were not really elected. The Justice of the Peace were appointed by the Crown and the Overseers of the Poor were nominated by the Justices of the Peaces themselves. An administrative system like this implied that in the matter of facts it was hard to reason through agency theory findings so far as the supposed principals did not choose their agents.

So, the lack of the voluntary element and the statutory impositions of the agents represented basically other problems than those of agency, that is public law problems with particular reference to democratic aspects.

Yet, frequent were the cases within which people donated property to parishes voluntarily. That is, they chose as their agent the public institution instead of a private individual or organization. The interests of these donors in encouraging good behavior (from the public administrators) and personal industry among paupers (so in avoiding indiscriminate charity) was reflected by the conditions the donors themselves used to provide for in their deeds [Birtles, 1999].

[15] See the description of Emmison [1931] above p. 29

Accuracy requires to remind that obviously the money and benefits arising from private charity could not used to offset the rates. So, donors who chose to put into parish hands their personal properties still were obliged to pay the poor rates.

§1.4 THE WELFARE SYSTEM CHARITY

The legislative process – for which Queen Elizabeth I [Reign 1558-1603] aimed firstly at establishing a private-public partnership for charity services and secondly at speeding up the efficiency of this system – reached the final consecration in 1601, with the decision respectively of the Poor Law Act and the Statute of Charitable Uses.

As seen above, the former was at the same time an evolution of the 1597 Elizabeth 39 c. 3 and a device for consolidating all the previous Acts containing practices related to the organizational aspects of poor relief; whereas the latter was an evolution of the 1597 Elizabeth 39 c. 6, thus concerned with the control over the administration of charitable funds. In other words, the Statute of Charitable Uses was specifically concerned with agency problems.

The consolidation provided by the Poor Law Act 1601 can be outlined as follows:

a) the church-parish was the governmental unit responsible for poor relief and with imposing a tax (the poor rate) for levying public resources for charity.

Therefore, the Elizabethan Poor Law was directed to restore somehow the theory of the British rule according to which "an established Church had the legal responsibility of providing nearly all religious, cultural, human service and educational activities" [Hammack, 1998];

b) the relief of the poor was placed in the hands of Churchwardens and of two to four "Overseers of the Poor", who were appointed annually by the justices of the peace, and drawn from the substantial householders of the parish. The Overseers of the Poor were in fact unpaid. Their duties were to levy and collect the poor rate and to see that it was actually expended for charitable purposes.

The role conferred to these figures represented a major change with the past. Previously, the responsibility of initiating measures for relief rested on the head officials of the towns or the justices of the peace in the parishes. Instead, the justices of the peace assumed a supervisory role. For most of the sixteenth century voluntary assistance was the

source of fund and their locus was in the church[16]. Poor relief became now part of the civil power [Fishman, 2005].

The poor relief system based on the parish unit has also been seen by economic scholars as a form of insurance. People were willing to pay a rate in the awareness they might need relief at some time in the future.

The efficiency of this system could be explained by the fact that the classic problems of insurance, that is moral hazard and adverse selection, were not really suffered: "there is moral hazard when as the result of being insured against a specific event, an individual changes his or her behavior in such a way as to make the event more likely. In the context of poor relief, this might involve feigning either illness or the inability to find work. But moral hazard was un likely to have been a severe problem in small communities where potential recipients were well known to relief authorities. Adverse selection occurs when providers of insurance cannot distinguish high from low risk individuals. Under the old poor law this was not a problem because all individuals were covered" [Solar, 1995].

The Statute of Charitable Uses 1601 aimed at providing a mechanism to make trustees more accountable for the appropriate administration of charitable assets deriving from donations.

To begin with, the Crown restored the role of the Church in charity matters.

This intention of the Queen can be detached at paragraph 4 of the Act where it was provided that the Bishop of the Church of England headed every investigation against charitable boards and directors.

The involvement of the Bishop was actually only an element of the articulated procedure prospected by the legislation.

In particular, the Bishop was one of the five commissioners that had already introduced by the 1597 Elizabeth 39 c. 6 Act.

[16] According to MacKay [2009], "it is often plausibly but incorrectly asserted that the dissolution of monasteries rendered Poor Law necessary". The confiscation of the religious houses, however, only affected a few localities. These establishments were, moreover, rather great inns than places devoted to the relief of distress. The philanthropic legislation of Elizabeth, as evidenced by Acts for the encouragement of charitable endowments and compulsory assessment for the poor, seems to be part of a general policy, and though possibly it may be referred to the Legislature's desire to show that the interests of the poor, as then understood, were not to be allowed to suffer by the ecclesiastical revolution, the dissolution of monasteries was not in itself a sufficient economic cause to warrant the universal compulsory assessment which then began.

Once the commission had been issued by the Court of Chancery it would have discussed the allegations in a public hearing together with jury and the parish officers.

The latter were represented by the Churchwardens and by the Overseers of the Poor and they played a very fundamental role in the decision making process of the commissioners. In fact, they were required to provide all the evidences of all the hypothesis of charity maladministration which they were aware of.

This meant that the control over charity was exerted at a local level where the parishes acted as government agencies. In other words, every county had its own Chancery Court that, when required by the Crown, issued the commission for the inquisitions over charitable funds. The commission was formed by local parishioners that had to know quite well the situations that occurred in the parish where they lived in. Similarly, a good knowledge of the parish life was expected to be held by the Churchwardens and the Overseers of the Poor.

The decree issued by the commissioners could be appealed by the interested people before the Court of Chancery.

Obviously, some peculiarities had to occur when the investigations carried out by the commissioners involved parish officers such as the Overseers of the Poor, Churchwardens, Vicar etc. As seen earlier, in fact, it could happen that bequests or donations were accomplished on behalf of the parish which, therefore, was expected to act as trustee.

In fact, actually, one of the problems of the Poor Law, of which the charity commission procedure was a part, was local corruption at the parish level. Theoretically, if a donor to a trust to assist the poor found that the churchwardens or overseers were misappropriating the funds, the donor could demand that a commission be set up, and such commission would if empanelled investigate[17].

Other than the establishment of a new procedure – that as mentioned before had already been partially introduced by the 1597 Elizabeth 39 c. 6 Act –, the 1601 Statute helped to draw definitively the outlines of the "legal" definition of charity. In fact, the

[17] That happens today in the United States all the time. A local authority is accused of corruption and in defense, the mayor or some other official appoints a group to investigate the charges or the matter is turned over to a grand jury to investigate.

jurisdiction of the commissioners would have covered all the uses set out in the Preamble of the Act[18]. By the way, the catalogue was never regarded as exclusive.

According to Stalteri [2002] the Statute of Charitable Uses introduced a new methodological technique of selection that vested the judge with the power to recognize or not the charitable nature of a certain organization.

[18] Whereas Landes Tenementes Rentes Annuities Profittes Hereditamentes, Goodes Chattels Money and Stockes of Money, have bene heretofore given limitted appointed and assigned, as well by the Queenes most excellent Majestie and her moste noble Progenitors, as by sondrie other well disposed persons, some for Releife of aged impotent and poore people, some for Maintenance of sicke and maymed Souldiers and Marriners, Schooles of Learninge, Free Schooles and Schollers in Universities, some for Repaire of Bridges Portes Havens Causwaies Churches Seabankes and Highwaies, some for Educacion and prefermente of Orphans, some for or towardes Reliefe Stocke or Maintenance of Howses of Correccion, some for Mariages of poore Maides, some for Supportacion Ayde and Helpe of younge tradesmen Handicraftesmen and persons decayed, and others for reliefe or redemption of Prisoners or Captives, and for aide or ease of any poore Inhabitantes concerninge paymente of Fifteenes, setting out of Souldiers and other Taxes; Whiche Landes Tenementes Rents Annuities Profitts Hereditaments Goodes Chattells Money and Stockes of Money nevertheles have not byn imployed accordinge to the charitable intente of the givers and founders thereof, by reason of Fraudes breaches of Truste and Negligence in those that shoulde pay delyver and imploy the same…:

§1.5 THE POLITICAL CHARITY

The efficiency of the system of poor relief designed by the Elizabethan Acts did not survive to the Civil War (1642-1660) as during this period there were far more important issues in the country to be resolved than the proper use of charitable assets. Utilization of charity commissioners declined [Owen 1964, in Fishman 2008].

In the words of Jones [1968], "the method of investigation established under the Charitable Uses Act 1601, could not efficiently function in a society whose gentry served with reluctance as commissioners, whose jurors resented their jury service, whose parish officers were lax and inefficient, whose central government was pathetic, and whose Chancellor would not oppress any man for the sake of a charity and bitterly regretted the privileges which his predecessors had afforded to charitable trust".

This led to two consequences. The first was that the Justices of the Peace and the Overseers of the Poor in each locality were left to interpret the provisions of the 1601 Poor Law Act as they thought best [Rose, 1971]. The decline of the commission jeopardized in fact the Governmental attempt to centralize the control over the administration of charities, increasing the degree of local discretion.

The second implied that

> instead of the charity commissions, which depended upon the energy and good will of neighbors, petitioners on behalf of charities used another procedure, the information, which was an appeal to the Attorney General. The attorney general as *relator* sought to enforce charitable trusts on behalf of an aggrieved individual or charity through an action in Chancery. By this time, many of the Commission proceedings wound up in Chancery on appeal, so one of the initial advantages of the commissions, an expeditious hearing, was lost. The information was felt to be a more efficient procedure, and the commission procedure fell into disuse. Thus, the Commission procedure was undermined by the legalization of the process, the use of traditional channels of litigation to prolong and to change the internal result [Fishman, 2008].

Moreover, the Attorney General, representing the Crown in its character of *parens patriae*, was the protector of the charities (as the property of the public), and could sue *ex officio* by information for the reform of abuses to which charities might be subject. It can be said that the duty to protect the charity had to involve also the duty to control charities, in the sense that he had the duty not only reform the abuses but also to avoid them.

Anyway, since 1680 to 1760 England experienced the “dark age” of philanthropy. One reason could be that donations for social purposes began to be considered as violations of the heir’s at law rights so that judges demonstrated a stricter attitude in recognizing those privileges that had been happily recognized during the previous century. According to Goose [2006], an expanding tax base and increasing per capita poor relief payments swung the balance decisively towards formal relief.

The distrust against charity was then expressed by legislation. The Mortmain Act of 1736 avoided devises of land to charity and vested the property so devised in the testator’s heir at law or (exceptionally) his next of kin.

During the “dark age of philanthropy” the income of charities still continued to increase, this not being due to donations but to the increased value of land, urban and agricultural. That is, the lands that had been devised to non-profit organizations in the previous century used to be given on rent on behalf of third parties. The increased value of the land would have ensured a high fee.

The decline of donations meant actually the decline of institutions of new charitable trusts. In the matter of fact donors still used to direct their flow of benevolence those non-profit organizations established (mostly) during Tudor or Stuart times or to the familiar charities for the poor.

Yet, within in this period it became common that charities were developed through voluntary subscription forms. These fundamentally consisted in a plan or in a project to be financed on voluntary basis, in a certain sense resembling the model of joint-stock company. For example, the *The Lunatic Asylum*, out of Bootham Bar, was built by general subscription, in 1774, from a plan prepared by Mr. Alderman Carr. The subscription list formed by about three hundred names included a number of amounts as high as 500 pounds and many of 100 pounds [Owen, 1964].

On one side, the (new) practice of launching voluntary subscriptions entailed the replacement of the individual doer of good works with philanthropic associations.

On the other side, it implied of course different legal aspects to be regarded. In fact, according to Owen [1964] “a children’s home maintained by voluntary subscriptions operates on an entirely different basis in law from an orphanage supported by income from funds in trust. In the former the law is relatively uninterested, making few demands and

offering few concessions, but around the charitable trust, the charitable benefaction in perpetuity, has grown up one of the more demanding and complicated (as well as lucrative) branches of equity practice" .

Owen's observation recalled the different perspective of the agency problems. While in charitable trusts the donor would not have retained control over the organization, in voluntary organizations subscribers would have sit on the board of directors or, at least, would have had voice in administration matters, for instance by electing the directors themselves.

By the end of 1700, the Industrial Revolution posed problems for philanthropists different in degree and kind from those they had faced in the past. In particular the great social and economic changes implied an unceasing growth of the population and a high percentage of unemployment or low wages.

Charity therefore could no longer reflect that economic phenomenon – of the earlier century – for which generous Englishmen by *inter vivos* or *mortis causa* acts decided to help local indigents whose poor conditions were well known. In other words, the danger of professional mendicant became significant so far as the beggar was more often a stranger than a known neighbour [Slack, 1990].

This led to two consequences. The first was that philanthropic donations were much more careful and, therefore, no longer open-hand as before, while the second was a greater involvement of public activities for what concerns the relief of the poor.

The carefulness of the donations might be demonstrated by the practice of constituting charity on the basis of voluntary subscriptions. As this scheme would have ensured the contributors to control the entity, the help would have been guaranteed only to selected people.

The second consequence was realized through new structures and new approaches.

As concerns the structures, the government established several charity commissions charged with investigating on the financial status of existing charitable trusts. The aim was to identify inefficient organizations so that the State could recover the relevant assets and provide public services reducing the need for public monies [Fishman, 2005].

The idea for which the government had to be the primary source of support for the indigent implied that these new structures – that is the charity commissions – would have

functioned through a more scientific approach. In fact, probably due to the influence of the Enlightenment, "rational and purposive control based upon measuring, counting and observing" [Fishman, 2005] became the fundamental parameter to which commissioners had to refer for adopting procedures on behalf of the charitable trusts scrutinized.

Of course, other than representing a parameter for the commissioners, such empirical techniques – which actually had already been introduced in 1760 since the accession of George III, who promoted the institution of a Royal Commission of Inquiry – represented also an important parameter for legislation.

The first inquiry on charitable trusts was promoted by Thomas Gilbert – a member of Parliament – in 1780. The inquiry did not actually establish a commission but it required ministers and church-workers to file data concerning the activity of charities. The returns would have been examined by a committee of the House of Commons.

Although these reports were incomplete and inadequate to have a clear idea about charitable abuses and although these were hardly settled within the Court of Chancery, Gilbert's initiative was important as it recalled the attention on the accountability of non-profit sector.

The second inquiry was supported in 1816 by Peter Brougham, a very important lawyer and figure in the English public life. He actually proposed a Select Committee to investigate on the London city charities. As well as concerns the Gilbert Act, no commission was actually established.

The Committee's report found many abuses. When he talked about the report in the House of Commons, he pointed out the reasons for which charitable assets were lower than they should have been:

1) Trustees had insufficient powers for the profitable management of the funds under their care. For example, they could not sell or exchange lands in the middle of towns.

2) There was a diminution of revenue because of loss of property through defects in the original charitable instrument and a consequent extinction of the trustees without the possibility of supplying their replacements.

3) Trustees exhibited negligence in all its branches, including carelessness, ignorance, indolence, and omission.

4) Various kinds of willful abuses.

In the light of his findings, Brougham proposed to extend the inquiry also to the territories outside the city of London assuming that the data in that way obtained would have not only underscored the necessity of a legislative intervention but also shaped the possible public policies to be taken.

Thus, after several debates in the Parliament, the government adopted almost all of Brougham's positions and in 1819 the Committee was expanded into a Select Commission on Public Charities.

As mentioned above, the establishment of the commission depended on the suspects over the administration of charitable trusts and on the fact that the Crown wanted to take a dominant position in the provision of public services. In the matter of facts, the establishment of charity commissions depended also on the fact that there was not effective legal device to exert control on charitable trusts.

The legal problems related to the prevention of maladministration of charitable funds in early nineteenth century reflected those that had brought to the adoption of the Statute of Charitable Uses in 1601. Even in that case, in fact, there was an establishment of commissioners and even in that case the establishment of commissioners were due to the inefficiency of the Court of Chancery and to the practice according to which the relator of the information brought in the person of the Attorney General would have had to pay all the costs if the suit was unsuccessful. The restoration of a charity commission would have facilitated the adoption of decrees aimed at correcting those charitable trusts that were found inefficient.

To be more accurate, in 1812 the Parliament had decided the (Sir) Romilly Act. This legislation, other than being a further confirmation of the concern over charities' administration, had introduced a even simplified procedure for bringing suits against charitable trustees. In particular, the Act established that any two or more persons on obtaining fiat or certificate of the Attorney or Solicitor General were allowed to present a petition into the Court of Chancery.

"Any two or more persons" had to mean that it was not necessary that parties needed to have an interest in the charity in order to initiate the procedure. But, much more importantly, parties would have not bore high costs of the proceeding as the Act established

that the Chancellor or the Master of Roll would have decided thorough a summary way, that is in a much less expensive way.

The spirit of this legislation was well explained by Sir Romilly himself: "because relators need have no interest in the result of the decision, it could not be expected that such a person would be disposed to put himself to great expense which this would occasion, for the public benefit […] it would be difficult to find a man so public-spirited as to advance a great sum of money to carry on a cause in which he had no personal interest, imputing gross misconduct to a neighbor, with a chance of recovering a part of his expenses after so great a lapse of time".

The Act would not have ensured impartial management, for any two or more persons being able to present petitions under it, whether they were in anyway interested in the charity or not, vexatious suits were continually brought by mere outsiders for the sake of the costs which they might get out of the funds of the charity [Edmund, 1887], for this reason the legislation was rarely applied[19].

However it represents the occasion to understand firstly that already in the nineteenth century the idea for which charity was a "public thing" was very well established – only the Attorney General could in fact bring suits into the Court of Chancery – and, therefore, stronger than the Romilly legislation which to a certain extent conferred a private character to charities. Although it was true that he wanted to protect a public interest, he pursued this scope by conceding a purely private remedy whose misuses led legal professional to re-conceive charity only on a public dimension.

Secondly, the idea for which charity had to be public affair would have resisted during centuries and against the more and more pressures exerted by thinkers conceiving charities as a private affair. Indeed, in the United States the fear of a proliferation of suits had always been eschewed by conferring to the Attorney General the exclusive right to bring

[19] Technically it was interpreted very restrictively by Lord Eldon, in Attorney General v. Green, 1820 . In 1868, in Braund v. Earl of Devon, Mr. M. Ware said: "the first objection to the bill is the want of interest in the Plaintiffs. They are not legatees, they are merely objects of the charity, and, except as such, have no interest in the testator's assets. The way of obtaining relief in such case is by information, not by bill. The Plaintiffs cannot properly represent all the objects of the charity, which is not confined to the special class to which they belong, but extends to children of officers in the navy, and to the public generally. No one but the Attorney-General can represent such a body. The allowance of this bill would introduce a very inconvenient practice, because in every case where a testator gives a legacy to a charity, some of the objects of the charity might file a bill for administration of the estate without the leave of the Attorney-General: Magdalen College, Oxford, v. Sibthorp n(1) ; Nash v. Morley n(2)" .

suits against charitable directors. This approach, as it shall be seen in Chapter VI, would have suffered some exceptions, as for example the doctrine of the special interest.

Thus, for not being the Romilly Act really applied, the Parliament decided to take on the Lord Brougham Commission for the prevention and correction of charitable abuses. The concept of Commission is slightly different from the one of Committee. The Committees, as they were those instituted in 1780 (by Gilbert) and 1816 (by Brougham), are "one or more member of a legislative body to whom is specially referred some matter before that body, in order that they may investigate and examine into it and report to those who delegated this authority to them". The Commission is "an instrument issued by a Court of Justice, or other competent tribunal, to authorize a person to take depositions, or do any other act by authority of such court or tribunal" [Bouvier, 1843].

So, whereas the function is similar, that is to investigate, what actually changes is the degree of independence, higher of course as concerns the commission and the power to adopt decision in relation to the investigation. While the Committee could only write reports and present them to the Parliament, the Commission could even issue decrees, injunctions, etc.

Accordingly, the last instance of commission before 1819 was evidently the one established in 1601 by the Elizabethan legislation. Yet, several differences occurred between that and the 1819 one.

To begin with, the Charity Commissions of 1601 were not permanent organizations, nor were they responsible for overseeing charities as they were instead the 1820 Commissions. They were organized by parish and only came into existence when somebody complained that a charitable trust was being misused. In fact, while the 1601 Commissions were issued by local Court of Chancery the 1820 Commissions were issued by the Parliament. After the 1601 Charity Commission had been empanelled, heard evidence, reached a decision it would dissolve. Another such Commission would be created if there was another complaint.

Secondly, the 1820 Commission operated through the scientific approach said above. This means that Commissioners had to "determine the amount, nature, and application of the earnings of estates or funds; and whether by change of circumstances or by other means, the trusts could not be beneficially applied for their original purposes. The Commissioners

prepared annual reports of their deliberations, which were published as Parliamentary Papers" [Fishman, 2005]. The approach adopted by the Commissioners established by the Elizabethan Statute was far less technical for not being provided in the Act itself any reference to obligations of detailed report.

The third difference regarded the power of the commissioners. For the Elizabethan legislation, they had to make orders for the due and faithful employment of the property given to the trusts. These orders had to be certificated into the Court of Chancery and the Lord Chancellor was the responsible to make provisions for the due execution of the orders. This implied that the commissioners were constantly subjected to the supervisory jurisdiction of the Chancellor.

Any interested person who was aggrieved by the orders could challenge them before the Court of Chancery.

Differently from the 1601 provisions, the 1819 Commissioners were acknowledged with a direct power to correct the trusts. The CAP. XCI, Geo. III Act, 10 June 1818, in fact, established that

> "*the said Commissioners or any Three of them shall, once in each Half Year during the Continuance of the said Commission, report and certify, in Writing under their Hands and Seals, to The King's Most Excellent Majesty, and to both the Houses of Parliament, their Proceedings, touching the Amount, Nature, Management, Application and Appropriation of such of the aforesaid Estates and Funds as they shall have inquired and examined into, and also what is the Nature of such Estates, and Funds Respectively, and the actual annual Produce thereof, and what is the actual annual Value thereof, and in whose Possessions as Tenants thereof, any Part thereof conflicting of Lands, Tenements or Hereditaments shall be, adding at the same time such Observations as shall occur to them respecting such Mode as they shall deem most effectual for the recovering of such Part or Parts of such Estates or Funds as shall appear to them to have been applied in breach of the several Trusts created in respect of the same, or shall appear to have been omitted to be applied in pursuance of such Trusts, and subjoining such Suggestions as may seem to them expedient respecting the most effectual Mode of securing such Estates and*

Funds, and their respective Produce, against any future Misapplication thereof".

The Statute moreover provided that the interested parties could act against the acts of the Commissioners within six months the "Fact committed".

The Commissioners had operated for two decades and the first report was published in 1850.

The charitable trusts who had a visitor did not fall into the inquisition of the Charity Commissioners. Yet, even those were found not in order. In fact, Fishman [2005] refers to two big scandals which occurred just during the time that the Charity Commissions operated.

The XIX century charitable trusts involved in shameful situations were the Rochester Cathedral Grammar School and the St. Cross Hospital. Both were managed by the Church and expected to be supervised – and therefore visited – by the Bishop.

The public as well as political attention focused on the former almost by chance. The headmaster of the school was indeed on of those conceive the legal litigation as "raison d'etre". His name was Robert Whiston and his complaint regarded the fact that the dean of the Cathedral – within which the grammar school was established – on one side did not adjust the stipends of the undergraduate students according to the inflation while, on the other side, he increased his own emoluments.

The argument of the Dean was that he was not obliged to change the amount due to student as it was originally established by the statutes of the Cathedral.

After endless legal battles, letters to the press, Whiston firstly succeeded to convince the Dean to take some step towards the augmented scholarships and secondly to lead the Parliament to adopt the Endowed School Act according to which schools could no longer be controlled solely by the dean (and by the chapter) but by a diverse governing body.

Also as concerns the St. Cross Hospital a misappropriation of funds generated by the properties of the charitable trusts was found out. This time, the suspects on the charitable trust were steered by the press and brought behalf jurisdictional authorities by Henry Holloway, a churchwarden of the parish where the hospital was located. In particular, the opportunistic behavior of the trustee consisted in taking advantages of the fines paid by tenants to lease lands belonging to the hospital itself. The fine system was a practice that

basically functioned as follows: the tenant paid a sum of money in order to get a low rental term; for example one paid £ 15,000 and he obtained the lease of £ 6 per annum. So the 15,000 flowed in the trustee pocket and the rent was employed for the charitable trust purposes.

The manager of the Hospital claimed that he was entitled by the by-laws to appropriate the revenues left after having satisfied the purposes of the charitable trust itself. This argument was discredited by the Court of Chancery which deemed the by-laws of the hospital as establishing exactly the opposite.

What was important in these two cases was not really the procedure followed to render the trustees accountable. Both the cases relied on an information filed by the Attorney General on behalf of the interested persons (Whiston and Holloway) and this did not represent a novelty.

On the contrary, it was interesting the relation between surplus and (the concept of) charitable activities. In not even one of the cases the Court gave an opinion concerning this. In the first case because Whiston succeeded to resolve the question out of the tribunals and in the second because the Court focused on the interpretation of the by-laws rather than deciding if it was legally possible to appropriate surplus resources in a charitable trust context. The point was and is therefore to guess what the Court would have hold if the by-laws of the St. Cross Hospital had clearly established that the trustees were entitled to gain the surplus.

To be sure, from a legal point of view, charitable activities were identified on the basis of the object they pursued – that to some extent had to fall within the list of the Statute of Charitable Uses – rather than on the *nondistribution* constraint clause.

Still, as the law of trust applied, this envisaged that the trustees were forbidden to draw any economic personal advantage in the exertion of their function.

In 1853 the Parliament decided the Charitable Trust Act. This legislation established a permanent Charity Commission which would have functioned and worked according to the recommendations that the Parliament Committee of 1835 and the Royal Commission of 1849 made on the basis of the Brougham Commission Reports.

As regards the power of the Commission it can be held that they were very broad. Basically they were as broad as the powers of 1601 and 1819 Commissions. In particular:

a) no power of audit was given to the Commission, although it was authorized to require accounts yearly from the trustees of charities;
b) the sanction of the commissioners was made a necessary condition to judicial proceedings by any person other than the Attorney General in connection with any charity, except when the action was brought by the claiming adversely to the charity;
c) the possibility for a limited category of persons – limited as to avoid proliferation of suits – to apply directly to the Court of Chancery or to the County or District Court for relief concerning charity matters. In other words, there was no need for information or petition.

Yet, in 1860 the Parliament adopted an Act that would have entailed a significant change. The Commissioners, in fact, would have been granted with judicial powers.

Although further laws (Charities Act 1960, 1992, 1993 an 2006) were adopted by the legislative power, it can be held that the very structure of the Charity Commission has been held intact since its initial inception by the Select Committee of the House of Commons in 1835 [Elson, 2010].

§1.6 RESUME

The foregoing discussion has demonstrated how since the era of persecution until the XX century, the non-profit sector has been represented by charity activities. This means that during all this period non-profit institutions aimed at "relieving the physical, mental, moral, or spiritual needs of one's fellows". Yet, the motivations and the purposes that led people to donate changed and, at the same time, also the problems of agency and their relevant discipline changed.

In fact, in the very early stage of charity, for this was *strictly religious*, law did not intervene to regulate the administration of the given funds. The interest of the donors was supposed to be represented simply by the material transfer of the goods: I do give, and I do not expect anything in consideration. This situation had not to arise hard legal problems, as the majority of the donations were realized through direct almsgiving.

When the practice of donations increased, above all through *inter vivos* and *mortis causa* acts, the Roman and the Canon law soon identified the problems of agency in relations to those donations where the donors specified which use had to be done and envisaged provisions aimed at ensuring a trustworthy administrator (the Church) and a conferring to whoever had an interest to sue the secular individual/entity charged of mismanagement of charitable funds.

In this period charity was still religious based, however the fact that donors used to specify the employment of their funds suggested that they were interested also in contributing to a social cause. For this reason, in the previous paragraphs, the charity related to that period has been defined as extended religious charity.

In the XIII century, a papal Decree promised salvation to all those who made bequest for charitable purposes. Also the position of Church in the administration of the funds was strengthened.

The identification of many abuses from the Church led the English Government to secularize charities. This did anything else than moving the problems of agency from the donor/Church relationship to the donor/secular individual-entity relationship: "the creation of an independent English Church and the development of Protestant doctrines did not change the nature of man.

After the Reformation, petitioners still complained to the Chancellor about the misuse of charitable assets" [Fishman, 2008]

In fact, as also the secular trustee proved not that fair in the administration of charitable funds, people that felt jeopardized by such misbehavior began to look for justice within the Court of Chancery whose competence in charity matters had been consecrated by the employment of the institute of trust to make charitable donations.

The Lord Chancellor could offer a remedy that either the Common Law and the Roman Law did not offer: the specific performance.

The power of the Equity to enforce charitable trusts anyways had to crash against several legal issues and against the excessive formalization of the procedure. One of the legal issues was represented by the acknowledgement of the right to sue as the class of beneficiaries was normally uncertain (the poor, the sick, etc.).

This explains why Queen Elizabeth urged the adoption of the Statute of Charitable Uses that envisaged the establishment of a local commission every time there were suspects over the administration of charitable trusts. The commission could solve problems of administration by issuing orders whose execution was guaranteed by the Court of Chancery.

The Civil War (1642-1660) jeopardized the efficiency of the local commissions so that claims against the misappropriation of charitable funds were brought to the attention of the Attorney General through an information.

The intervention of such office into charity matters demonstrated of these economic practices had a public relevance.

During the XVIII century, England experienced the "dark age of philanthropy". This was due to the belief that charitable donations/bequests would have jeopardized the rights of the heirs.

One expression of such rationality and caution was represented by the practice of constituting charities through voluntary subscriptions which involved the direct participation of the contributors in the administration of the funds and, therefore, which implied a reduced exposition to agency problems. In particular, contributors would have been able to select the beneficiaries of the charitable activity.

Another expression of this rationality was the establishment of governmental commissions charged with examining into and correcting the inefficient charitable trusts

established in the national territories. The rational aspect of such inquisition was represented by the provision of specific parameters which commission had to refer to assess the efficiency of the organizations.

In 1853 the Charitable Trust Act was passed in the UK Parliament. This established a permanent Charity Commission whose very structure would have lasted to date.

§2. THE AMERICAN *NON-PROFIT*

The colonial experience with charity was generally favorable, but it was surely not uniform [Wyllie, 1959]. In particular, the reception of the English system as configured by the 1601 Poor Laws implied that some states such as Virginia and Maryland were more bent to conceive charity on a public dimension – therefore charitable activities had to be exerted by the state – while others such as like Pennsylvania, Massachusetts and other northern states went to some length to encourage (private) philanthropy.

Evidences of the first category of States were provided by Deutsch [1941] who maintained that

> "the settlers brought over with them poor relief principles and practices of the old country, which were applied in modified form to accord with the requirements and limitations of the new environment. The English settlements adopted the principle of local responsibility set down by the Elizabethan poor law of 1601, whereby each parish or town was responsible for its own needy" .

In fact, the scholar focused the attention on the many instances of governmental intervention for health care, poor relief and education.

It is true, not only the local parish but also other public agencies such as the county, magistrates, selectmen, overseers of the poor and even the colonial government were involved in charitable programs[20].

The public dimension of charity implied that the funding relied on taxation as demonstrated by the 1702 Act of New York City assembly through which city authorities were permitted to raise poor rates from the existing level of £ 150 to £ 300.

Deutsch, anyway, was well aware of the circumstance that his picture did not reflect the whole situation of charity in America. He indeed claimed that his article "dealt most exclusively with public provision for the sick of poor, omitting the private efforts of such socio-religious groups as the Quakers and the activities of the Scots Charitable Society, the Deutsche Gesellschaft of Philadelphia, and other immigrant aid societies".

In addition, in his discussion there was room for considering two important private-public partnerships for the provision of public services.

[20] For a specific study on the operation of Poor Law in Virginia, see Mackey [1965].

The first was represented by the 1695 South Carolina Act that created colony-wide commissioners of the poor, in whose hands were to be placed private donations for charitable purposes together with an annual grant from the public treasury not exceeding £ 10. The office of commissioners was suppressed in 1712.

The second was the foundation of Pennsylvania Hospital in 1751. This was financed by both public and private contributions but the most relevant aspect is that it was run by private officers, as it is still today.

Deutsch's finding pointed out that the positive factor discernible in the colonial care of sick poor was the principle implicit in the Elizabethan poor law that society was responsible for providing for its helpless and disabled members. Yet, he went on with "[…] towards the end of colonial era the shift in emphasis from governmental responsibility to private enterprise in social welfare was already evident, and this shift continued steadily in later years until private philanthropy became for some time a dominant fact in provision for the sick poor".

Deutsch opinion that the encouragement of private philanthropy was fundamentally a characterizing element of the end of the colonial period is confirmed by an observation of Hammack [2001] arguing that "their [nonprofit organizations] finance relied upon tax funds until the American revolution [1775-1783] disestablished the state connection and forced NPOs to seek for private donations".

Yet, this must not lead to forget that in some states, the favor for private charities had existed since the beginning.

Evidences of American private charity were presented by Wyllie [1959]. The author identified in the state of Pennsylvania the strongest tendency – promoted by the Quakers – in financing charitable projects through private contributions.

Now, the private or public conception of charitable activities did not simply imply that some states provided social welfare through taxation and governmental agencies and others through private donations and private organizations.

The distinction involved important consequences related to the discipline of charitable uses (trusts). That is, in the States where a public conception of charity was dominating, the enforcement of charitable uses would have been more complicated. This was due to the fact that where the private conception of charity dominated, the courts would have given more importance to the intentions of the settlor, even if such intentions were not clearly expressed in the documents supporting the donation (will, deed, etc.).

The original uncertainty of the US Supreme Court on this question was demonstrated by two decisions handed down in 1819.

In both the following cases, *Dartmouth College v. Woodward* and *Philadelphia Baptist Association v. Hart's Executors*, the Supreme Court had to establish to what extent the state (New Hampshire and Virginia respectively) could interfere with the specifications indicated by the settlor.

While for the former judge John Marshall argued that "philanthropic giving would be discouraged if the state were allowed to alter Dartmouth's charter", for the latter he himself held that the endowment provided by the will could not be received by the Association for two reasons: the trustees were not identified in the will and constituted an ever-changing body of unnamed persons and no society could take personal property by devise without a charter of incorporation.

The opinions of the same judge reflected what it has been said above: Virginia was a state where public conception of charity used to dominate while New Hampshire was supporting a liberal-private dimension of it.

In particular, the restrictive attitude of the Supreme Court in the latter case was due to the fact that the state of Virginia had repealed the 1601 Statute of Charitable Uses in 1792 – (the above mentioned will had been drawn up in 1795.) In fact, the legal reasoning followed by Judge Marshall set out from the assumption that in the absence of the Statute of Charitable Uses, it was necessary to look for judicial precedents in order to declare valid or void a charitable use.

Put it differently, since the Statute of Charitable Uses established which *inter vivos* or *mortis causa* acts had to be considered as charitable trusts (uses), its abrogation constringed the judge to address his attention on other sources of law. That is, the Supreme Court had to verify if the Court of Chancery had already recognized uses/trusts similar to those the Supreme Court had to decide on. Now, according to the investigation conducted by Marshall himself, there were no records demonstrating that such indefinite bequests were allowed in English cases.

The opinion of Marshall was soon challenged by a more liberal judge whose name was Henry Baldwin.

The occasion to set forth his ideas was represented by the *Magill v. Brown* case which involved a will dated in 1819. In such circumstance, the judge dealt with the two above mentioned legal questions: the possibility for unincorporated societies to take real or personal property by devise and the validity of donations for constituting charitable uses by deed or will.

As regards the latter, judge Baldwin discredited the research accomplished by Marshall and, differently from him, he demonstrated that in English cases very often trusts were upheld in courts of chancery independent of the Statute of Charitable Uses. Yet, as he did not find a precedent concerned the bequests for the purchase of a fire engine and hose – that is one of wished expressed by the testator of the *Magill v. Brown* case – he took the position that the law should always be stretched to cover new uses that promised some public benefit.

As concerns the former, Baldwin opinion reminded that in Pennsylvania religious societies had always enjoyed the right to purchase and manage property, to develop their own systems of charity and their own forms of worship. Therefore, the prohibition to devise funds to these organizations would have crashed against local customs and habits as well as against the First Amendment of the American Constitution that is interested with the free exercise of religion.

On the basis of these arguments, Baldwin approved the bequests envisaged by the will.

It is true, while these decisions were not directly concerned with the focus of this work, still they provided fundamental elements for framing the discipline of *non-profit* trustees.

In fact, rather than considering problems of agency, they aimed at clarifying the privileges of charity in the light of the application of the so called *cy press* doctrine. According to this doctrine, where a charitable trust failed because its objects were uncertain, impossible to achieve or illegal, the court would apply the property to similar charitable uses, provided that this was in accordance with the settlor's intention.

The application of *cy press* doctrine and the successive confirmation occurred in *Vidal v. Girard's Executor* 1844, demonstrated how the US Supreme Court supported a

private liberal approach to charity and overcame the idea that it was the policy of the law to prevent indefinite accumulations of property for the benefit of individuals.

If compared with English policy, the American one[21] had to be far more liberal as the Statute of Charitable Uses was considered only a "piece of remedial legislation, intended to remove some of the burden of legal restraint under which managers of charities had been forced to operate, and to improve England creaky philanthropic system". [Wyllie, 1959]

The independence of charity from whatever public force and, therefore, its private dimension represented the framework within which agency problems of that period had to be studied.

To make it clearer, in England under the Statute of Charitable Uses the protection of all the interested people against managers misuse of assets was guaranteed initially by a royal-ecclesiastic inquisition, and successively by an information brought by the Attorney General. Both the solutions reflected the public component of the private charity system promoted by the said Statute.

The question therefore was to find out if the more liberal and private policy adopted by America maintained a public-based protection or instead proposed a legal solution more shaped upon the new ideas of charity, like for example conferring the right to sue trustee to the people interested in the administration of the charity itself, this device representing a typical private remedy.

Similarly to the discussion concerning the English system, the answer requires to understand firstly what was the role exerted by *non-profit* sector in the Colonial and Post-Colonial period.

Literature [Tamburrini, 2010 and Hammack, 1989] agrees to distinguish two stages: the first covers the years until 1873 and the second those until the years of 1960.

As regards the first stage, on one side US charities strongly resembled those of the Old-country. In particular, these were charities "founded by the piety of our ancestors to alleviate human misery and scatter blessings along the pathway of life" [Hammack, 2001] and/or charities established in accordance with the welfare system prospected by the State of Charitable Uses. On the other side, around the end of the XVIII, in the US organizations

[21] As seen earlier, the American policy on charity reached that liberal dimension around the end of the colonial period.

without profit purposes were likely constituted by elitist people that, “fearing the political power of the general populace, endowed universities, hospitals and other charities in order to build up the learned professions (such as law, medicine, science and business) for their sons” [Brody, 1996].

Moreover, another kind of non-profit organizations was very popular in US. These were the “grassroots organizations to be considered as the mutual-benefit, single/issue interest, based in the goals of ethnic, neighborhood, denominational, political, aesthetic (and some times athletic) interests” [Hall, 2002].

As one can easily note, the existence of these two kinds of non-profit organizations demonstrated that, differently from England, the American territory of the first stage was characterized by a heterogeneousness of *non-profit* organizations whose functions depended on the particular local culture.

Therefore, every specific kind of charity presented a different degree of exposition to agency problems.

For sure, the more exposed were the sociological charities because of one fundamental reason: they were normally established by will so that their administration was mandated to a third party. Of course, the more the charity was old, the more their controllers were in a fittest position to pursue personal interests rather than those of the organization.

The grassroots and the *elitarian* non-profit organizations were less exposed to the extent to which they were controlled by the founders themselves. It is worth, anyway, that the role of these organization did not longer actually reflect the Ryan [1908] definition of charity, so that instead of charities, these organization might well be defined as non-profit organizations.

Anyways, in those cases where misuses of non-profit assets were suspected, the right to bring suit before the court rested with the Attorney General.

The very first observation at this regard would question the relationship between the private liberal conception of charity expressed by the application of *cy press* doctrine and the public conception of charity expressed by the just mentioned control exerted by the Attorney General.

In fact, non-profit organizations have always presented a hybrid aspect between private and public dimension. It is not a chance that the non-profit sector is also known as

third sector and that, whatever the qualification, the entities involved in this sector are thought to pursue public interests – although they are not public institutions – and to be formed and disciplined by private law – although they are not profit seeking [Coelho De Castro, 2000].

In a certain sense, it can be argued that the two-fold dimension of non-profit organizations before the law depended on the two separate moments within which private and public interests deserved protection.

The first moment was represented by private interest of the testator/donor in setting in force the trust. Through the application of the *cy pres* doctrine, the law charged itself with ensuring that the devised funds are effectively placed for charitable purposes.

Once the funds were placed, the private interest of the donor/testator became accomplished and left room to the second moment. From a legal point of view, in fact, the correct and fair administration of the funds reflected no longer the interest of the donor/testator, but the interests of the of the whole society.

For public interests[22] referring to interests for which states bear responsibility [Vonk and Tollenar, 2008], the Crown was expected to protect charities.

As seen earlier, this duty commenced to be executed by the Attorney General on behalf of the Crown around the second half of the seventeenth century [Cullity, 1981].
This approach was confirmed and therefore continued by American judges through decisions that took on the principles stated by several UK decisions among which can be reminded the one held by Lord Macclesfield LC, occurred in 1724, that stated:

"In like manner, in the case of charity, the King *pro bono publico*, has an original right to superintend the care thereof, so that, abstracted from the statute of Elizabeth relating to charitable uses [Charitable Uses Act, 1601] and antecedent to it as well as since, it has been every day's practice to file information in Chancery in the Attorney-General's name for the establishment of charities. Also in Viscount Falkland v Bertie (6) LORD SOMERS, in delivering his opinion, takes notice that several things are under the care and superintendency of the King as he is *pater patriae*, and instances charities, idiots, lunatics, and infants".

[22] See Vera Langer 1988 American Journal Comparative Law

The hypothesis for which until 1873, that is the first stage, only those (old) US charities established by will were exposed to agency problems and, therefore, only those required the intervention of the Public Attorney has been tested by a research conducted by a digital legal browser: *Lexis Nexis*.

Indicating in the research parameters all the cases between 1600 and 1873 that involve Attorney-General and Trust, the result has been a list of 991 decisions. By having taken into consideration a sample of 20 random decisions[23], it has come out that all of them involved a will or a bequest, or even a *inter vivos* donation where the donator had died.

The hypothesis for which only charitable trusts established by will were those more exposed to agency problems had to confirmed also in the second stage of the US non-profit history, that is after 1873.

In fact, other than the charities/non-profit organizations that have been quoted earlier, also other kind of non-profits showed up. These new non-profits, similarly to the grass-roots and *elitarian* organizations and, therefore, differently from the old-fashioned charities, were controlled by their founders.

Their story is strongly connected with the liberal capitalist-based American state which was threatened by worker riots against the industrial class. Indeed, the most thoughtful men of affairs understood that their economic system would have resisted only in the case institutions would have guaranteed equal opportunities for every citizen. Such condition would have allowed the "*Social Darwinism*" to select the most skilled people for high locations in the business hierarchy. The latter, therefore, was not conceived by these leaders as a birthright [Hammack, 1989].

Such "*scientific philanthropism*" became importantly widespread in the US so that it succeeded to assign a new role to *non-profit* organizations, that is a political role. Such political role could actually resemble the role that XIX century English Government wanted to confer to charities through a strong control into their administration or through public-private partnerships. In particular, these organizations were expected to provide those services theoretically of public competence, but which the state was not in the condition to perform.

[23] See http://www.lexisnexis.com/us/lnacademic/search/casessubmitForm.do

The study of the agency problems exclusively based on the relationship between donors/funders and administrators of the non-profit organizations would have had to take into consideration another fundamental change occurred in the XIX century.

In particular, the approach aimed at studying the relationship between p*atrons* and administrators had uncovered agency problems only in relation to self-dealing behaviors or misappropriations accomplished by the agents. It is true, in the late XIX century the complexity of the non-profit activities and the establishment of the freedom to incorporate, led many funders transform their charitable trusts – or directly establish – into non-profit corporations. This change implied the ingress of other principals that would have added to the patrons. The most important of them was represented by the corporation itself in light of its legal personality.

Thus, the corporate structure rendered the trustee accountable not only to the donors but also the entity. In other words, trustees not only had to employ the funds in accordance with the purposes established by the by-laws – which indeed contained the intentions of the donors – but they also had to ensure economic efficiency to the organization.

As regards the first duty, agency problems were not expected to arise so long as the trustees remained those that had incorporated and financed the organization.

As regards the second duty, trustees might not have the technical knowledge to manage the structure.

For example, in 1809 – that is when it still was necessary an Act of Parliament to incorporate – the State of Florida had conceded its permission in favor of private funders to incorporate the Miami University. In consideration of that it required that the directors had to be appointed by the superior court. In 1873 the University was shut down for it was unable to face the enormous debts that it incurred [the university reopened its doors ten years later]. The problems of agency characterizing this structure were wonderfully described by a contemporary scholar:

> "There are advantages and disadvantages in this method. It ensures a conservative management and expenditure of funds. This is important to state institutions of all kinds. Inasmuch as all appropriation must be provided by the legislature the university is held to a careful regard for the intelligent public opinion of the state. There being no corporate rights to be forfeited the legislature might, at any time, change the character, alter the methods, or entirely abolish the institution. On the other hand, the limitations of the State University are such as to hinder it from meeting emergencies as they arise, or devising plans looking into the future.

> There is a limit to the resources available from the state, and this limits as well what may be undertaken" [Burns, 1982 in Hall, 2002].

As it has been demonstrated, the agency problem that characterized those *non-profit organizations* run by a combination of public and private, did not imply any financial scandal. The inefficiency of the firm was not due to self-dealing behaviors or whatever shameful managerial operation. The reasons were rather rooted in the incompetence of public directors to raise funds or to manage them in order to lead to a financial increase.

However, it must observed that the incompetence of the directors to manage a non-profit corporation was not due to their public or private status, rather it was due to their background. In fact, even if the directors of the Miami University were the funders of the organization, problems of efficiency would have likely arisen for those directors were not business professionals.

It is true, the private/public partnership for the management of Universities did not concern all the states of the Federation since they historically had been autonomous in relation to corporation law. This means that some of them, acknowledging the private nature of *non-profit organizations*, did not require to seat directors as consideration of the permission to incorporate.

An example might be represented by Harvard University [State of Massachusetts] whose board was composed by members of the state senate only until 1865 when, indeed, the corporation began to be regarded as a private non-profit organization in the modern sense [Hall, 2002]. Moreover, in 1865 the freedom of incorporation had already been well established.

The private or public management of non-profit corporation did not therefore concern problems of agency related to opportunistic behaviors. In case the management was private, *the boards were the organizations* so that it was improbable a misappropriation of funds [Wood, 1992]. Where the management was public, theoretically the control of the court had to ensure a minimum of loyal behavior.

In order to face the agency problems related to inefficiency, in the beginning of the XIX century, some non-profit directors, above all those seating in hospitals and health services institutions, decided to hire physicians [DiMaggio & Anheier, 1990].

On one side, this corporate governance change assumed that physicians would have conferred prestige to the structure and, therefore, would have brought money. In other words, it would have resolved the problems of agency – between the corporation and directors – related to the inefficiency.

On the other side, the ingress of these professionals commenced a process that Berle and Means [1991], analyzing business corporations, had defined as "separation of ownership and control". Given the absence of owners, that expression would have sounded better as "separation of supply and control". The funders, in fact, were no longer in the control of the non-profit organization and this could restore problems of opportunism as those studied in occasion of traditional charitable institutions. However, physicians were not feared to behave immorally as a hospital had to be considered the last place for someone with such professional ideologies to work in.

The solution represented by the hiring of physicians anyway did not resist for long time. In fact, during the '69s, President Reagan's policy envisaged federal cutbacks concerning non-profit organizations' funds. Such provisions forced directors to hire business professionals to intensify their efforts to seek for private donations or any profiting activity. This was true for hospitals and health care institutions that had hired physicians, but also other non-profit organizations that had continued to be managed by their funders or successors.

In particular, the lack of economic expertise did not allow the old p*atrons* to raise sufficient resources to guarantee the survival of the organizations they operated. Rather than dissolving their non-profit organizations, they opted to strengthen their links with business corporation management reflecting the assumptions of resource-dependency theory, according to which "organizations require resources to survive, and so must interact with others who control these resources" [Eikenberry, 2004].

For-profit directors saw in the non-profit sector a formidable key to extend and increase their businesses. They felt very happy to join and finance non-profit organizations, frequently requesting the chair of the boards and the engagement of a certain number of executives with whom they had strict ties in return.

Therefore, corporate financial intervention into non-profit organizations was basically executed for restructuring purposes. Once the firm had restored its financial assets

it would have been far more trustworthy for attracting private donations. Furthermore, business executives, unlike their non-profit colleagues, were able to raise funds through "commercial income such as fees for services, product sales, and other profit-making ventures" [Eikenberry, 2004].

Thank to the business professionals the US non-profit sector grew until counting 1.4 million *non-profit organizations* at present, holding $ 2 trillion in assets and accepting annual donations totaling $ 241 billion [Fremont-Smith, 2004].

The described situation represents the framework within which the agency problems of non-profit corporations have to be studied.

To begin with, the problems related to opportunistic behaviors present a new dimension. The sharp increase of assets necessarily has created more possibilities for accomplishing self-dealing transactions or abuses. Similarly, more possibilities for such behaviors have been brought by the circumstance for which the day-to-day agents of the corporation are no longer those who have founded it.

Among incidents of opportunism, which certainly mirror the ones having occurred in Enron and Worldcom in the business sector, notable are the misuse of non-profit funds committed by William Aramony as president of United Way [Salmon & Whoriskey, 2003], and the embezzlement done by Jacques Crozemarie, president and leading fund-raiser of the Association for Cancer Research [Gibelman & Gelman, 2000].

Anyway, not necessarily all business professional directors are greedy agents. In fact, literature underlines that some of them, the most thoughtful, aimed at a ROI (return on investment), a SROI (Social Return on Investment), a FROI (Financial Return on Investment) or a EROI (Emotional Return on Investment) [Gingold, 2000].

As regards the problems related to the economic choices of the management, the hiring of business professionals has brought positive externalities only in part.

On one side, as it has been seen, these executive directors have solved the problem of the organizational efficiency. It is true, such target might not well represent the sole interest of the non-profit corporation or of who founded it.

To ensure efficiency, indeed, directors may be obliged to make economic choices which do not comply with the social, altruistic and ethical values promoted by the corporation and by who finances it.

For sure, both the problems related to opportunistic behaviors and to the economic choices made by managerial directors affect the current US non-profit sector. Yet, as some institutions might be more exposed than others and as some institutions might present those problems in a very peculiar way, it is necessary to make a choice that limits the analysis of these problems only to a certain category of non-profit corporation.

Thus, the attention shall be focused on those non-profit organizations which are *unowned* and that are supposed to exert an economic role.

In particular, the discussion shall take into account the sector of the health, of the education and of the social services.

The reasons that are behind this choice are three.

The first concerns the fact that *unowned* organizations are more exposed to agency problems, either opportunism and economic oriented managerial choices. In fact, in non-profit organizations characterized by memberships, the associates may exert a certain control over the administration.

The second concerns the fact that although health, education and social services non-profit organizations exert a market role, still they present a charitable dimension. This of course implies an internal conflict of cultures that increases the chances of agency problems.

The last one is represented by the fact these institutions are the more representative from an income point of view, that is those that in the non-profit sector produce the most quantity of richness.

CHAPTER III

THEORETICAL FRAMEWORK

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§. 1 TERMINOLOGICAL EXPLANATIONS

Law is a science made up of words, so words are very important for definitions and for normative prescriptions.

In the previous chapters, several expressions have been used to refer to the non-profit sector: charitable corporations, charitable trusts, non-profit corporations, not-for-profit corporations, charities, foundations, associations etc. Although, their aspects have already been pointed out, a more detailed analysis is necessary to avoid confusions and inaccuracies.

To begin with, the expression non-profit organization represents the general concept which embraces all the mentioned legal-economic schemes.

A non-profit organization is any structure where "no part of the income or profit of which is distributed to its members, directors or officers" [Oleck, 1979].

This definition represents actually a very liberal approach that is not only "new" but also peculiar to the US legal literature, doctrine and legislation.

In fact, the liberal conception for determining a non-profit organization has been introduced by three decisions of the US Supreme Courts between 1930 and 1960 [Zoppini, 1997], then translated into legislation through either the Model Nonprofit Corporation Act elaborated by the American Bar Association and through Corporate Statutes adopted by the states of the federation[24]. Finally it was also recognized by legal literature [Hansmann, 1981].

[24] "The Model Nonprofit Corporation Act was originally drafted in 1952 by the Committee on Corporate Laws of the Section of Corporation, Banking and Business Law of the Maerican Bar Association, and was consquently revised in 1957 and 1964. It has had considerable influence, having been adopted in whole or in part in substantial number states" [Hansmann, 1981].
The Model Nonprofit Corporation Act received a further revision in 1987.
"The Revised Model Act has been adopted, in whole or in part, in Arkansas, Indiana, Mississippi, Montana, North Carolina, South Carolina, Tennessee, Washington and Wyoming. Georgia and Ohio have explicitly rejected the Revised Model Act. Nearly half the states, while not formally adopting the Act, follows the Act's application of the traditional duty of care on nonprofit directors, and possibly other aspects". [Brody, 1996]
It is important to underscore how even through the revisions of the Model Act, the concept of NDC has been playing a more and more significant role.

Before the above mentioned US Supreme Court decisions, the criteria adopted to identify the non-profit dimension was represented by the evaluation of the purposes pursued by the entity.

This approach, known as "traditional" was the one established by the Statute of Charitable Uses in 1601 which, as seen in chapter II, envisaged an enumeration of charitable purposes. Thus, differently from the (majority of the states of) US, UK would have maintained the idea that only organizations pursuing charitable purposes, generally speaking, could benefit of the advantages reserved for the non-profit sector.

While a corporation is undoubtedly an organization, a corporation characterized by a NDC clause is hence a non-profit organization. If such non-profit corporation/organization pursues charitable intentions, then it also can be classified as a charitable

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For example, in section 4 of the 1964 version, it was provided:
"Corporations may be organized under this Act for any lawful purposes, including, without being limited to, any or more of the following purposes: charitable; benevolent; eleemosynary; educational;...; athletic;...; animal husbandry; ...; but labor unions, cooperative organizations , and organizations subject to any of the provisions of the insurance laws of this State may not be organized under this Act".
There was an alternative Section 4 that simply stated that: "corporation may be organized under this Act for any lawful purpose execpt ...[list, if any].
Hansmann [1981] provides a useful and brief discussion on the meaning of the two alternative provisions.
Anyways, what wanted to be remarked was the fact that in the 1987 Version, section 3.01 no longer deals with enumeration or esclusion of purposes, rather it introduces the concept of activity and a even more liberal provision:
"Every corporation incorporated under this Act has the purpose of engaging in any lawful activity unless a more limited purpose is set forth in the articles of incorporation".
As concerns non-profit statutes enacted by the states of the federation, two are worth to consider: New York Not-for-Profit Corporation Law (N-PCL) and Calfornia Nonprofit Coporation Law.
The first is well-known for identifying the non-profit dimension in four categories [Type-A,B,C,D]. In a few words, the N-PCL accepts the NDC principle for the application of the Statute, yet it reserves different degrees of regulation for the different types which are distinguished by the purpose. This can be: lawful non-business, charitable, lawful public or quasi-public, business.
The N-PCL enacted in 1970 was edited in 2009. The amendments anyways concerned:

a) membership quorum requirements;
b) the dissolution of not-for-profit corporations.

The California Nonprofit Corporation Act also identifies the non-profit dimension in categories. Instead of 4, there are 3 types which are – like in New York – distingushed according to the purpose and treated with different degrees of standards.
The Calfifornia Statute, therefore, shares the NDC principle within the limits of the definitions regarding the type of nonprofit corporation.
"Some persons see a subtle distinction between *not-for-profit* and *nonprofit* in that the first term is more precise since nonprofits may seek profit, as long as that profit is employed only to fulfill the organzations major, i.e., nonprofit purpose" [Oleck, 1979].
Such distinction is not welcome by this work as in the California legislation, that is where the expression *nonprofit* is adopted, a *nonprofit* corporation may – as well as a *not-for-profit* New York corporation – seek profit to be spent for pursuing by-laws [lawful] purposes – third type.

corporation/organization. Whether the non-profit corporation/organization is charitable or not is established by the applicable law. In fact, although the majority of the states of the Federation have adopted the NDC approach, they distinguish non-profit corporations which pursue charitable purposes from non-profit corporation which pursue any lawful purpose[25].

The distinction between a not-for-profit and nonprofit organization/corporation is only terminological[26].

A charitable trust also can be categorized as a non-profit organization as long as it presents an organizational structure. Charitable trusts, in fact, may well be set in a simple structure which envisages a single or few trustees charged with the administration of a certain fund – or certain funds – on behalf of the categories indicated by donor's deed.

While the legal scheme of charitable trust was commonly adopted in the period of State's grant for obtaining legal personality, nowadays the majority of charitable trusts apply for incorporation [Stalteri, 2002; Zoppini, 1997].

The transformation of charitable trusts into charitable corporations have always entailed confusion about the extent to which the general law which relates to charitable trusts is applicable to charitable corporations.

On this regard, Professor Scott has described the position with his usual clarity: "The truth is that it cannot be stated dogmatically either that a charitable corporation is or that it is not a trustee. The question is in each case whether a rule which is applicable to trustees is applicable to charitable corporations, with respect to unrestricted or restricted property. Ordinarily the rules which are applicable to charitable trusts are applicable to charitable corporations, as we have seen, although some are not. It is probably more misleading to say that a charitable corporation is not a trustee than to say that it is, but the statement that it is a trustee must be taken with some qualifications." [Cullity, 1981]

The circumstances for which the expression "non-profit organization" is often adopted in a general sense, compel the studious to always ascertain the exact legal nature of the entity concerned.

[25] *Id.*
[26] *Id.*

In fact, other than confusion concerning the expressions charitable trust/charitable corporation, the expression charitable trust is often employed to indicate another non-profit sector'structure: the foundation.

A foundation is for sure the most studied non-profit organization structure by north-American literature [Ponzanelli, 1999].

As well as a non-profit corporation, a foundation is a kind of – is a manifestation of – non-profit organization.

Hence, other than the general NDC clause, a foundation is distinguished by its purpose which is generally recognized as "public utility" purpose.

Still a foundation can be structured as a corporation – of course non-profit corporation – or as a trust [Hondius and Van de Ploeg, 2000].

Actually, in US it is not possible to track down an explicit legislative definition of foundation. In order to find out what a foundation is from a legislative point of view, it is necessary to refer to the International Revenue Code (IRC) and to accomplish an *ex adverso* reasoning.

To begin with, the term foundation appears in section 501 (c) (3) among the tax exempt organizations:

> Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation (except as otherwise provided in subsection (h)), and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.

Foundation appears again in section 509 (a). The content provided by this article concerns the <u>private foundation</u> "which means a domestic or foreign organization described in section 501 (c)(3) other than [...]" the organizations described by section 509 (a) (1), (2), (3), or (4).

In other words, all the organizations described by 501 (c) (3) are private foundations unless they present the characteristics prescribed by section 509 (a) (1), (2), (3) and (4) for which they are recognized as *public charity*. Those characteristics regard mainly the kind of

support received by the organization and its administration, not being therefore the distinction based on aspects related to the purposes contained by the by-laws: *public charity* and *private foundations* follow the same purposes. Hence, a non-profit corporation which does not pursue charitable purposes can not be considered as a foundation – whether private or in public charity version.

The qualification of *private foundation* or *public charity* involves different tax treatment. In fact, with the Tax Reform Act of 1969 it was introduced "the distinction between private foundations and public charities[27]. Private foundations are subject to the excise taxes imposed by IRC chapter 42, while public charities are not. It is, therefore, most advantageous for an IRC 501(c)(3) organization to be classified as a public charity rather than as a private foundation" [Richardson and Reilly, 2003].

Finally, association "is a vague term for a group of people who have joined in a common purpose. Sometimes the word *society* is used in the same sense, but this word is confusing because of its frequent use in other contexts. Many other terms are also used to convey the idea of a group or association (e.g. fraternal order, club, brotherhood, union etc.). Ordinarily, an association is not incorporated. If it is, it is more accurately called a corporation, whether its purposes be profit or non-profit" [Oleck, 1979].

Association anyways implies that the organization is composed of members who exert control over it, implying that the agency costs are theoretically lower. As seen earlier, these structures are defined as mutual non-profit organizations and they actually fall out the attention of this discussion.

[27] From a legal point of view, the word charity has actually never brought in itself a clear definition. Even today, the English Charity Act 1993 provides that "charity" means any institution, corporate or not, which is established for charitable purposes and is subject to the control of the High Court in the exercise of the court's jurisdiction with respect to charities. Differently from the US law which – as it shall be seen – has ended up to identify the non-profit dimension in any lawful activity under the condition of a *nondistribution constraint* to be contained in the by-laws of the organization , in England the legislator has continued the tradition for which the non-profit must pursue charitable purposes to be regarded as non-profit before the law.

§ 2. THE ECONOMIC STRUCTURE OF NON-PROFIT ORGANIZATIONS

The exposition to agency problems and the ways by which these affect corporations – whether business or non-profit – are strongly connected with the economic structure of the corporations themselves.

Shaped in terms of finance and control, the most popular categorization of the non-profit structures is suggested by professor Hansmann [1980] including: (1) donative mutual, (2) donative entrepreneurial, (3) commercial mutual, (4) commercial entrepreneurial.

The donative and commercial mutual are non-profit organizations controlled by their *patrons* such as Social Clubs – controlled by their customers – and Common Cause, the citizens' lobby controlled by its contributors.

Patrons of these organizations are therefore members or associates and as such they have the right to elect the board of directors. Because of that, theoretically agency costs are expected to be low.

The donative and commercial entrepreneurial are non-profit organizations controlled by self-perpetuating boards such as Hospitals and Universities.

P*atrons* of these organizations end their commercial relationship with the entity once they have accomplished the donation or paid the service/product. As patrons do not take part in the economic and organizational structure, these kinds of non-profit organizations are defined as *unowned* [Hansmann, 1981] and, consequently, the problems of agency might be more pronounced.

Strictly connected with the economic structure of the organization is the market for corporate control, recognized in literature [Fama Jensen, 1983 and Manne, 1965] as one of the devices available for the reduction of agency costs.

For mutual non-profit organizations a market for corporate control is possible and it works through operations aimed at extending the number of members prepared to vote for the "bidder". As obvious, this market for corporate control is pretty different from the market for corporate control characterizing business corporations[28]. Anyway, it represents only extraordinary cases and not the normality.

[28] For a more detailed discussion on the market for corporate control regarding non-profit organization see Brakman [2006].

For being *unowned*, entrepeneurial non-profit not only are more exposed to agency problems but they also can not take advantage of the market for corporate control to keep directors' interests aligned with p*atrons'* one.

§ 3. THE LEGAL NATURE OF BUSINESS CORPORATION

Every economic phenomenon is potentially apt to arise problems, that is situations within which the interests of one or more parties – that are not necessarily part of the transaction – are or risk to be jeopardized. The function of the law is just to recognize/identify and to protect these interests. The identification and the protection of the interests take place in two ways:

a) drafting -new- provisions;

b) interpreting the -existing- provisions.

The way a) is expected to be accomplished by the legislative power while the way b) by the judicial power. Both the ways are supported by legal-economic literature whose function is to shed light on which are the interests supposed to be identified and to have protection.

For sure, the corporation represents an economic phenomenon and as such it is capable to arise problems. Corporate governance scholars are therefore expected to uncover the interests which risk to be jeopardized in the exertion of the corporate activities.

This kind of analysis requires first of all the definition of the concept of interest.

In the opinion of Jaeger [1963] and Freund [1897], and in general of the theory of elementary law – the interest can be conceived as the "relationship acknowledged by the law, between an individual who has to satisfy a need and the good that is suitable to satisfy that need".

Such definition implies that the second step of the analysis is represented by the investigation on the legal nature of corporation. In fact, according to the legal nature of the corporation, one shall know which are "the relationships acknowledged by the law".

To begin with, in order to clarify and to reason on the notion of interest provided by Jaeger [1963] one can imagine the following example: a girl has to satisfy the need to arrive to her job place sooner and for this reasons she decides to buy a mopped instead of using public transports.

Taking on the mentioned Jaeger definition of interest, if the law recognizes a relationship between the girl and the mopped that she is meant to buy, then this relationship involves an interest.

It is clear that the law shall not recognize the relationship between the girl and the mopped only because the former has seen it in a retailer shop and she has decided to buy it. Rather, the relationship between the girl and the mopped shall be recognized by the law only when the girl signs a contract with the seller.

Then, once the contract has been signed, the law acknowledges the interest of the girl in receiving the mopped.

In particular, the law shall protect the interest of the girl – that is, shall protect the relationship between the girl and the mopped – by obliging the seller to respect the purchasing contract. For instance, the law establishes that if the mopped is not delivered, or is delivered with late, the girl shall be entitled to recover damages she has suffered. The law protects the interest of the girl in receiving the mopped by obliging the seller to pay damages in case of non-performance or partial performance[29].

In some cases, the law could even oblige the seller to execute a specific performance instead of paying damages so that the girl is entitled to receive the mopped that has been indicated in the contract[30].

However, the interest of the girl in the mopped, either protected with recovering damages or by specific performance, is not relevant for the law until the girl adopts a legal device (which in that example has been the contract): the legal device is necessary for the production of –legal– effects[31].

Once the legal device is adopted, the rules governing this legal device itself shall protect the relationship between the individual and the good meant to satisfy her need.

As to the satisfaction of the need of the girl to receive the mopped corresponds the need of the seller to receive the money, the legal device employed - that is the contract – involves two interests – and hence two relationships acknowledged by the law:

a) the interest of the girl in receiving the mopped and hence the relationship between the girl and the mopped;

[29] This is actually a common law rule. In civil law legal systems, the agreement of the party is sufficient to transfer the right of property so that the seller is first of all obliged to execute a specific performance.
[30] This is a remedy elaborated by the Courts of Equity.
[31] At the same time the law protects the interest of the seller in receiving money. For example, if the contract establishes that the delivery of the mopped precedes the payment, then if the girl does not pay until the date agreed or pay only part of the sum, then the seller also is entitled to act for the damages.

b) the interest of the seller in receiving the money and hence the relationship between the seller and the money.

In addition, when two or more interests are involved in a certain transaction, the risk is that the accomplishment of one of them jeopardizes the accomplishment of the other.

Thus, one can assume that the girl signs the contract on May the 5th 2010 and that the agreement provides that she shall receive the mopped the day after and that she shall have to pay the full amount by the 10 of August 2010. The price agreed for the purchase of the mopped is 2,500 dollars.

If by the 10th of August 2010 the dollar has dropped so dramatically that 2,500 are worth nothing, then by paying the agreed price the buyer shall have satisfied her need while the seller not.

Law therefore is expected to focus on the contractual relationship and to make the best to combine all the interests involved. A problem of currency such like the just mentioned one, could be resolved by envisaging a statutory provision that compel parties to behave with *good faith* when performing their pecuniary obligations.

It is true, while one can discuss how and to what extent law should protect the interests involved in the transactions, there is no room for discussing to whom the interests belong. To put it differently, while one can argue that law should limit its intervention and hence leave parties with the widest freedom to choose the rules that govern their relationship (their interest) or while one can argue that law should affirmatively intervene into private affairs with the intent to prevent market failures – for example by providing the *good faith* clause to eschew the risks connected with a drop of currency –, one can not argue that the legal device contract, so far as it is considered by the definition as the king of private tools for operating within the market, involves only the interests of the parties involved in the transactions: the buyer and the seller in the example offered in this discussion.

Now, if the need of the individuals is simply to earn money, there are many ways for them for satisfying this need. For example they can sell mopeds, they can open restaurants, they can be doctors etc.

In all these cases, the individuals shall likely earn money through contracts with the buyers of the mopeds, with the clients of the restaurants, with the patients. Contract law,

other than defining to whom the interests belong, shall also define what kind of interests are to be protected.

By the way, individuals may satisfy their need of earning money through holding shares in a corporation. As in this case the legal device chosen by the parties is called "corporation" and not "contract", it might mean that the relationships involved are not represented only by the parties and the profit. In other words, while the legal device contract left no room for discussing that the interests to be protected were only those belonging to the parties involved in the transaction, the legal device corporation not only does not reveal to whom the interests belong, but also which are the interests involved so clearly as the contract legal device.

This aspect of unclearness is due to two reasons:

a) not all the scholars and professionals agree on the function of the corporation. Differently from the contract, where everybody agrees that is a private tool, corporations are considered either private or public tools;
b) not all the scholars and professionals interpret the law in the same way so that for some of them the corporation looks more like a contract while for others like an institution.

The stream of thought that conceives the corporation as a private tool and hence as a contract is known as *contractiarian* while the school supporting the idea that the corporation is a public tool and hence an institution is known as institutionalism. Therefore, point a) and b) represent actually two approaches concerned with the analysis of the nature of the corporation: functional and structural approach.

The next sections shall discuss these approaches in order to identify those findings that shall be useful for understanding the nature of non-profit corporation.

§3.1 FUNCTIONAL APPROACH

Some scholars think that the corporation does not simply represent a private legal device which is employed by individuals to earn money. Rather, in their opinion the corporation presents certain features related to its function that bring such economic structure beyond the private dimension.

It is true, while all these scholars agree that corporation involves a public and institutional dimension other than a contractual and a private one, they reach this conclusion through different ways of reasoning.

One of these theories refers to Walther Rathenau [Jaeger, 1963] and is known as *Unternehmen an sich*. This scholar assumes that the function of the corporation is to offer security for the community, to provide job and to improve the techniques for the scientific progress.

Rathenau therefore seems to not consider or to give little importance to the fact that the corporation has actually been the product of the efforts of private individuals. The scholar focuses his attention directly on the organizational dimension of the corporate phenomenon and underscores which are the needs that this organization is expected to satisfy.

As the needs are represented by benefiting the national economy, the corporation may satisfy these needs by accomplishing the three objectives inherent to its function. The corporation, therefore, from a legal device of the private individual, becomes a person that boasts its own interests, that is the corporation establishes a relationship between itself and the goods; the goods are indeed represented by the security of the community, the provision of job and the improvement of the techniques for scientific progress.

The public nature of the corporation itself implies that its relationship with the mentioned goods is acknowledged by the law.

As long as the interests of the shareholders and of the corporation may not coincide, then the accomplishment of one interest may jeopardize the accomplishment of the other interest. So, the interests of the shareholders and the interests of the corporation may stay in

conflict and according to Rathenau, in such circumstances, law is expected to protect those of the corporation.

However, as well as law cannot protect the interest of the girl in receiving the moped unless she adopts a legal device – as for the example the contract – to advance her interest, so the law cannot protect the interests of the corporation if there is not a legal device that supports the relationship between the corporation and the goods. This legal device is represented by the management body of the corporation itself.

Thus, as well as the law of contract is expected to protect the interests of the seller and of the buyer by providing a mandatory good faith clause, so the corporate law conceived by Rathenau shall advance the interests of the corporation by providing mandatory rules of governance that shall drive directors to prefer corporation interests in detriment of shareholders one.

It is true, according to Rathenau, the public dimension of the legal device corporation implies that this organization is accountable before the community as well.

The community, as the public, implicitly adopts the legal device corporation to satisfy the need of producing resources to be distributed among the people. Therefore, through the corporation the community establishes a legal relationship with the three mentioned goods inherent to the function of the corporation itself.

Community and corporation, other than shareholders, are all parties whose interests deserve to be protected by corporate law.

Another institutional theory refers to Haussmann [Jaeger, 1963]. The scholar actually maintains that the firm is a “living body” participated by several subjects that are, other than the shareholders, the members of the management and of the supervisory board, the creditors and the employees.

As the life of the corporation depends on these subjects, the function of the corporation is to promote their interests. Differently from Rathenau, Haussmann indeed believes that only physic persons may have an interest so that the sum of the interests of the mentioned subjects represents the interest to be pursued by the corporation. Another important divergence between Rathenau and Haussmann idea is that the latter denies that there is a public interest in corporation law. This means that for Haussmann corporation law

should only aim at maximizing the wealth of whoever participates in the firm. For Haussmann the wealth maximization of all the constituencies reflects the corporate interest.

In other words, because of the convincement of the public interest inherent to the concept of the corporation, Rathenau argued that law had to resolve the conflict of interests between shareholders and corporation in favor of the latter, while according to Haussmann, in a situation of conflict of interests between the constituencies, law had not to prefer one interest in detriment of the interests of the others, rather law had simply to consider the interests of all the constituencies on the same level.

According to Haussmann therefore, the corporation remained a legal device through which the constituencies attempted to satisfy their needs and through which the constituencies rendered legally relevant their relationship with the good that would have satisfied their need. For example, an individual needs money for living. Law cannot ensure him the good for the mere circumstance she needs it. So the individual enter into a contractual relationship with the corporation and becomes an employee. The legal device contract between him and the corporation and the statutes dealing with labor law ensure that her interest in receiving the wage shall be protected by law. However, when she enters into a contractual relationship with the corporation, according to Haussmann she becomes part of the corporation. Her need of money for living is satisfied within the corporate context by not losing the job. The law therefore is expected to protect the relationship between the individual-employee and the good-maintaining her job position. In Germany, for example, where the institutional theory is predominant, workers' representation is part of the supervisory board. Their interests in the decision making process of the corporation is a right acknowledged by corporation law (Aktiengesechzt 1966).

The conflict of interests that could arise between shareholders and employees is evident so long as one considers that directors may jeopardize the interests of the former each time they take a long term decision and the interest of the latter each time they take a short term decision.

For example, by selling an asset of the corporation directors would increase the cash-flow and this itself could be distributed as dividend. This decision would make the shareholders happy but not the employees that shall see the danger that the corporation –

where and through which they satisfy their needs – loses its stability. And of course, the instability of the corporation threats their jobs.

According to Haussmann, the directors, that in this case represent the legal device corporation, faced with such kind of choice, should consider both the interests of shareholders and employees without the law imposing any indication about the decision to be taken.

Thus, Rathenau and Haussmann "only" shared the idea that corporation was not simply a private device aimed at maximizing the interests of the shareholders, but a legal device that, because of its function, takes necessarily in consideration the interests of other parties.

Jaeger [1963] was actually right in holding that Haussmann theory is more complete than Rathenau's one from a dogmatic point of view, for it is more logic to think that legal interests can belong only to physic persons and that the corporation is just the frame where these interests must be gratified. If Haussmann had taken in consideration even the interests of the community, then his theory and Rathenau's one, although setting out from different perspectives, would have reached the same conclusion: before corporate law, the interests of who participate with the firm and of who deals with it deserve at least the same protection of the interests of the community.

A more recent institutional approach to the role and nature of corporation has been divulgated by the French scholar Bissara [1999] according to which the corporate activity is expressed by "*l'intérét supérior de la personne morale elle-meme, c'est-à-dire de l'enterprise considerée comme un agent économique autonome, porsuivant ses fins propres, distinctes notament notamment de celles de ses actionanaires, de ses salariés, de ses créanciers dont le fisc, de ses fournisseurs et de ses clients, mais qui correspondent à leur intérét general commun, qui est d'assurer la prospérité et la continuité de l'entreprise*".

It is clear how this theory sets the interest of corporation as the main interest to be pursued by the management.

Institutional theories based on functional approach were actually advanced also in the United States. Scholars like Berle and Druker [in Jaeger, 1963] reasoned on the wide dimension reached by the American corporations.

They noted that earlier in the XIX century, the shareholders had an active role in the control of the corporations. In fact, the small economic structure of these involved the presence of a major shareholder, traditionally represented by a family. The family therefore managed and controlled the corporation actively.

When the need of resources for investments showed up, then corporations were compelled to issue new shares. The result was that the economic structure no longer involved a major-family shareholders, but many minority shareholders.

The scholars remarked how these exerted a very passive role in the control and management of the corporations, for this was put in the hands of specialized professionals.

The fact itself that shareholders were anything but passive investors led Berle and Means to form the idea that the corporation could not represent actually a private affair as this indeed involves the management or at least the control of the transaction. The big corporation becomes therefore independent from the private wills of shareholders and absolutely sovereign of its own choices.

Another important evidence of the not very private character of the corporation was represented by the large donations that corporations used to accomplish on behalf of universities and other charitable institutes.

Basing their idea on these considerations, the US scholars conceived the corporation as a device operating on a public dimension and as a trustee of the community.

As such, this implied that in the corporate phenomena not only the interests of the shareholders but also those of other stakeholders had to be considered.

Either Drucker and Berle are close to the idea of Rathenau to the extent to which both the American and German side acknowledge the personality of the corporation (organ and tool of the society) and the consequence for which the corporation has its own interests.

Similarly to the position of Drucker, Berle and Rathenau, the English scholar Goyder [Jaeger, 1963] acknowledges the corporation as a separate entity with its own interests. Yet, he underscores the need for the law to pay more attention to the devices available for the corporation itself, shareholders, workers and consumers to render the corporation more accountable before the community in general. According to Goyder, one of these devices is the by-laws, where the interests of those four classes are to be expressly considered.

Now, differently from the institutionalism scholars, there are scholars that think that the corporation is a legal device invented by the economic actors to increase their wealth and, as such, it should be left to the full autonomy of them.

To introduce this approach, it would be useful to observe that ironically one of the institutionalism scholar, Berle, two decades earlier was one of the most confident authors in the *contractarian* theory. In 1932 he held: "all the powers granted to a corporation or to the management of a corporation, or to any group within the corporation, whether derived from statute or charter or both, are necessarily and all times exercisable only for the ratable benefit of all the shareholders as their interest appears". The 1932 version of Berle conceived that the function of the corporation was to maximize shareholders' wealth as these were those who risked money and as residual claimants their interests had to be protected before any other one.

The fundamental element of Berle theory was represented by his accent on the final interest of the shareholder, that is in the need to profit of the shareholder. He said that corporate directors must make the best to ensure "the maximum profit compatible with a reasonable degree of risk" [1932].

Shareholders organize themselves as corporation so that law shall recognize their interest in the profits which represent their good.

Differently from the contract between the girl and the moped seller where law, in a way or another, would have succeeded to satisfy the need of the parties – by recovering damages, specific performance etc. – in a corporate context law cannot actually ensure shareholders that they shall obtain the dividend.

This limit of the law is acknowledged by *contracarians*.. The limit is explained on the basis that the corporation before being a legal device is an economic tool. Such economic tool presents in its own nature a strong risk dimension for which the shareholder very well knows that her investment may not succeed to satisfy her need. In fact, in a simple contract like the one related to the purchase of the moped it is very easy for the parties to reach an agreement which specifies in details the exchange of the goods; one party has a certain degree of certainty that the counterpart has or shall have the good to be exchanged. If the party had not had this degree of certainty, she would have not reached an agreement at all.

In the corporate context, for sure the good is not immediately available. To this extent, the situation may resemble the one of the contract of moped purchasing to the extent to which in the latter case the retailer is waiting for the delivery from the supplier: that is, the buyer has possibly paid a good which still does not exist, but that she believes it shall exist with a certain degree of certainty, so does the retailer. The situation indeed does not longer resemble the one of the contract of moped purchasing whereas either the shareholders and their counterpart – corporation in the person of the directors – do not have a certain degree of certainty that the good shall exist and, if it shall exist, they have no idea of its consistency. This explains why it is impossible for shareholders to specify details related to the good in the by-laws of the corporation and consequently explains how the lack of the specification of the good renders the transaction more risky. Rather, by-laws provides that shareholders shall receive the dividends (good) so long as there are residual returns.

In other words, in a hypothetical fact situation where the by-laws of the corporation provides a relationship for which shareholders shall be entitled to receive a minimum dividend of 1,000 dollar for each share hold at the time of the approval of the financial year, and where shareholders receive 900 dollars instead of the 1,000 envisaged by the by-laws, shareholders shall be entitled to claim against the partial performance of the corporation.

Yet, this scheme does not reflect the economic nature of the corporation to the extent to which it shall never happen that shareholders are able to find directors available to sign a by-laws containing a clause establishing the minimum of the profit.

A corporation functions just the other way round. That is, directors shall accept to be directors only if through the by-laws shareholders entrust them with the best discretion in the decision making process, recognizing the risk of not receiving any good in exchange of their investment.

In the light of this picture, Berle believed that notwithstanding the impossibility for the law to ensure the profits, law had somehow to recognize the interest of shareholders in obtaining the maximum dividend.

In order to achieve this goal law had therefore to set the profit maximization of the shareholders as guiding principle for directors [Clarke, 2004].

§3.2 STRUCTURAL APPROACH

The "structural" or *positive* approach consists in the analysis of the black letters governing corporation. Accordingly, the solution to the question "what is the corporate legal nature or the corporate interest?" has to be detached through the interpretation of the applicable law of a certain jurisdiction. If the jurisdiction is a common law jurisdiction, then for applicable law one has to give special attention also to judicial precedents. .

Because of that, the concept of corporation shall vary according to the legal order the scholar is referring to. In particular, if one wants to measure the contractual/institutional dimension of US non-profit corporations, one has to look at the US legal system and must not forget the common law principles that have been developing in UK.

The most authoritative institutional theory based on the structural approach develops its reasoning from the legislative provision that acknowledges legal personality to corporations.

It is well known that legal personality is a necessary element of business corporations so that all the jurisdictions contain this norm, yet, in the US, the legal literature has not always interpreted this norm in an institutional sense, as it has happened in Germany.

In fact, while the German Professor Gierke [Freund, 1897], maintained that corporations are something real and as such law acknowledged their legal personality, US scholars have been more bent to think that corporations were just an aggregate of investors so that their legal personality was simply a *fictio juris*.

The legal personality implies the existence of corporate own interest, which does not reflect the one of shareholders. This means that the conclusions reached by Gierke and Rathenau are basically identical; what differs between these scholars is the approach through which their findings are reached: structural and functional respectively.

As said earlier, the interpretation of English and American jurists of the provision concerning the legal personality tended to conceive this as a grant of the law, and not as an acknowledgment, as Gierke thought.

The Anglo-American legal tradition, in fact, suggests how for common lawyers the legal personality was a grant of the law, for corporations were not considered as distinct persons that could claim an own interest. The legal personality was only a *fictio juris* created

by the law for practical purposes. Because of that, the real interests of the corporation were to be considered only those advanced by the individuals.

Anyway, the legal personality represents only one of the structural criteria that the studious can refer to for assessing the nature of the corporation. Another very important legal parameter to measure the institutional and contract dimension of the corporate structure is represented by the notion of contract.

Similarly to the legal personality, also the notion of contract varies according to the jurisdiction, above all if one considers the civil and common law point of view.

Thus, if one wants to find out the contractual dimension of the US corporation, it can not skip the analysis of the common law idea of contract.

In law and economic terms, this is an obvious case of path-dependency. In fact, this is actually the main reason why professor Gallor, a prominent English scholar of company law, believed that comparative study of company law was better pursued in comparing only common law jurisdictions: American corporations and British companies, this was for him a field in which comparison could have brought fruitful results.

In common law, a contract involves a bargaining between two or more parties. The bargaining is based on an agreement and it is defined as an exchange of promises. With a contract one promises to perform and therefore one undertakes an obligation. A contract is able to bind. One is obliged to do something or to exchange something.

It is true, the voluntary arrangement on which the formation of a corporation is based could never be considered in common law as a contract in the legal sense. In fact, in business corporations, shareholders actually do not exchange any promise among them to do or to perform something. They only agree to take part of an entity which is governed by the rules contained in the by-laws and in statutory provisions.

If from a legal and technical point of view the corporation can not be a contract, then it is an institution and as such the interests that it pursues are expected to be suggested by the legislator.

Before advancing this conclusion, it is however necessary to interpret the common law notion of contract in the light of the corporate law. Instead of proceeding to accomplish this step by considering the US corporate law, it is useful to first check how the common law notion of contract fits into the UK company law. In fact, as it shall be soon noted, such

analysis shall lead to different findings that would reveal the coexistence of both the institutional and contractual dimensions within the corporate structure.

On one side, the English Company Act 2006 perfectly reflects this latter idea providing that the directors have to promote the success of the company and at the same time to consider:

a) the likely consequences of any decision in the long term, so not only to short term profit, but look what happens to the company if they do something;
b) the interests of the company employees;
c) the need to foster company business relationships with suppliers, customers and others, employees, suppliers and customers and others are typical stakeholders;
d) the impact of company operations on the community and the environment, again the public at large, not only public interest but also what a civil lawyer calls “interessi diffusi”;
e) desirability of the company maintaining reputation for high standards of business conduct, so way of doing fair deals, fair business etc.
f) finally also the need to act fairly as between members of the company, so defines also the quality of treatment of different duties.

Another clue that leads to think the company as an institution can be detached at Part 10 of the Act. Section 170 (scope and nature of general duties) where it is provided that directors' general duties are owed to the company rather than to individual members. Hence, it is clear the connection with the ideas of legal personality.

One more track of institutional dimension of the company is detachable into the introduction of a new discipline of the derivative claim, provided by Companies Act 2006 at Part 1.

The derivative action represents the possibility for shareholders to enforce management fiduciary duties in the name of the corporation for officers and directors, who are in control of the corporation, are unlikely to authorize the corporation to bring suit against themselves.

To understand better the derivative claim one has to get back to *Foss v Harbottle*[32] where the House of Lords basically established that an action against corporate directors could be brought only in the name of the company, that is on the basis of a valid deliberation of the general meeting. This principle has always been in force in England and this is demonstrated by the provisions contained in Section 170 Part 10 of the 2006 Act.

The *Foss v Harbottle* rule was actually grounded on the idea that corporations were democratic institutions and therefore a single shareholders had not to be allowed to interfere with managerial choices.

However, with the growing of the idea that the balance between managerial and shareholders protection was too much bent towards the former, English judges began to develop doctrines for which shareholders themselves deserved the right to bring suits in the name of the corporation without the need to obtain a general meeting deliberation.

Of course in the beginning such right was very limited. The exceptions to the *Foss* rule were confined to cases of self-serving negligence or worse (i.e. fraud) from directors. With the decision of the Company Act 2006, from the first time the derivative claim was established on a legislative basis and was extended to breaches of duties including duty of care and skill.

On the other side, the Companies Act contains provisions which instead would suggest also a contractual dimension of the company. In fact, at Section 33 Chapter 4, the Act envisages that the provisions of a company's constitution, when registered, bind the company and its members to the same extent as if they:

a) had been signed and sealed by each member ;
b) contain covenants on the part of each member to observe the provisions.

It has to be firstly observed that the black letter of the provision speaks about covenants and not contract. The legislator could not use the term contract as the provisions – that is the by law – are not a contract in the legal sense described above. Still the legislator wanted to ensure the same consequences as the shareholders relationships within corporation were contractual, that is to allow the shareholders to enforce their rights through contractual action.

[32] (1843) 2 Hare 461; 67 ER 189.

Already in *Bratton Seymour Service Co Ltd v. Oxborough* [1992], Judge Stein held: "It is, however, a statutory contract of a special nature with its own distinctive features. It derives its binding force not from a bargain struck between parties but from the terms of the statute. It is binding only insofar as it affects the rights and obligations between the company and the members acting in their capacity as members".

The contractual dimension of the company implies that shareholders have contractual rights and therefore that these can be enforced through a direct lawsuit by the shareholders in their own name.

Obviously, the particular nature of the "company contract" implies some limitation regarding the enforcement of its terms "as the rights given to a member are not necessarily absolute ones. They cannot be seen in isolation but only in relation to the rights enjoyed by the other members [Drury, 1986]".

This explains why there is not a universal doctrinal approach which discloses when a member has the right to bring a contractual action. Judges have indeed often adopted different *ratio decidendi*[33].

However, one of these limitations envisages that the rights given by the company contract to third parties cannot be enforced by these. Third parties are considered as outsider while articles of associations binds only the members and the company[34].

The understanding of the difference between derivative claim and contractual action would be crucial to identify both the institutional and contractual dimensions of the English company or what is defined as "enlightened shareholders approach".

The former has to be brought for breaches of fiduciary duties owed to the company. If a manager goes to a business meeting and he behaves like spending extra corporate money for hotel, rent car, business class in the flight, he might be breaching his *fiduciary* duty to promote the success of the company. The shareholder can not sue him/her for breaching a contractual obligation as there is no contract between him and the board of directors where it is specified that the director has an obligation to not behave selfishly. Yet, the shareholder

[33] For a detailed discussion on the cases involving contractual actions brought by shareholders see Drury [1986].

[34] Judge Stein [1992] continues: "It is binding only insofar as it affects the rights and obligations between the company and the members acting in their capacity as members. If it contains provisions conferring rights and obligations on outsiders, then those provisions do not bite as part of the contract between the company and the members, even if the outsider is coincidentally a member".

has instead the institutional right to enforce that obligation and through the derivative claim he can protect his/her and corporation interest (the success of the company).

As regards the latter, a contractual action can be filed for breach of *common law* duties owed to the shareholders and detachable in the bylaws. The rights actionable directly by shareholders then affect their property, that is their shares, as for example the distribution of dividends, the right to vote etc[35]. Shareholders have no power over corporation property.

The structural approach to the English law reveals therefore that the interests protected by company law are those of shareholders as well are those of the other stakeholders. This interpretation could lead to consider the corporation as an institution, yet it is crucial to underscore that only the shareholders may enforce the corporate interests, through a contractual action or derivative claim.

In fact, the duties enlisted at Part 10 do not give rise to a direct right of action by employees or any third party outside the company (for example, environmental activists). The directors still only owe these duties to the company, and a breach of such duties can only be enforced by the company or its shareholders.

This is can be drawn from the section 170 (1) itself where the legislator provides that the duties are owed to the company and not to the persons specified in the subsection.

One could then wonder what is the point to envisage normative provisions protecting stakeholder interests if the former can not be enforced by the latter. One interpretation can be that the list of the interests represents a sort of defense for directors. Put it differently, whereas a shareholder brings suits against a director for having pursued a public interest in detriment of the shareholder interest itself, then the director can argue that he/she had complied with positive rules of law.

Now, as regards US law, it has first to be remembered that each State of the Federation has its own corporate law so that for the purposes of this dissertation it is necessary to focus only on the most significant ones.

To begin with, it can be considered the Delaware General Corporation Law, for it is commonly recognized as the most liberal.

Indeed the contractual dimension of a corporation organized under the Delaware Act is very easy understandable from the lack statutorization of the general duties as the one

[35] See for example *Wood v. Odessa Waterworks Company* [1889].

introduced by the Companies Act 2006 and, above all, by the accent posed by the legislator on the bylaw, for the duties of directors "shall be stated in the bylaws or in a resolution of the board of directors which is not inconsistent with the bylaws"[36].

The absence of a statutory consecration of the corporation interests' might be the cause for which "the distinction between direct and derivative claims has been the source of considerable litigation in the Delaware courts through the years. Whether a claimant has standing to sue directly or derivatively is not always clear" [Olson, 2008].

Thus, the trend followed by the Supreme Court of Delaware has been the one established in 2004 case of *Tooley v. Donaldson, Lufkin, & Jenrette, Inc.*

The Tooley test provides that the determination of whether a claim is direct or derivative "must turn solely on the following questions: (1) who suffered the alleged harm (the corporation or the suing stockholders, individually); and (2) who would receive the benefit of any recovery or other remedy (the corporation or the stockholders, individually)?"

Moreover, in Delaware as well as in most of the States of the Federation, the derivative action is seen as a regulator of corporate management and one of the most effective means of enforcing the management's duties and obligations under the law[37].

For the purposes of this work, the state corporate law to be analyzed is the one of New York. As seen earlier, in fact, New York adopted an important non-profit corporation law so that it would be interesting to compare it with the business corporation act. Note that the State of Delaware has not adopted a non-profit corporation law and, as a consequence, non-profit corporations are organized under the General Corporation Law.

At section 601 the NYBCA provides that "the by-laws may contain any provision relating to the business of the corporation, the conduct of its affairs, its rights or powers or the rights or powers of its shareholders, directors or officers, not inconsistent with this chapter or any other statute of this state or the certificate of incorporation".

The norm undoubtedly confirms the contractual dimension of the document.
Other than being contained in the by-laws, the duties of directors are envisaged also by the Act which specifies that these have to pay regard at:

[36] See § 142.
[37] Accuracy requires to quote Ramsay [1994] according to which the "United States experience is that shareholder derivative actions are a rare occurrence despite the existence of contingency fees. One study of 179 public companies in the United States found that, on average, a company is involved in a shareholder derivative action or shareholder class action only every 17.5 years".

(1) both the long-term and the short-term interests of the corporation and its shareholders and (2) the effects that the corporation's actions may have in the short-term or in the long-term upon any of the following:

(i) the prospects for potential growth, development, productivity and profitability of the corporation;

(ii) the corporation's current employees;

(iii) the corporation's retired employees and other beneficiaries receiving or entitled to receive retirement, welfare or similar benefits from or pursuant to any plan sponsored, or agreement entered into, by the corporation;

(iv) the corporation's customers and creditors; and

(v) the ability of the corporation to provide, as a going concern, goods, services, employment opportunities and employment benefits and otherwise to contribute to the communities in which it does business.

Section 601 resembles section 171 of the 2006 Companies Act in so far it confers an institutional dimension to the corporation and at the same time recognizes the protection of the interests of the shareholders. In this, they differ from Delaware General Corporation law where it is simply envisaged that directors duties are o be exerted according to the articles of association (Section 141).

Moreover, the existence of the derivative claim, which is disciplined by Section 626 confirms the common law rules for which directors owe their duties to the corporation.

The conclusion for which corporations, either under the UK Companies Act and the US corporate laws, present both a contractual and institutional dimension suggests that there are different devices to protect the interests of the shareholders and those of the corporation. Yet, it does not disclose the degree of responsibility that directors have before such interests.

In order to uncover this question, one has to go back into the eighteen century, when the Government hardly granted the right to incorporate and therefore business activities were carried out through the form of trust. The shareholders simply and directly put in the hand of the trustees the money and the law of trust would have applied to this relationship.

With the act of incorporation, a “thing” – that is the corporation – would have stood between shareholders and directors (trustees). For the law, this thing would have had legal

personality and would have gathered all the interests belonging to shareholders, directors and all the other stakeholders.

As quote above, for many years, the personality of the corporation has been thought a *fictio juris*, something created by the law for convenience. The truth that this *fictio* would have hided was that directors and shareholders were still tied by a trust relationship so that the law of trust would have applied to possible conflict of interests. The law of trust would have shaped the fiduciary duties of corporate directors even if the legal phenomenon of corporation did not involve actually a trust.

In fact, Duggin and Goldman [2007] stated that

> "The original model for defining the director-shareholder relationship emerged from the law of trusts. This is not surprising, for the duty of a trustee is a paradigm for allocation of fiduciary responsibilities in cases where one person holds money or property on behalf of another. In addition, the rules governing financial trusts were already well established by the time courts began to define the core relationships of corporate governance. Consequently, the potential fit appealed to courts and commentators. There was significant support for the idea that a corporate manager should be "a trustee—a guardian," with "every shareholder . . . [as] his ward" and, at least in cases of large public enterprises, "the community [as] his *cestui qui* trust." A number of nineteenth-century judicial decisions reflect a similar propensity to invoke the law of trusts in the corporate arena. The conservative rules of the trust approach, however, did not fit the entrepreneurial mold of corporate capitalism and its captains. As the twentieth century dawned and the corporate form became increasingly popular, corporations began to grow and diversify. It was evident that the skills that made individuals successful business directors were not necessarily the same qualities that made good trustees. It soon became clear that saddling corporate directors with the kinds of standards applicable to the guardians of trusts and eleemosynary institutions was counterproductive. This approach suited neither the needs of evolving business corporations nor the objectives of their investors. Consequently, the courts began to develop a separate set of principles for corporate management. As the law of corporate governance evolved, what remained of the trustee model was the idea that directors owe a fiduciary duty to the corporation, and, indirectly, to its shareholders".

This understanding for which corporations were and are a mix of institutional and contractual dimensions is not shared by a new stream of thinkers, the *contractarians*, who identify exclusively the latter dimension.

To begin with, *contractarian* are actually not legal scholars but economists. Although this would imply incorrect findings on the legal nature of corporation, it must be reminded that Courts have several times applied their positions[38].

Thus, according to these economist thinkers the relationships which characterize business corporations can be actually considered contractual in the traditional common law sense.

This idea, known for defining corporations as *nexus of contracts*, sets forth the firm not as an entity but as an aggregate of various inputs acting together to produce goods or services. Employers provide labour, so there is an exchange represented by labour against wage, creditors provide debt capital, which is in exchange of interests, shareholders provide equity capital in exchange to get dividends.

The presence of a bargain and therefore of a valid consideration represents the sufficient legal element to consider these relationships as contractual before the common law notion of contract.

The twofold idea arguing that the corporation is not an entity and it is rather a nexus of contractual relationships, is employed by *contractarians* to identify which are the interests protected by statutory corporation law.

Although legislation is very clear in establishing that directors duties are owed to the corporation and to the shareholders – as provided by section 717(b) of NYBCA –, for *contractarians* the interests of the latter should prevail in management decisions.

The scholars argue that corporation is not an entity but just a *legal fictio* that hide the real interests of the shareholders. These, as real individuals may boast rights and these rights are identified in the company contract, that is in the contractual terms which bind them to the directors.

Still, *contractarians* go further and conceive the contract between shareholders and directors as an agency relationship, offering therefore a more extreme version of the contract "special in nature" one suggested by Judge Stein [1992].

For the employment of agency law terminology is employed to refer to the relationship between shareholders and directors, the interests of the former come up to a position of unchallenged pre-eminence which implies two consequences.

[38] The most important of these is *Blasius Industries v. Atlas Corp*. [1988].

The first is that shareholders should have the power to control the board in order to minimize the agency costs either in a *de jure condendo* perspective and in relation to the interpretation of law in judicial cases. The easier way to enforce their (contractual) rights for shareholders sets forth the contrast with the old eighteenth century conception that saw the directors/ shareholders relationship governed by the law of trust. According to this discipline, the directors had to face a lot of limitations during the exertion of her power so that, as seen earlier, legislation and Courts began to confer more discretion to managerial decisions. Yet, this acknowledgement was not counterbalanced by a power of control from the beneficiaries (corporation and shareholders), for the law of trust provides that beneficiaries remedies are limited to specific enforcement of the trust, claim for breach of trust, appointment of a receiver, or removal of the trustee. Put it differently, if the beneficiary requires the trustee to accomplish some act, transaction and she refuses to do so, the beneficiary can do nothing. The gap between managerial discretion and beneficiary control therefore would have been filled by conceiving the application of agency law [Dalley, 2006] .

The second consequence, other than confirming that the firm is seen simply as a legal fiction which represents the complex set of contractual relationships between these inputs, means that, from a strict legal point of view, corporate law should be made only, or at least mostly, of rules freely adopted by the parties. The law that govern these bilateral contracts or bilateral relationships should limit as much as possible the envisagement of mandatory rules, since it is believed that only default rules may have a positive impact on such relationships.

It is true, default rules help contractual parties to reduce transaction costs: instead of spending time and money in the efforts of framing or writing or even discussing all the clauses, these are already provided by law.

The function of law acknowledged by the more extreme theories of this *contractarian* view in only to express the most efficient solution through written rules which can be opted out by the parties.

Therefore, parties are free to accept the solutions proposed by the legislator or instead to choose different ones which can be more tailored for their exigencies and preferences.

The principal-agent conception of the shareholders-directors relationship has been rightly criticized by Dalley [2006], at least from a (strict) legal (structural) point of view. The professor explains that

> "an agent is a person who has agreed to act on behalf of another person (the principal) and is subject to that person's control. The principal has a complete right of control over the agent, which serves to offset the fact that the principal is vicariously liable for all the acts of the agent. The agent owes fiduciary duties to the principal, including the duty to turn over to the principal all profits or other benefits arising from the relationship. The relationship between shareholders and directors has none of these features, and it should therefore be apparent that a board is not an agent of the shareholders".

§3.3 NEW INSTITUTIONALISM

The employment of the functional and structural approach to explain the nature of corporation has involved also another stream of thinkers, known as new-institutionalist.

To begin with, these authors criticize the *nexus of contract* theory because they do not believe in the rationale which is behind it.

In particular, contractarians claim that people act rationally for the promotion of their own interests.

In fact, the study of contractual relationships is based on the assumptions [Asimov, 1988)] that these scholars have expressed through the rational choice theory. They basically claim that:

homo economicus has stable preferences;

homo economicus acts rationally to pursue those preferences.

Point (a) demonstrates that economists like to make things simpler. In their opinion, regardless of the type of contract [James, 1979], actors "are not assumed to be governed by causal factors operating behind their backs" [Hedstrom & Stern, forthcoming]. When they negotiate contractual clauses, actors aim at increasing/maximizing their wealth.

As regards point (b), it is asserted that "actors… are seen as conscious decision makers" [Hedstrom & Stern, forthcoming] because before they conclude a contract they calculate, they seek information, they assess all the effects that might take place, and so on. The latter is thought to be *optimal* by definition, as it satisfies parties' preferences.

It is true, this rationale has been criticised by new-institutionalists for not taking into account – especially in very large institutions – that the circumstances within which people bargained change and the relevant contractual relationship might no longer be optimal.

For example, in large corporations it is very common that new shareholders show up in the ownership structure. These might elect a new board of directors whose decisions might not reflect the preferences of the previous shareholders. Hence, shareholders have definitely no growing up experience of what shall happen.

Moreover, the rational choice theory is very different from "old" institutional scholars assumptions which maintain that the decisions of economic actors are (and must be) shaped by external factors which are deeply rooted in a certain culture. Among these

external factors there are (and there must be) the rules of law which are expected to supply the lack of information bore by the weaker contractual parties.

Thus, for "old institutional" thinkers the presence of mandatory rules in corporate governance is necessary to align directors decisions to shareholders and stakeholders' interests, for both are not considered enough expert (shareholders) or in the position (stakeholder) to elaborate contractual clauses aimed at their protection.

The old institutional and contractarian views reflect therefore two stages of the idea of corporation, respectively aimed at underscoring stakeholders (and of course shareholders, '50-'60) and (only) shareholders interests ('70-'80-'90).

For new institutional scholars corporations are now in a third stage which might be labelled as "socially responsible capitalism" [Wilson, 2003], implying that there must be a new way of thinking of management with regard to functions, duties and responsibilities of the corporation.

In particular, new institutional scholars are not actually concerned with identifying which interests must be followed by the corporation. It is by now commonly accepted that either shareholders and stakeholders deserve to be protected. Therefore, the debate for these scholars is "not whether corporate managers have an obligation to consider the needs of the society, but the extent to which they should consider these needs" [Wilson, 2003].

From a structural approach point of view, similarly to contractarians, new-institutionalist scholars have reasoned on the traditional common law notion of contract and have found that corporation is a *nexus of incomplete contracts*.

Assuming that in common law a contract is an exchange of legally binding promises to act in the future [Scott and Triantis, 2005], new institutional thinkers consider that these promises are contained in the by-laws clauses and in the statutory provisions.

The promises obviously are made by who partake to the control of the corporation and, therefore, by directors and shareholders.

The content of the promises themselves is represented by some basic rules which define how parties have to behave in the future, especially when a certain situation occurs. For example, these rules shall establish how shareholders shall vote in the meeting, how they shall be able to exercise their right of vote, how they shall be able to obtain dividends or how the directors have their obligations to follow.

These rules and, therefore, the promises to comply with these rules can be deemed legally binding only when the obligations become defined, that is when the element of consideration comes out: by acquiring shares, an investor becomes shareholder of a corporation and in exchange of the money invested the corporation shall pay dividends; yet, the shareholder can not enforce the obligation to pay dividends until the financial year is approved. So, the contract represented by the exchange "buy share for dividends" is not really a contract as one of the promises – the distribution of dividend – is not legally binding until a certain moment, until a certain situation occurs – the decision of the financial year.

Seen in this way, the incomplete contract is efficient – from an economic point of view – so long as the obligations are well defined and so long as the law envisages a "mechanism that will complete the contractual incompleteness by monitoring the contractors" [Brosseau & Fares, 2000]

For new institutionalist scholars the problem in fact occurs when the rules which establish how parties shall behave are not envisaged.

The fact that the contractual rights of the shareholders are enforceable only when directors' obligation is defined and when the behaviour of this occurs, implies that the protection of their interests is and must be firstly accomplished within the corporate context whereas:

a) in the opinion of contractarians, the definition of the obligation would be a sufficient condition for being enforced;
b) in the opinion of new institutionalist scholars the directors' obligations are expected to be established by statutory provisions and, therefore, are expected to protect certain stakeholders' rights;
c) in the opinion of old institutional, shareholders have only institutional rights enforceable by the corporation itself.

If ones takes into consideration the UK Companies Act 2006 and the NYBCA then one easily notes that these Acts actually provide for directors' obligations. Among these obligations, part are directed to protect stakeholder interests (171ss-601ss), part to protect shareholder interests as for example the discipline of general meeting resolutions (281 ss).

Shareholders are supposedly not interested in enforcing the former – if for example they enforce the duty to protect the environment, they might jeopardize their dividends – but

are of course interested in enforcing the second. Yet, according to new institutionalist the enforcement is not as immediate as contractrian would suggest.

For example, section 656 provides that "where the net assets of a public company are half or less of its called-up share capital, the directors must call a general meeting of the company to consider whether any, and if so what, steps should be taken to deal with the situation".

In both the cases it is undoubtedly necessary that the situation described by the provision must occur for a contractual enforcement.

The different view of new institutionalists and contractarians comes out in the hypothetical fact situation for which the call of the general meeting hinders a prompt adoption of steps potentially fit to restore or defend the social capital.

In such a case, while for contractarians shareholders could enforce their contractual right to the maximization of dividends, jeopardized by the call of the general meeting, for new-institutionalist the behavior of directors could be challenged only if the call of general meeting has been announced with unjustified delay.

This example underscores how new-institutionalist focus their accent on the respect of the procedures, reflecting somehow the finding of the less extreme contractiarian theorists.

However, while for the former these procedures have to be contained in statutory provisions and mandatory, for the second they have to be left to the free choice of the parties.

§ 4. THE LEGAL NATURE OF NON-PROFIT CORPORATIONS

While literature either economic and legal is abundant concerning theories of business corporation, little has been said on behalf of non-profit organizations.

It is true, the potential resemblance of business and non-profit organizations allows to analyze the nature of the latter on the basis of the studies already accomplished on the former.

The discussion on the nature of business corporation has provided the devices to analyze the legal nature of non-profit corporation. The aim of this section is in fact to see how the institutionalist, contractarian and new-institutionalist theories fit in the concept of non-profit corporation and therefore to find out which are the interests pursued by this legal scheme.

As done for business corporations, the study shall take into consideration functional and the positive approach.

§ 4.1 FUNCTIONAL APPROACH

§ 4.1.1 Theories on the Role of the Non-Profit Sector

As done in the discussion on business corporations, the analysis shall aim at identifying the role played by non-profit organizations and then at detaching the interests concerned.

Chapter II had already described how from a *strictly religious charity* , the non-profit sector would have finally played a pure economic role. However, this theory is not the only one as there are several other theories that attempt to explain the role of the non-profit sector.

Since the identification of the interests depends on the role exerted by the non-profit sector, one can not skip the analysis of the mentioned theories.

One of the most authoritative theory has been provided by Professor Hansmann [1980] whose arguments to justify the development and therefore the function of *non-profit* corporations have been essentially underpinned on the basis of an economic analysis.

The scholar sustains that, for certain entrepreneurial initiatives, non-profit organizations may perform better than ordinary business firms.

The *contract failure* theory, indeed, relies on the fact that sometimes p*atrons* are not technically able to evaluate the goods or services they are purchasing or financing.

For instance, one may imagine consumers shopping in a supermarket. In that case, buyers may personally and directly check what they are buying. Among the stock of products, they easily choose the one which satisfies their preferences the most.

In other situations, though, such advantages may not be available. The clearest example is represented by the Red Cross. If one of its commitments is to distribute food for African children, contributors will barely know if their money has been fairly employed. They are not in a position to countercheck for what purposes for which their aid has been actually utilized.

Similar circumstances can be found when someone engages a company for flower delivery. Nonetheless, though consumers are not able to personally evaluate the performance they've required, they still can make sure by phone-calling the recipient. This evidently does not occur in the aforementioned instance concerning the Red Cross.

It is true that, in situations where *patrons* would hardly realize a possible misuse of their money, the market alone *fails* to provide any tool for the problem. In other words, the market itself can not guarantee a fair allocation of the resources.

When this happens, the authority of the state is expected to come into play. Through commercial law, it historically has been aiming at:

a) preventing unfair distribution of risks – above all when it is delegated to a weaker part, as for example the donor to the Red Cross – or;

b) reaching greater efficiency.

Accordingly, *non-profit* corporations have been penetrated via legal provisions directed to "help" the market satisfy the conditions for working efficiently. Undoubtedly, the most significant among them is the *nondistribution constraint* which, as quoted in the introduction, disallows to distribute any income generated by an entity's activities.

Such mandatory by-law clause would ensure *patrons* that the money they have given will be employed for organizational purposes. This explains why the American scholar claims that *non-profit* organizations play a protective role

Hansmann [1980] therefore justifies the existence and the survival of non-profit organizations on the basis of the *NDC*, seen as an excellent device to reduce the agency problem occurring between p*atrons* and directors.

Yet, the rationale offered by the American scholar is complete only if one assumes that many "if not most, not-for-profit firms are started by entrepreneurs" [Glaeser & Shleifer, 2001].

In fact, before bringing to life any activity, the latter are expected to make cost-benefit evaluations. Consequently, once they realize their enterprise might present problems related to market failure, they would find the *non-profit* option to be more trustworthy because of the *NDC*, that would attract more consumers than a business organization would. Yet, many *non-profit* organizations are joined by entrepreneurs only after they have already been constituted. This would lead the scholars to sustain that the "protective role" would justify the survival, rather than the mere existence of NPOs.

Moreover, the stream of thought based on Hansmann's [1980] findings relies too much on the effectiveness of the *NDC*.

Such disallowance, indeed, implies penalties for whoever is found responsible, but this does not actually mean situations of mismanagement may not occur .

Ortman and Schlesinger [2002], for instance, sustain that the monitoring mechanisms of *non-profit* corporations have historically been weaker than the business counterpart so that the *NDC* alone would not guarantee that expected management's fairness. The legal provision would appear fragile even where one assumed it to be supported by other elements such as the altruistic and ideological motivations supposedly driving NPO directors [Ortman and Schlesinger, 2002]. P*atrons* know directors change, situations change, and behaviors change. The authors define Hansmann's [1980] theory as "trust hypothesis", underscoring its extremeness.

Rather than upon the trust element, they instead prefer to explain the market share of *non-profit* organizations upon the concept of reputation supposed to best ensure a proper usage of financial resources [Ortman and Schlesinger, 2002] for p*atrons*. At the same time,

however, they acknowledge that reputation takes time to be formed and, moreover, would play its protective role just in cases where information flow among customers is good.

Hansmann's [2000] counter-response has insisted on the misinterpretation of his article. He claims that the *trust hypothesis* should not to be considered so strong. He outlines that if *NDC* were sufficient to guarantee interest alignment, then the agency problem would have been solved and the whole economy would have functioned thorough *non-profit* organizations. Accordingly, he has been keen to acknowledge the limitations of his findings, clarifying that he simply wanted to underscore the asymmetric information element, and quote one of the possible legal solutions to challenge mismanagement.

The *contract failure* theory is definitely the most popular in literature [Brody, 1996]. However, it still has some detractors. Ones of these are Sacco and Zarri [2006]. In particular, the Italian authors have underscored how the co-existence within the same sector of market of for-profit and non-profit firms should be the demonstration that Hansmann theory is not fully valid, as if it were, then only non-profit firms should survive. Another observation advanced by Sacco and Zarri [2006] regards the fact that the NDC can not be a warranty of the trustworthiness of the non-profit enterprises. These, in fact, as well as their business counterparts, still have to comply with rules such like minimum profit of the firm or general requirements of the financial year, so that their managers, although not distributing resources among themselves, could divert the money expected to be employed for the quantity and quality of the services/goods to ends related to the survival of the firm. The *NDC* therefore does not necessarily ensures quality and quantity: managers can take advantage of the *asymmetric information* to follow a management style which is quite similar to that of business firms. Other observations on the NDC point out that his could be envisaged by the founders of an enterprise just in order to obtain a particular - or rather - a relaxed fiscal status and that it could no ensure the trustworthiness of the non-profit firm so long as the stakeholders change in times – for example employees, donors, volunteers can be replaced by less motivated people.

The third and last critique to Hansmann theory concerns the fact that the *market failure* due to the asymmetric information does not represent a problem that can be resolved only by non-profit organizations. Also State-owned firms are not indeed profit seeking so that they might well flank the non-profit organizations.

Some other scholars attempt to explain *non-profit* sector success underpinning the statutory tax advantages which are granted to *non-profit* entities but not to their business competitors [Schoenfeld, 1970 and Fama & Jensen, 1983].

If one took on this justification then one could ascribe a completely different role to NPOs. Rather than structures aimed to protect *patrons* in cases of *contract failure*, such entities would represent an ideal device for astute entrepreneurs to hide business activities, taking advantage of the fiscal benefits.

In this work tax exemption theory is not considered convincing enough to motivate the impressive increasing number of NPOs. Along with that, it is important to underscore the fact that non-profit entities existed long before the introduction of the income tax in the United States, and hence are unlikely to be a byproduct of income taxation [Glaeser & Shleifer, 2001]. Moreover, the rationale behind fiscal exemption in actuality has never been very clear. Hansmann [1981] himself has provided a very significant article in which he has firstly analyzed the relevant existing legal and economic theories and, secondly, offered a novel, perhaps more satisfying, justification for the benefits recognized to NPOs.

In particular, he argues that "the best justification for the exemption is that it helps to compensate for the constraints on capital formation that non-profit organizations commonly face, and that such compensation can serve a useful purpose, at least for those classes of non-profit organizations that operate in industries in which, for various reasons, non-profit firms are likely to serve consumers better than would profit-seeking firms" [Hansmann, 1981]. Such argumentations demonstrate that Hansmann [1981] still relies on the *nondistribution constraint* element, considering it as a prerequisite for granting tax benefits and, therefore, confirming his idea that NPOs play a protective role on behalf of *patrons*.

A more general observation referring to legal aspects, however, would explain tax exemption based on the fact that *non-profit* incomes do not match with the terms used in the Internal Revenue Code.

Anyways, as Hansmann himself claims, *contract failure* and tax exemption are not necessarily competing theories [Hansmann, no year specified]. The author, indeed, acknowledges the benefits of fiscal advantages to strengthen the protective role of the *non-profit* sector.

The Hansmann [1981] rationale to justify the existence-survival of non-profit organizations has been challenged also by Fama and Jensen [1983] who have stated that their hypothesis that the nonprofit form is related to donor financing is more promising.

In particular, the latter argue that Hansmann relies too much on the nature of the products rather than the agency problems of donations. In fact, Fama and Jensen [1983] maintain that if a certain activity must rely on donations it could not be organized in a shareholding structure. For example, if a University had shareholders, donors would never be sure that their contributions would be adopted for the defined output (conferences, teaching, scientific publications etc.) as shareholders have contractual rights on the cash flow. This problem of agency could only be resolved by not envisaging a shareholding capital.

It is true, Fama and Jensen hypothesis seems to not consider the agency problem that would therefore incur between management and donators. According to these scholars, such kind of agency problem would and could be resolved by adopting the strategy of separating decision management from decision control in the decision process. This strategy shall be analyzed in details in chapter IV.

Another leading theory concerned with the development of non-profit sector has been provided by Weisbrod [Sacco and Zarri, 2006] who, instead of contract failures, speaks in terms of Government failure. A wonderful explanation of this theory has been offered by Sacco and Zarri [2006]:

> "the idea developed by Weisbrod focuses on the ways of supplying and financing public goods o services from the State. In his model, the authors advances specific hypothesis related to the ways to finance the public activities. In particular he assumes the proportion between the marginal contribution and the marginal benefit in relation to a certain public good/service can not be the same among citizens. Moreover, in Weisbrod theory, it is also fundamental his belief that the public decision making hinges crucially on the results of the political processes which are driven by first-past-the-post electoral mechanisms, where quantity and quality of the several goods/services are in function of the vote.
>
> Therefore, within such an economic model of electoral competition, the preferences of the median voter shall be relevant, since the political winner shall be the one that succeeds to obtain the 50% + 1 of the votes (for this reason his model is also known as Median voter theorem).
>
> Given the practical impossibility to render proportional for every single voting citizen the marginal contribution and the marginal benefit related to the goods or service to be provided, for sure some people shall deem the level of supply of the said good/service as

very high (so they shall be over-satisfied) while others shall consider it has too low (so they shall be under-satisfied).

With the majority system vote, only the median voter would be perfectly satisfied by the level of supply decided by the Government. In a political system where the candidates are elected through simple majority, the winner shall be the one that has presented the political program best aligned with the preferences of the median voter.

For what concerns the rest of the population, it is fundamental to understand if the given society is internally homogeneous or heterogeneous from a cultural, ethnic, religious and socio-economic point of view: the more a population is heterogeneous under such profiles, the more there shall be un-satisfaction among the voters in relation to the quality and quantity of the good/service provided by the Government.

From this point of view, the Weibrod theory seems outstandingly actual, since many economically developed societies are currently more and more characterized by a multi-cultural layer, as consequence of massive and intensive migratory flows.

Thus, it is possible to guess that such growing internal complexity of the socio-economic, ethnic, religious and cultural layer, implies a higher and higher rank of heterogeneousness also in relation to the individual preferences for what concerns quality and quantity of the public goods/service to be produced.

How is therefore possible to answer to the minorities un-satisfied by the rank of the public good/services decided by the State? According to Weisbrod, the key solution is not represented by an alternative that involves the profit-seeking enterprises operating in the market. In fact, the private goods/services offered by business firms can not perfectly replace the goods/services provided by the State as the former present fruition costs much higher (although they present the advantage of permitting the owner to accomplish a personalized control on the ways the goods/services are fruited).

Instead, according to the scholar, the existence of non-profit organizations as subjects offering public goods/services required by the consumers who unsatisfied by the political choices on the matter represents a much more promising path. In his reasoning, indeed, the non-profit organizations enter into the game as a consequence of the *government failure* underscored by the median voter system for they are able to allow the unsatisfied minorities to organize themselves in order to produce “from the bottom” the desired public goods in the quantity and quality they think fit.

Considering non-profit organizations as substitute of the State in the provision of public goods/services on behalf of the minorities which are unsatisfied by the choice mechanisms, Weisbrod goes on holding that the wideness of the non-profit sector shall depend on the degree of un-satisfaction of the consumers and, therefore, on the degree of heterogeneous of the preferences of themselves, from the demand side.

As noted earlier, such heterogeneousness of the preferences, in turn, shall crucially hinge on a complex nexus of socio-economic, ethnic, religious and cultural factors. Weisbord model, therefore, envisages that within a certain Country, the dimension of the sector are as greater as the more the given population is heterogeneous under the above mentioned parameters.

> In this view, as Mancinelli [2004] finds out, "in the public sector the advantage of the non-profit firms in satisfying the consumers demand is as higher as the demand is specific and restrained to a particular section of the population. The State, deciding on the basis of the preferences of the median voter, leaves unsatisfied the demand of certain sub-groups of the population. Thus, there are created niches of sub-offer within which the non-profit firm can establish itself and act as alternative or additional offeror of public goods/services".

On this concern, Musella e D'Acunto [Sacco and Zarri, 2006] observe that the Weisbrod model leads to interpret that the atypical dimension reached by the non-profit sector in the United States are explained in the light of the high degree of ethnic, cultural and religious heterogeneous which is typical of that Country.

Does Weisbrod theory have some shortcoming? There are actually two critiques concerned with the government failure theory.

The first concerns the fact that the non-profit organizations are superficially presented as organizations expected to supply a unique category of economic goods/services (although these are goods/services which are very important for the community): the public goods/services.

However, it is well known, that the non-profit organizations are potentially able to commit themselves to produce private goods/services and therefore be successful also in the market by financing (at least to a certain extent) its own mission-oriented activities through the direct sale of the goods/services to consumers. Obviously, accuracy requires to note that a direct involvement into the market from a non-profit firm, while it is theoretically compatible with the maintaining of a mission-nonprofit oriented identity, could render more pronounced the risk of a "commercialization" [Weisbrod, 1998] of the firms itself. This circumstance would no longer reflect the real identity of the non-profit organization.

Actually, it often seems particularly problematic for a non-profit firm to combine properly "identity" and "service", that is the "pursuance of a role of service (that has to be censure through an acceptable level of the organizational performance) with the maintaining and the continuous refresh of their original identity (that is censure by the high compliance of the staff and members of the organizational mission" [Ranci 1999 in Bonetti and Mellano 2004].

Refocusing the attention on the previous question, it is necessary to observe how it stays unsolved the problem of a theory – the one of Weisbrod – that does not take into account the capability of non-profit firms to act as producer of goods/services which are different from the typical public ones.

To begin with, one cannot not consider how the foregoing explanation is only partial to the existence of non-profit organizations, for it take into consideration, at the best, the role of a very specific segment of the non-profit universe: that, certainly important, represented by non-profit bodies that seem actually to have taken existence in the attempt to give voice to specific groups of citizens and social groups that are not reflected into the preferences of the median voter where all the whole Weisbrod idea has been set forth.

Anyways, it does not seem plausible the thesis of who meant to limit within these lines the activities that non-profit firms carry on.

The second and stronger critique to the *government failure* theory is represented by the observation advanced by Weiss [1985 and 1986]. In his analysis, as economic actors are not ingenuous, are able to foresee the consequences of their own choices: in informative systems which are not perfect, free riders are more incentivized to show up.

For example imagine an individual that has a very high income. Because of the imperfectness of the informative system, he can easily hide her real income. Now, if she votes for a politician whose program envisages low taxes and low level of public goods and assume that such politician wins the election, she will pay low taxes but she will not benefit of a good provision of public goods. If she votes instead of a politician whose program envisages high rates and high levels of public good, assumed that such politician wins the election, she will still pay low taxes – as she can hide her real income – and she will benefit of a high level of public goods. Whereas the majority of voters are such interested free riders, there will be a minority that, unable or unwilling to hide her real income, shall have to bear high burdens of taxes. According to Weiss, the intervention of the non-profit sector, would “help” the politician to envisage a softer tax program and, therefore, to stabilize the provision of the public goods on the level expected by the median voter. In other words, the presence of the non-profit sector facilitates the strategic distortion of the preferences: if there was no intervention of the nonprofit sector, in fact, the median voter would be unsatisfied

with the high level of rates and would vote the politician that would envisage a low level of public goods.

Sacco and Zarri [2006] underscore how both Hansmann and Weisbrod believe that non-profit organizations play a significant role in providing public goods/services, but they also set forth how the former holds that the latter gives too much attention to this aspect. Hansmann, in fact, maintains that the public goods/services are just a particular aspect of his *contract failure* theory, so that this seems to be more general and embracing than Weisbrod one.

Moreover, the Italian authors actually observe that Hansmann and Weisbrod, although providing an interesting rationale to explain the existence and, therefore, the role of non-profit sector, pay too much attention on the demand side of the matter. In other words, Sacco and Zarri [2006] argue it would not be correct to think that the non-profit sector exists only because there are some public goods/services that the State or the market cannot provide. It would be like to say that whereas State and market shall fill their gaps/failures, non-profit organizations would no longer exist.

The authors think instead that non-profit organizations are necessary to the community as well as the State and the market. These three institutions share the same level of dignity.

It means that the need of non-profit organizations, other than being explained on a demand side, should be explained also on a supply side. Non-profit organizations would be able to offer something that is as fundamental as what is offered by State and market.

This something is represented by the social capital, that is the set of the values, life styles, behavioral norms that, when the private and the public interests are not aligned, shape the individual choices on the promotion of the common good of the community or of the social group concerned[39] [Ecchia and Zarri, 2005].

Among these values one finds the *trust*. Non-profit organizations role would be to widespread trust among the community or among the members of the organization.

In the first case, non-profit organizations would play a *bridging* role while in the second a *bounding* one. The difference of these kinds of functions could be related with the

[39] Therefore in this circumstance the expression social capital is not to be meant in the economic corporate sense.

governance structure of the organization. In fact, those exerting a *bridging* role are expected to be *unowned* while those exerting a *bounding* should present a membership structure.

As underscored by Sacco and Zarri [2006], in both the cases the problem is still represented by a *misplacement of the mission*, that is a risk strongly connected with the opportunistic behaviors of whoever is in control of the organization.

The *misplacement of the mission* implies indeed a danger for the real or original identity of the organization and, as a consequence, a danger for the widespread of trust.

It is true, the idea of trust wide-spreader reflects the peculiar aspect of non-profit organizations of being mission oriented rather than profit-oriented.

To understand this linkage one has to assume that the *trust* is anything but the result of human behaviors not driven by individualistic purposes. This feeling of *trust* or general trust is crucial for the fair development of the society.

Market without trust is inefficient. No one would safely accomplish a transaction while knowing that the other party could behave egoistically. State without trust is inefficient too. No State could ensure the provision of basic public fundamental services (health, education) while its people is not wishing to pay taxes because of the fear their money shall be misappropriated by politicians.

Non-profits therefore are able to widespread trust because of their commitment to the mission which is historically – that is by definition – not simply lawful, but more importantly, the mirror of the highest values existing in the nature of the human being. That is particularly true for the *bridging* missions.

Sacco and Zarri [2006] theory certainly makes sense and is logical. Yet, it is not as general as the Hansmann one. Hansmann himself would express the same opinion that Sacco and Zarri have expressed about Weibord theory, that is to remark the fact that it can not explain the existence of all the non-profits. Rather, Sacco and Zarri [2006] theory seems to involve only a small segment of non-profit organizations, in particular those that are known as advocacy or support groups which in the United States they represent only the 1.8% of the whole non-profit sector [Salomon, 1999]

In order to appreciate the reasoning that would lead to acknowledge the partial validity of Sacco and Zarri [2006] theory, one can ironically take on the same question they

have advanced for detracting Hansmann and Weisbrod explanations: would non-profit firms exist if State and Market were perfectly functioning?

The answer is yes, but only those firms whose mission is something external to the State and the Market, that is missions that are exclusive territory of the non-profit sector.

Such answer assumes that the majority of non-profit sector is represented by hospitals and schools.

Thus, it is necessary to find out if these structures actually render the human being that come into contact with them, more accountable and less egoistic.

As concerns the hospitals, customers expect only to be cured and not to be indoctrinated on certain issues. Similarly, the staff simply aims at curing the customers. The hospital exists because disease exists, the non-profit hospital as well as the for-profit one exist when the State is not able to comply with its duty of providing health care.

For sure the hospital may represent a social organization where a structure of long lasting relationships, based on cooperation and reciprocity and therefore aimed at producing either material and symbolic values, yet this is not enough to explain the establishment of a hospital and the consequent survival, that is its simultaneous existence with a optimal public care system. People shall prefer the latter to the extent to which they shall not pay any fee to receive the service and to the extent to which material and symbolic values may well be produced also in the public structure itself.

As regards the schools, students expect to be educated. No one could deny that an educated people shall better organize its social life. Still, schools as well as hospitals are historically structures which are intrinsic to the very nature of the State, that is people acknowledge the State as the best body for providing these services. No school would be established with the mission of creating stable and trustworthy relationships, but for sure these relationships would represent values that shall flank the fundamental objective-mission which is to provide a high cultural background to fellows.

For the State is not able to provide optimal education and health care, it delegates or it even promotes the relevant function to both for-profit and non-profit organizations. The latter may be preferred by the public of consumers because of the market failure suggested by Hansmann as well as the knowledge that non-profit organizations other than the principal mission –provision of health and education - follow other missions that are actually not

secondary, that are envisaged directly or indirectly in the by-laws and that are represented by the promotion of social capital as argued by Sacco and Zarri [2006]. Yet, as seen above, the co-existence of non-profit and for-profit schools or hospitals is one of the counterdemonstration of Hansmann theory.

Once analyzed the sector of education and health care and once argued that non-profit organizations dealing with such services would not exist if State and Market provided them optimally, it should be found out which part of the remaining non-profit structures would exist out of consideration of the role exerted by those primary institutions.

This goal could be attained by repeating the reasoning accomplished for schools and hospitals for each existing category of non-profit organization.

Following the scheme proposed by Stalteri [2002], after schools and hospitals, one finds the category of religious entities. These actually present the aspects pointed out by Sacco and Zarri. In particular religious entities basically operate as *bounding* organizations, in the sense that their fundamental mission is to tie adherents in the name of a certain culture or of certain values.

The opinion that these organizations would exist regardless of any *government* or *market failure* is actually demonstrated by the fact that

a) for a long time the State has forbidden their incorporation;

b) they do not present aspects of economic redistribution as primary mission.

As concerns point a), the prohibition obviously concerned the religious entities which did not belong to the *established* church. This means there has always existed in the nature of religious entities a force that expressed the need to stay together for the maintenance and the worship of certain traditions. And this need can only be satisfied by a non-profit organization. The difference between the religious entity and the school/hospital is represented by the very circumstance for which the latter pursue a mission that could well optimally pursued by the State where the mission of the former belongs exclusively – and not residually – to the people that have decided to follow it.

The liberal incorporation of these organizations perfectly reflect the pluralistic principles of democratic states and undoubtedly contributes to the improvement of the social capital, above all if other than the *bounding* role, they exert also a *bridging* role.

As concerns point b), it can be said that religious entity carry on economic activities so that the Hansmann reasoning could be referred. Yet, the economic activity represents just a secondary mission with an aim to facilitate or to give credibility to the values pursued by the institution.

For example, the sale of religious icons would be successful even if there were for-profit institutions that would offer the same icons at a lower price, implying that in these transactions the laws of market and the theories of market failures have little to do: adherents would buy directly from the institution as they know their money shall be utilized for the worship of the tradition.

Similarly, the charity activity of the religious entity, as for example the feeding of the poor of a certain parish, shall be financed not because donors rely on the *NDC* but because they know they are contributing to the promotion of certain values which can be expressed or supported also by the charity activity itself.

In his categorization, Stalteri [2002] then mentions the cultural and sportive sector. As regards the first, one can remind: museums, galleries, libraries, theaters, festivals etc.

Actually the mission of such structures is to widespread culture just as it happens for schools[40]. Yet, it would not be correct to repeat the same reasoning accomplished on the latter since the kind of culture promoted by the museums, galleries, etc. is different. In particular, schools (college, universities, etc.) provide essential education while the cultural sector provides additional education. Additional education represents only secondarily a seat of learning[41].

While State and market have historically been involved in the essential education, that is in offering seats of learning, they would demonstrate only an indirect interest in additional education. Additional education is rather a matter of people who decide to gather human and financial resources to promote it among the human beings.

The difference between essential and additional education is still a question of time. In the future additional education might well become essential education so that State and market shift their interest from indirect to direct.

[40] As regards museums see for example Hein, http://www.museoliitto.fi/seminaarit/museolehtoripaivat05/esitelmat/Finland-lec.1PC.pdf
[41] *Id*

The conclusion is that cultural non-profit organizations exist regardless of any *failure* of *State* or *market* as they offer public benefit/goods which are exclusively inherent to their nature.

The same reasoning can be repeated for sportive organizations to the extent to which sport is an expression of culture whose mission, even more than mere cultural organizations, aims at supporting stable and altruistic relationships between people.

The next category proposed by Stalteri [2002] is represented by entities of solidarity whose missions may involve the protection of animals, the elimination of racial or sexual discriminations, centers for advising pairs in crisis etc.

Also in these cases, there is a service which is offered regardless of the demand. The service is offered because some people have decided to offer it on the basis of their beliefs that the service itself could improve the social capital.

Finally, Stalteri [2002] identifies those non-profit structures whose mission is represented by exerting pressures on the public opinion in relation to certain social matters.

The difference between such lobbying groups and organizations of solidarity is actually quite blurred, since also the latter are meant to promote a sensitization of the public opinion.

The difference may consist in the fact that lobbies are more active from a political point of view.

However, in describing the lobbies the Italian author makes an express reference to Putnam; in particular the American scholar is recalled to underscore how the more are the lobbies the more there are benefits for the whole community, as they function “as a device for the growth of the social capital by reducing egoistic behaviors of the members”.

Putnam has actually been quoted also by Sacco and Zarri [2006] in occasion of their explanation of the non-profit sector existence. If that is not a sheer chance, it follows that lobbies represent the sector of non-profit organizations that best demonstrate the Sacco and Zarri [2006] theory.

Thus, the findings of this analysis reveal a very important point on the role exerted by non-profit organizations. On one hand, if one takes on the organizations that most represent the non-profit sector in terms of number and resources involved, that is schools

and hospitals, then the role can be considered as a support for the *government* and *market failure*.

On the other hand, if one takes on the types of organizations involved in the non-profit sector, one shall find out that most of such kinds – although they do not reach a dominant position in terms of number and resources –, that is all the non-profit organizations which are neither schools nor hospitals, exert a role that can be defined as improver of social capital.

Finally, it deserves to be mentioned also that literature which identifies other key-factors involved in the development of NPOs. Two in particular are to be referred.

The first one is related to the general observation that, since 1960, "as Americans became wealthier they bought more services of all kinds" [Hammack, 2001]. The second, instead, is more specific and it is associated to the "world-wide quest to find alternatives to government in the provisions of human services, a quest largely borne out of disillusionment with government's handling of the welfare state" [Gibelman & Gelman, 2000]. In Hansmann terms, this actually means that the cases of market failure have increased and, accordingly, NPOs have found more room to pursue their objectives.

§ 4.1.2. The Interests Involved

As seen many times, the very first difference between the current non-profit sector and the old one is the heterogeneousness of the former.
This has also been demonstrated by the existence of the several theories whose findings are far to present a general validity. Put it differently, some theories are more adapt than others to explain the constitution and the survival of certain organizations of the non-profit sector and vice-versa.

This compels the analysis to make a choice, that is to decide which non-profit organizations are to be studied in order to identify the interests involved.

It is true, the attention shall be focused on the organizations that occupy the major share of the non-profit sector, that is health care, education and social services. In fact, in the United State they represent respectively the 46.3%, 21.5% and 13.5%, that is the 81.3% of the total of the non-profit organizations [Salamon, 1999].

In the foregoing discussions it has been underscored how the theory that best explains the establishment of these institutions is represented by the *market failure* of Hansmann who relies on the *non-distribution constraint* for justifying high quality and big quantity of goods/services offered. Yet, at the same time, it has been underscored how also Fazzi and Zarri observations on the values expected to be promoted by a non-profit organization are relevant.

Therefore, the role of the non-profit organization identified in this work is represented by a structure that not only is committed with providing high quality and big quantity of goods/services but also with producing them by respecting the social and ethical values which historically have distinguished the non-profit sector, in particular when it was expressed by a charitable dimension.

The very first observation on this role is that the combination of the two parameters tracks undoubtedly an institutional dimension of the non-profit corporation. In fact, if the distinguishing parameter of the non-profit sector were only the *NDC* , then the non-profit structure could represent a wonderful device for a private entrepreneur to carry on her business. Put it differently, if an entrepreneur had to establish a hospital, he could choose the non-profit scheme counting on the competitive advantage represented by the expectation that non-profit goods/services are better. In such a way, she could take advantage of the high

income to set a high salary as executive officer of the structure and, at the same time, she could freely take decisions that would jeopardize stakeholders of the corporation such as the employees. For example, in the name of the high quality and big quantity of services she could justify the firing of the too many workers. Yet, as here it is maintained that the high quality and the big quantity standards have to be considered at the same level of the respect of social and ethical values, then the non-profit corporation gives up to represent an optimal device for greed entrepreneurs.

From the institutional dimension of the non-profit corporation it is hence possible to study which are the interests involved, that is who and what is interested in the two just mentioned parameters.

To begin with, it is useful to compare business and non-profit corporations and to set forth the differences concerning the subjects involved.

In the former, the p*atrons* are represented by the shareholders while in the latter the p*atrons* are the donors and the consumers. In both the business and non-profit corporations directors, stakeholders and the corporation itself represent subjects involved in the activity.

In the business corporation context, the interests of the p*atrons* – the shareholders – may well be in contrast with those of the stakeholders and of the corporation. Therefore, the institutional or *contractarian* conception of the corporation shall be extremely important for directors and for the judges that shall assess directors' decisions.

In the non-profit corporation context, the interests of the p*atrons* – consumers and donors – are actually not in contrast with those of the stakeholders and of the corporation. All these subjects are expected in fact to be interested in the accomplishment of the two parameters indicated above.

Yet, there are some situations where the decision of the director is not easy. These are represented by those decisions within which directors have to act by considering the organization as a "living body" or as an institution which offers security for the community, provide job and improves the techniques for the scientific progress.

Given that this kind of decisions do not affect the interests of the p*atrons*, who are broadly speaking interested only in the fair administration of the funds, directors shall decide only on the basis of an evaluation of the interests directly involved.

For example, if a director of a hospital had to decide between to invest the incomes or to employ them to increase the salary of the staff, both the decisions could be considered as complying with the two non-profit parameters.

If the same director were running a for-profit hospital, first he would have had to resist to the pressures advanced by shareholders who were definitely not interested either in the investment or in the increase of the staff salaries – they were rather interested in the distribution of such income as dividend – and, secondly, whereas he had resisted, he probably would have taken the decision that the most had reflected the shareholders' interest: the investment.

Such power of the p*atrons* to influence the decisions of the directors represents another crucial difference with the non-profit sector. In fact, the donors or the consumers of a non-profit corporation, although they have an interest in the fair administration of the funds, this interest is considered a "legal" interest - that it is considered an interest in the sense described in paragraph "external controls" – only in certain circumstances that shall be described in the next chapter.

§ 4.2 STRUCTURAL APPROACH

The institutional dimension of non-profit corporations outlined in the discussion developed through the functional approach is well shaped also by statutory provisions, judicial doctrines and common law principles.

To begin with statutory provisions, non-profit corporations, as well as business corporations, have legal personality. This observation implies that non-profit corporations have their own interest and therefore confirms one of its institutional dimensions[42].

Another provision is directed to set forth the public interests concerned by non-profit firms. Yet, differently from the legal personality provision, this is not detachable in all the jurisdictions and, in the ones where it is envisaged, the provision itself can be subject to wider or stricter interpretations.

This is the provision which establishes that a non-profit corporation must follow a charitable purpose, which is *in re ipsa* something public and as such does not leave any doubt of the institutional dimension of the corporations that follow this purpose.

This provision is not envisaged in the General Delaware Corporation Law where it is simply established that the corporations organized under the Act may follow any lawful purpose. The lack of the provision obviously does not deny the institutional dimension of the "non-stock corporation", which can be still identified in the by-laws[43] other than in provisions such like the mentioned one conferring legal personality.

Yet, Delaware's approach makes it possible that the by-laws of a non-profit corporation envisages a purpose which is not charitable. This would mean that the non-profit status shall be identified by the *NDC* with the consequence it shall be possible to establish even a shoe store as non-profit corporation.

In cases like these, the institutional dimension of the Delaware non-stock corporation becomes significantly compressed. In fact, as underscored in the previous paragraph, a non-profit corporation whose non-profit element is represented only by the NDC would exert a pure economic role. This would not only render the non-profit corporation business-like but

[42] See for example § 717 of the New York Not-for-Profit Corporation Act, Section 8.30 Revised Model Non-Profit Corporation Act,

[43] The bylaws can in fact contain clauses which clearly indicate that one is in front of a non-profit corporation.

it would also imply that the interests of the corporation and of the other stakeholders shall be relevant for the law only so long as they have been concerned in the by-laws. This is just what happens for business corporations. The non-profit status therefore shall have importance only for tax law provisions.

As concerns the New York Not-For-Profit Corporation Act, all the purposes indicated by § 201 have to a certain extent a public dimension. In particular, type A speaks about any lawful non-business purpose or non-pecuniary purposes such as civic, patriotic, political, social, fraternal, athletic, agricultural, horticultural, animal husbandry, and for a professional, commercial, industrial, trade or service association.

Type B provides for charitable purposes and for other purposes that in the matter of facts fall within the concept of charitable.

Type C even establishes that the purposes of the corporation shall be public or quasi-public. Type D recalls the purposes indicated in the previous types in relation to non-profit corporations formed on the basis of an authorization "by any other corporate law of this state".

Thus, according to the New York Act, so long as it provides for many lawful purposes, still these purposes demonstrate a public dimension so that it would be very hard for example to establish a shoe shop under the Act itself.

Even fewer doubts of this nature are to blossom if one considers the UK legislation of non-profit corporations, whose name already suggests its public dimension: Charity Act 2006 and whose section 1 provides:

> "For the purposes of the law of England and Wales, "charity" means an institution which - (a) is established for charitable purposes only, and (b) falls to be subject to the control of the High Court in the exercise of its jurisdiction with respect to charities".

As regards the judicial decisions that shape the institutional dimension of non-profit corporations one can remind those that conferred to the Attorney General the power to prosecute the non-profit directors who did not comply with the purpose of the corporation and with the intents of the donors. Moreover, accuracy demands to remind that in a certain point of the United Kingdom history, the principles established in these decisions were flanked by the legislation instituting the Charity Commission underscoring once again the public-institutional dimension of non-profit corporations.

However, it has been mentioned that some judicial decisions identified to some extent also a private dimension of charitable organizations. In particular, those related to the cy-pres doctrine. If the aim of the judge was that of giving importance to the intention of the donors in relation to the enforcement of the trust, maybe a further judicial effort would have recognized also the intention/interest in a proper administration of the trust itself.

The wall between the interest in the enforcement of the trust and the interest in the proper administration of the latter has been smashed only lately by acknowledging the giving of the donor as a contract and not as a donation[44].

In order to find out the extent to which a non-profit corporation is a contract one has to set forth the concept of contract in common law.

Although from a strict legal point of view the common law concept of contract did not really reflect the relationships underpinning business corporations, it had been observed how their by-laws could be considered contracts of special nature and how the terms which conferred property rights to shareholders could be actually enforced by the latter.

Similarly to business corporations, the relationships between donors and the corporation can not be considered contractual from a strict point of view, for the donation is not a contract in common law. Donors moreover do not sign any by-laws as it were a covenant (UK Companies Act Terminology) and do not even participate in the drafting of the clauses.

As underscored earlier, for the non-profit corporations are *unowned* there are not property rights to be boasted.

This explains why, the only way to detach a legal relationship between donors and the corporation has been to deem the act of benevolence as a contract.

This perspective has implied the identification of a set of promises supported by a valid consideration, whereas the promise of the donor is represented by the giving and the one of the corporation is to use the funds received for certain (charitable) purposes.

The type of contract established in this way is by no means a charitable trust. The discussion on this recent judicial doctrine shall be developed in the next chapter as well as the one on the trust seen actually as a contract.

[44] This observation is obviously valid only if one deals with common law jurisdictions, for in civil law jurisdictions the donation is (already) a contract.

Also, it shall be developed a discussion on the contractual dimension of the relationship between costumers and the non-profit corporation.

§ 4.3 NEW INSTITUTIONALISM

The main finding of new institutionalism scholars is represented by the conception that the corporation is a private tool that has to take into account also public interests. The extent to which the latter are to be considered shall depend on the peculiar function, duty and responsibility conferred to the corporation.

For sure, the function of the non-profit corporation seems to be more economic than political. Therefore, if the function is to act in the market on the same level of business counterparts, then the interests of the patrons are to be preferred to those of the stakeholders and of the corporation. This approach would of course imply that the mentioned interests do not correspond.

Thus, if the non-profit corporation concerns an activity which is traditionally deemed as charitable, as for example a hospital, then the interests of the corporation and of the stakeholders might benefit enough consideration in the light of the interests of the output/outcome. Where instead the non-profit corporation is rather concerned with activities which are not historically classified as charitable, then the new institutionalism model would attribute to the interests of the p*atrons* a wider consideration.

Differently from contractarians – which deny the need of mandatory rules – and from institutionalists – which promote a set of mandatory rules aimed at considering the interests of shareholders, stakeholders and corporation on the same level – according to new institutionalists, the law is only expected to provide a set of rules governing the decision making processes.

The law should not expressly indicate which are the interests to be protected, but it should only provide the procedures for the adoption of the decisions. The respect of such procedures would mean that the interests involved in a certain organization have been respected.

Therefore, in the hypothetical fact situation within which in a hospital – that is a non-profit corporation with a charitable purposes – the directors take a short-term decision while

complying with the procedures envisaged by the law, it would be hard for stakeholders to claim a breach of fiduciary duty. In fact, new institutionalism scholars deem that the decisions are shaped by all the internal and external factors involved in a certain institution and that these factors might change with the time. The short-term decision taken in a hospital and procedurally correct, shall demonstrate that the charitable dimension of the hospital has been lost – or has never existed.

Reasoning in terms of structural approach, the effort of the new-institutionalists is to identify an incomplete contract between p*atrons* and directors.

The clauses of the by-laws – mandated by the law – should describe how directors shall behave and, therefore, p*atrons* would be allowed to bring suits every time they detach a misbehavior.

The external control of the patrons would represent the additional private device to the activity of the Attorney General which would instead represent the public (institutional) device.

§ 4.4 NON-PROFIT EFFICACY

The discussion on the non-profit concept of efficiency is fundamental to evaluate managerial accountability for the decisions that have been taken. In the earlier analysis it has been seen how the purposes of the non-profit corporation are represented by two parameters: high quality and big quantity of goods/services and respect of the social values that historically belong to the charitable dimension.

Thus, the very first observation is that instead of efficiency, it would be more correct to talk about efficacy of the non-profit corporation.

In order to demonstrate why non-profit corporation must be effective rather than efficient, it is useful to get briefly back on the role and on the interests involved in the non-profit activities.

Borzaga and Fazzi [2000] argued that these structures have undergone a rapid and deep evolution that have ensued a debate on their role and nature. In particular, while until the '60s they were studied mainly from a sociological point of view, after that they began to be seen more and more as social enterprises.

The Italian authors underscored how this new idea of non-profit corporation had enriched the doctrinal background for it introduced in the non-profit sector important know-how about managing, fund-raising techniques, marketing strategies, financial years etc.

This implied that many scholars concerned with the study of non-profit organizations began to assess and to evaluate their results according to the concept of performance, that is began to assess and to evaluate non-profit corporations as if they were business corporations.

For example Callen, Klein and Tinkelman [2003] measured the performance of non-profit corporations by using three metrics: the ratio of administrative expenses to total expenses, the ratio of fundraising expenses to total expenses, and the ratio of program expenses to total expenses.

Similarly, other scholars maintained that the dominant model to measure non-profit performance of firms was focused on the assessment of the output, that is what in a business context represented the good conceived as the objectively measurable result related to the

single performance [Weiss, 1971 in Borzaga and Fazzi, 2000]. Therefore, as the organizational performance had to be the sum of all the single performances, the former had to be measured through standards like: hours of production, profits, market shares etc.

The purely economic management and evaluation of non-profit activities uncovered actually a private and *contractarian* dimension in these structures. In fact, the exclusive importance posed on the outputs – that is on the quality and quantity of the products – demonstrated the aim of satisfying a purely material interest of the consumers.

Put it differently, the non-profit corporation began to be conceived as a private device funded by donors and consumers in order to obtain quality and price advantages with respect to the goods/services offered by business corporations [Callen, 1994].

Such conception would have detracted the fundamental assumption presented in the previous chapter according to which the interests of the patrons, corporations and stakeholders corresponded.

On one side, it must be admitted that patrons of non-profit hospitals and schools may be concerned only with the relevant output. That is quite clear as regards consumers who buy the services/goods. Less clear but still possible could be the fact that a donor fund a school since she knows one day she will take advantage of it.

On the other side, it is hard to identify a private interest in the funding of social services organization such as the red-cross. Whoever finance these kind of structures, either as donor or as consumer, is necessarily driven by altruistic motivations/purposes.

Whereas one can infinitely discuss on what the role of non-profit organizations – in particular hospitals and schools – actually is, one could not infinitely discuss on what such role should be.

For this reason social science scholars concerned with the study of the non-profit sector continue to accomplish efforts aimed at highlighting the real and public/institutional role of non-profit corporations. On this sense, it is of course especially important the contribution of legal scholars whose analysis should represent the base for judicial decisions.

As regards the argumentations provided by sociologists and political scientists, one can first of all quote the observation advanced by Letts, Ryan, and Grossman [1998] in detriment of the three ratio theory. In particular, these scholars claimed that if one relies too much on such ratios to assess the performance of a non-profit firm, then directors would be

induced to dysfunctional behaviors including underinvestment in the necessary organizational capacity to function effectively.

Also D'Aunno [1992] criticized the tool of financial ratio to measure the efficiency of a non-profit organization.

In particular, this scholar presented an institutional theory model according to which non profit organizations were influenced by widely held beliefs and rules present in the environment, advancing an approach to conceptualize effectiveness in the light of organizations' relationships with key external actors. The "ecological model or the participant satisfaction model defined organizational effectiveness according to organizations' ability to satisfy key strategic constituencies in their environment" [Sowa, Selden, Sandfort; 2004]. D'Aunno [1992] moreover underscores that those non-profit organizations whose outputs or outcomes are especially difficult to measure face strong pressures to conform to expectations about how they should behave. Therefore, to the extent that the outside environment in which nonprofits operate perceives ratios such as the proportion of program expenses to be related to organizational efficiency, nonprofits are likely to adopt such ratios as meaningful performance metrics.

Other scholars [Au, 1996 in Borzaga and Fazzi, 2000] have preferred to maintain that the introduction of the conception of performance into the non-profit sector did not necessarily imply a pure economic management and evaluation of the firms' activity. In fact, according to them the discussion on the non-profit performance had always been characterized by a noteworthy level of theoretical ambiguity and until that moment no one seemed to have shed light on the point.

Schuster [1997, in Borzaga and Fazzi 2000] shared the idea of the ambiguity of the conception of performance. Yet, he thought that such ambiguity did not represent something that was peculiar the non-profit sector. Rather he argued that the content of the concept of performance strongly depended on the research interests that were pursued or on the scientific discipline involved. According to this approach, therefore, to record a high performance of a non-profit firm could mean either that the structure was financially stable or that the structure offered high quality and high quantity of services/good or that quality and quantity of services/goods were supported by a strongly ethic and altruistic management;

the one of the other definition would have depended on where and in which circumstances the expression “performance” had been used.

According to Kanter and Summers [1987 in Borzaga and Fazzi, 2000], differently from profit-oriented firms, the actual problem concerning the assessment of non-profit performance was not technical in nature, but conceptual: it was not a problem about how measuring the performance, but which was the unit of measurement. While as concerns business firms this assessment is very easy for the output reflects the performance, within the non-profit sector the measure of the output would have not given an idea to the results accomplished [Forbes, 1998 in Borzaga and Fazzi, 2000].

Borzaga and Fazzi themselves [2000] set forth three risks connected with the employment of output concept to measure non-profit efficiency:

a) the employment of the measures of production did not succeed to give an idea of the differences which were inherent to the processes that bring to the realization of the product;
b) the employment of the measures of production left unsolved the problem related to who was the beneficiary of the goods or services produced;
c) the employment of the measures of production implied the reduction of the problem of the organizational performance to the one of the single performance.

According to them, the underestimation of the process through which goods and services are produced led to not give the proper consideration to the relational dimension of the service. As underscored by Wagner [1995 in Borzaga and Fazzi, 2000], the services on behalf of a person are characterized, or should be characterized, expressly by the relational character of the service. The service, in fact, to be offered in a satisfactory way, had to assume a fiduciary cooperation between who offer and who receives the performance.

Only by focusing on the relationship between firm and consumer, the personalization of the services, that is the capability to provide a suitable answer to the exigencies underscored by the social problems, became possible. The non-profit organizational performance had necessarily to take into account the ways products are realized, just because this aspect had historically represented the very force of the sector.

In relation to point b), a too strict analysis of the output diverted the attention from the problem concerning the beneficiaries of the service. If only the measures of production

of a certain service were known, the preferences of the consumers remained basically overlooked, as a logic correlation between the increase of the quantity of produced goods and the level of satisfaction of the consumers.

In order to understand how a service that aims at improving the social welfare reflects the preferences of the community, it was necessary to verify which were the concrete chances that beneficiaries have to express, directly or indirectly, a position of voice or exit before the firms [Hirschman, 1970 in Borzaga and Fazzi 2000]. The more these chances were present, the higher was the chance that the service reflected the real exigencies of the community.

Overlooking the problems related to the coordination, cooperation and communication among the consumers preferences and the firms, meant to render sterile the concept of performance and to promote social work perspectives that were identified by a concept which does not take into account the relationship between the firm and the consumer.

As regards point c), the services provided by non-profit organizations did not reflect, or had not to reflect, a demand-supply criteria. Such model, in fact, would have implied that the final result of the activity would have been represented by the output instead of the outcome. The difference between these two concepts concerned the fact that the former is the product of every single performance, while the outcome is the overall result on the welfare status of beneficiaries of the services. Therefore, where the output identifies the efficiency of a service on the basis of an assessment of the relationship between production capacity and employment of the resources, the outcome referred to the efficacy of the intervention assessed on the basis of a comparison with a previous supply of the same service.

To evaluate non-profit organization performance only on the basis of the productive output would have meant to not give enough importance to the services' results on the consumers welfare and, hence, would limit the purpose of the organizational processes to the satisfaction of partial exigencies, instead of increasing the overall welfare of the community.

Thus, according to the Italian authors the concept of organizational performance concerning the commercial non-profit organizations had to involve a multidimensional and multifactor nature, according to which:

a) not only is important what is produced, but how that is produced: the output of the productive process represents therefore only a general parameter of the quality of the service. This is not enough to establish how the service is able to satisfy the consumers;
b) not only is important what is produced, but also who is the consumer: the social relationships, system and coordination, communication and control processes play a crucial role for understanding how the product is able to reflect the reasons for which it has been produced;
c) not only is important what is produced, but its capability in not representing just a single performance: a performance analysis must not exclude the outcome of the service.

The accent posed by Borzaga and Fazzi [2000] on the quality of the product confirms one of the two parameters offered by this work to evaluate non-profit efficacy. Less attention the Italian authors have instead paid to the second parameter: the respect of the social values intrinsically promoted by a non-profit institution.

However, literature stressing this second parameter is not missing. Other than the institutional model suggested by D'Aunno [1992], also Eikenberry and Kluver [2004] claim that "the non-profit model stresses the values of community participation, due process and stewardship".

As concerns the contribution offered by legal scholars in determining the parameters to evaluate non-profit performance, chapter V shall explain which standards directors are expected to comply with.

CHAPTER IV

THE AGENCY COSTS IN NON-PROFIT CORPORATIONS

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§ 1. THE ROLE OF THE MANAGEMENT

The investigation on the nature of corporation, both business and non-profit, has revealed an aspect which is common to all the theories concerned with this topic: the presence of a group of persons charged with following certain purpose on behalf of other subjects.

The different theories, through the functional and structural approach, have done anything but identifying whose interests this group of persons is expected to promote:

a) of the corporation, including shareholders and (for some scholar) other stakeholders according to old institutionalism; as regards non-profit corporation, directors shall pursue the interests of the corporation and of the other stakeholders. The interests of the p*atrons* shall be taken in consideration only when expressed in a legal form. Yet, the interests of the p*atrons* are not supposed to be in conflict with those of the corporation and of the other stakeholders;
b) of the shareholders according to neo-liberal economists; as regards non-profit corporations, a private dimension of the structure is conceivable only when it is employed by an entrepreneur to pursue non-charitable purposes. That is the example of a structure whose non-profit element is represented only by the *NDC*. In cases like this, the neo-liberal theory would claim that the directors – that can be the founders themselves – might be expected to pursue the interests of the p*atrons*.
c) of the shareholders, of the corporation and of other stakeholders in the name of a socially responsible capitalism for new-institutionalism. As regards non-profit corporation, the importance of the rules of law shall be represented by the capability to resolve possible conflict of interests between the corporation and other stakeholders as for example the workers.

Although it has already been warned that it is not correct from a legal point of view, it can be held that in all these relationships the group of persons is an agent, while the principal

is represented by the subjects indicated in points a), b) and c) according to the theory that one chooses to adhere.

Whether the principal is represented by shareholders, corporation, stakeholders etc., there shall be always certain problems related with the decisions of the agents. Not only they could undertake selfish initiatives in detriment of the interests of the principals, but they could be also careless in the adoption of the decisions themselves, and this could jeopardize the interests of the principals as well.

The scholars that have reasoned on the agency problems are the *contractarians*. In particular their theories have aimed at devising mechanisms concerned with the protection of the shareholders.

Theoretically, once insisted on the institutional dimension of non-profit corporation, it would seem in odd to apply the neo-classical theory to this kind of structures. Yet, assumed that the interests of the donors and customers reflect the ones of the corporation and of the other stakeholders, it shall be possible to apply agency theories by considering non-profit patrons as if they were the shareholders of a business corporation. Put it differently, the mechanisms that shall protect the donors and customers, shall automatically protect also corporation and other stakeholders because of the overlap of the interests.

To begin with, *contractarians* have taken on Ronald Coase [1937] theory of the firm to understand why management does exist. If one understands the nature or the role of the management, then one might be able to think about the mechanism that may align the interests of this agent to those of the principals, whether the latter are the corporation, shareholders, stakeholders, etc.

Coase and contractarians believe that parties to contracts must bear costs when they transact [Hisiung, 1999][45].

Setting out from this idea, Coase ends up to maintain that the management (A) is a necessary body of the firm (B) which in turn is a legal-economic device aimed at reducing

[45] For example, imagine a simple contract in a hypothetical situation where a bicycle must be sold. While negotiating the price, the purchaser may be willing to spend some money for an expert's opinion on the conditions of the bike [information costs] Actors, therefore, reasoning in terms of costs and benefits, shall supposedly agree just in case the latter are higher than the former.
These mainstream economic ideas blossomed around the '70s-'80s, but the *transactions cost* theory was introduced fifty years earlier by Ronald Coase [1937] to justify the existence of the firm and, simultaneously, to disprove price system theory. In other words, Coase had already claimed that market was not costless.

the transaction costs (C). Thus if A=B=C then A=C, then management is fundamental to reduce transaction costs.

In fact, Coase's argument was that firm would have replaced market since it would have reduced the amount of transactions and therefore the relevant costs. To understand this concept, one may think about how entrepreneurs may better organize their economic activities. Supposing they need to contract a certain number of persons out in order to carry on with their enterprise, they would likely incur in the costs referred to above. The latter may still be lower than the benefits, so that the entrepreneur may choose to continue to seek for agents within the market. However, contracting persons out for every single operation would mean to iterate the transactions, increasing the relevant expenditures.

Ronald Coase's [1937] theory focuses just on these inefficiencies.

In Coase's opinion, entrepreneurs would better hire their agents on the basis of long-term contracts so that the series of contracts are substituted only by a special one which "corresponds closely to the legal concept of the relationship of employer and employee" [Coase, 1988]. The aggregate of the long-term contracts that entrepreneurs reach with their agents, constitutes the firm. More accurately, "firm is characterized by the existence of a central contracting agent and a contract whereby the factor, for certain remuneration, agrees to obey the directions of the entrepreneur within certain limits" [Coase, 1988].

From a cost-benefit analysis one may underscore that on one side, it is true that the entrepreneur dramatically reduces the quantity of transactions, saving the relevant costs; but, on the other, it is correct to notice that he/she will incur in diverse expenditures "associated with the administrative cost of determining what, when, and how to produce, the cost of resource misallocation (since planning will never be perfect), and the cost of demotivation (since motivation is lower in large organizations)" [Canbäck, 1988]. The latter are denominated management costs [Canbäck, 1988]. Accordingly, to explain the existence of the firm, the question is not whether management cost is more or less than transaction cost, but whether the sum of management and transaction cost incurred through in-house production is more or less than the sum of management and transaction cost incurred through purchase across markets, since either option entails expenditures on both cost categories [Demsetz , 1988].

Ronald Coase's [1937] theorem, though providing a logical explanation of the existence of the firm, is nevertheless not sufficient to motivate the survival of the firm itself. It fails to accurately focus on the problems that employment relationships entail and on how they may be resolved. In particular, we have to bear in mind that the presence of widely held corporations implies that the entrepreneur is not a single *homo economicus* but, instead, is represented by thousands and thousands of shareholders. In economics, the latter are thought of as the owners of the firm and as such, they are the employers. Through the *central contracting agent* [Demsetz , 1988] they proceed in hiring specialized managers put in charge of running the business. Normally, all employees who deal with third parties are considered agents [LegalMatch, website]. The separation of ownership and control identified by Berle and Means [1932] suggests that there is a very significant information asymmetry between the principals and the agents. The expenditures that the principals incur for monitoring purposes represent what Ronald Coase [1937] overlooked [Demsetz, 1988]. Entrepreneurs may choose to organize their activities under a firm since they have assessed that managerial costs are lower than the ones to be born if they had to contract an agent at every instant. The organizational form is thus justified, but its survival is not. The strategy opted for by the entrepreneur may well work just because he/she has direct contact with managers. The situation dramatically changes when huge corporations are involved. It is the case where the *agency problem* naturally occurs and calls for neo-classical economists to study the relevant solutions [Hansmann, 2003].

§ 2. THE MONITORING COSTS IN NON-PROFIT CORPORATION

Management reduces transactions costs only when monitoring costs are lower than those to be born if one had to hire an agent at every instant. This normally happens in corporate contexts, yet it has to be underscored how in non-profit corporations the monitoring costs are very high: even higher than business corporations.

To begin with, differently from shareholders, patrons do not take part to the control of the organization for two reasons:

a) they do not elect the board;

b) they are not informed about the day-to-day operations of the organization.

The only way through which p*atrons* could (at least formally) exert control would be represented by supporting their donations with a deed within which they specify how they would like that the funds shall be employed.

In such case, the donors – so not the consumers – through a contractual action shall have the right to sue the non-profit directors whereas they detach a misuse of funds.

Yet, the donors shall not have the right to enforce the fiduciary duties of the directors owed to the corporation. It is true, this would be possible only whereas the court considered the donation as a contract whose clauses are represented also by those envisaged in the by-laws of the organization.

Another aspect related to the high costs of monitoring is represented by the difficulty to find non-executive directors which have the necessary competences to ensure that managers shall take decisions which comply with both the parameters of efficacy and efficiency.

Also, the lack market for corporate control represents a further impossibility to save costs of monitoring.

§ 3. BOARD OF DIRECTORS AS CAUSE OF AGENCY COSTS

Once identified the agency costs occurring in non-profit corporations, it is possible to focus the attention on the mechanisms that could reduce them. In other words, the mechanisms that would ensure the survival of the firm.

To begin with, these mechanisms are to be provided by law. According to Hansmann and Kraakman [2005] legal mechanisms can be divided into two categories:

a) regulatory strategies;

b) governance strategies.

The regulation strategies are represented by mandatory rules which discipline the content of the agency-principal relationship or the formation and termination of this relationship.

Governance strategies are based on hierarchical and authority concepts which commonly characterize the agency relationships: they aim at protecting principals indirectly, either by increasing their power and shaping the agent incentives.

The categorization of Hansmann and Kraakman [2005] can be compared with the thesis of Fama and Jensen [1983] according to which in business corporations, the very fundamental tools thought to reduce the risk that *agents will cheat you* [Williamson, 1985] are represented by the market for corporate control, the free transferability of shares, and the board of directors.

Their functioning presents factors which are strictly correlated to each other.

Managers may feel the pressure of losing their jobs when the firm performs poorly.

In cases like these, the value of the stock decreases and expose the corporation to investors willing to buy it out for restructuring purposes. Yet, the takeover does not only mean new financial resources but also the possibility for the new major shareholder to elect a new management. The market for corporate control is an economic phenomenon inherent to the market force so that theoretically it should not be considered a law mechanism. But law is essential to ensure its functioning as incumbent management could adopt measures aimed at hindering the tender offers of the bidders. As the role of the law should be to forbid the adoption of these measures or to submit them to the approval of the shareholders themselves, then this can be considered as a governance strategy.

The principle of free transferability of shares guarantees shareholders the right to exit whenever they do not feel comfortable with the incumbent management, other than rendering possible the takeovers – if the shares could not be freely sold then nobody could buy out the target corporation. In relation to the first kind of protection, this can be considered as a regulatory strategy while in relation to the second, the free transferability is absorbed by the market for corporate control mechanism so that from this point of view it can be deemed as a governance strategy.

Finally: the board of directors. The members of this board are expected to oversee the activities of the managers and to make its best effort to align their interests to the ones of shareholders. The power to appoint the relevant members is the result of a shareholder meeting. Basically, the board of directors therefore represents an agent charged with overseeing another agent. This could lead to observe that its existence does not make much sense, as it would only duplicate the agency costs.

Thus, in order ensure the highest level of neutrality, the law requires that the nomination, audit and remuneration committees must be constituted by non-executive directors, that is directors not directly employed by the firm [Mace, 1971] and, therefore, directors that are interested at improving their reputation in order to secure their managerial office in another (non-competitor) corporation or to get better jobs of the same kind.

However, it can not be denied that, if, on one side, agency theorists state that an effective board should be composed only of *nonmanagement* directors [Dalton, Daisy, Ellstrand and Johnson, 1998], on the other, it must be considered that the latter may not have all the indispensable information to control effectively. This implies that independent directors must include top managers in the board as well, in particular the chief executive officer (CEO). Therefore, once appointed after the general meeting, directors are expected to select, evaluate and, if necessary, remove the management [Mizruchi, 1983].

The mandatory envisagement of the board of directors and the relevant mandatory criteria of its composition demonstrate that this legal mechanism belongs to point b) [governance] of the strategies for it is directed to shape the incentives of the agents.

The three legal mechanisms suggested by Fama and Jensen [1983] other than having been conceived while thinking on business corporations, represent by no means a *contractarian* approach.

This for two reasons.

The first is that the (statutory) promotion of the market for corporate control and the free transferability of shares are devices that involve directly the proprietary interests of the shareholders. The board of directors is as a consequence expressly composed and disciplined to promote those interests.

The second is the intentional choice to not consider or mention all the other possible legal mechanisms. In fact, this leads to guess that Fama and Jensen have thought that is better to leave in the hands of the shareholder, as rational *homo economicus*, the power to protect himself contractually and, therefore, to protect herself according to her own preferences.

Anyway, as concerns the market for corporate control and the free transferability of shares, these are tools that do not apply to the *non-profit* sector. This is due to the fact that *non-profit* corporations are *unowned* so that there are no shares and, consequently, no rights to control or to be taken over.

As regards the board of directors, where its role in non-profit corporations reflects much the same the one of business corporations – that is to say, members must oversee the activities of the management – there are very fundamental differences regarding the election, the culture and the competence of the board that may interfere with the level of director performance.

It has been seen that the first difference is that non-executive directors of business corporations are elected directly by shareholders. Since non-executives in turn appoint top-management, in some way shareholders, at least indirectly, participate in the selection of executives themselves. This scheme anyway has led some scholars to talk about a duplication of the agency costs [Enriques, company law seminars held in Sapienza University, 2009], for being non-executives accountable to shareholders and executives accountable to non-executives.

However, it must be added that in modern NPOs, non-executive members of the board are normally the constituents of the firms themselves. In those cases where *non-profit organizations* are so old that the founders are no longer living, the composition of the board is continued on the basis of self-perpetuation. Unlike shareholders, therefore, p*atrons* are generally not involved in matters related to the control of the firm, and most importantly

they do not choose the members of the boards – unless they are the founders of the organization or self-perpetuated members that continue to contribute.

The second difference concerns the culture of the board. In business corporations executives and non-executives share the same education, and they are expected to measure the efficiency of the firm according to the same parameter: profit maximization.

In non-profit corporations, on the other hand, one experiences a conflict of cultures which reflects a more delicate conflict of interests and which mirrors the different concepts of efficiency. Unlike executives, in fact, non-profit non-executives are normally not educated in economics. This implies that the latter, other than monitoring managers for possible expropriation of money, are expected to intervene every time the actions of their agents, though economically beneficial, do not meet the social purposes of the organization. In other words, those actions that may well be appreciated by business directors, may not be accepted by *non-profit* directors.

The differences in the way members are appointed and in the internal cultures are closely connected to the competence of the members. Indeed, in business corporations non-executive directors are elected by shareholders on the basis of their education. Accordingly, through the same criteria, non-executives choose executives. In *non-profit* corporations, instead, members of the board are community-based people who have founded the firm itself or have been chosen because of their ideological motivations. They therefore do not necessarily present some economic education which allows them to exert an effective control over executive directors.

Therefore, the Enriques' reminder of the duplication of agency problems occurs in non-profit corporations through a different perspective .

On one hand, in business corporations the duplication is based only on the rational choice assumption according to which the *homo economicus* is self-interested and as such he/she tends to maximize his/her wealth in detriment of the counter contractual party – non-executives in detriment of shareholders and executives in detriment of non-executives – .

On the other hand, in non-profit corporations the duplication of the costs does not concern the two-steps process of members' appointment but the circumstance by which the one-step process of executives' appointment is burdened by the cost of self-interested behaviors plus the cost related to the different culture of the executives.

§ 4. CATEGORIZATION AND ANALYSIS OF AGENCY COSTS

Opportunism (duty of loyalty).

All the behaviors that imply a conflict of interests can be defined as opportunistic.

In the section regarding the non-profit board configurations, it has been reported a quote by Williamson [1985] referring to opportunistic behaviors: "the possibility that the person with whom you are transacting will cheat you". The scholar, moreover, also provided a more technical description aimed at defining the concept:

> "by opportunism I mean self-interest seeking with guile…[O]pportunism refers to the incomplete or distorted disclosure of information, especially to calculated efforts to mislead, distort, disguise, obfuscate, or otherwise confuse. It is responsible for real contrived conditions of information asymmetry which vastly complicate problems at economic organization". [Williamson, 1985].

Opportunism is not a concept defined by law, so that it is up to the scholars to discuss its dimension.

In this work, by adopting Williamson general definition there shall be distinguished two categories of opportunistic behaviors. These shall refer to: a) expropriation of money; and b) self-dealing transactions:

a) ***expropriation of money***

This category can be associated with great wrongdoings, which other than involving corporate law rules – either *for-profit* or *non-profit* ones – are relevant to crime law, including theft and all the actions that may be recognized as such crimes.

In order to provide a very complete description of the phenomenon it shall be entirely reproduced a study realized by the American Association of Home and Services for the Aging [Herman, 2004]:

> "Most thieves' motivations fit into one of four categories:
>
> 1) *Greed* - some people steal simply because they need money to purchase basics or luxury items they want and can't afford.
>
> 2) *Personal financial loss or pressure* - others steal after suffering a personal financial loss or while under an unusual financial strain.
>
> 3) *Denial* - some employees steal without believing they are doing so. An example is the employee who regularly takes office supplies from the supply room for use at home. The employee may believe that she's entitled to the supplies, that the items won't be missed, or that they are of minimal value.
>
> 4) *Revenge or thrill seeking* - some thieves steal from their employers as a way of getting revenge for actions the employer has taken that the employee believes to be unjust, discriminatory or corrupt. And others steal to see if they can get away with it. Once they do, the desire to steal more frequently or larger quantities may become an incontrollable impulse.
>
> How - Some of the most common ways in which funds are misappropriated include the use of fictitious vendors, check forgery or theft, credit card fraud, theft of incoming receipts, and identity theft.
>
> Fictitious vendors or consultants - A common embezzlement scheme is the use of fictitious vendors or consultants. This plot can be perpetrated by any employee with authority to approve the payment of invoices. In most the non-profit organizations the CEO is always in position to perpetrate this type of scheme, while in larger organizations a mid-level employee may be able to do it. The thief creates fraudulent vendors and deposits checks written to pay the false invoices in his personal bank account. In a recent case involving a large DC-based trade association, the CEO is alleged to have embezzled $2.5 million from the association over a 13-year period through recurring payments to phony consultants. In this case, the consultants were real people (including one public figure), but no services were provided and the payments were received by the CEO. While any theft of resources is disturbing, this case extracted a

particularly heavy price as the association had undergone a painful downsizing process-before the theft was discovered-due to its weak financial condition.

Check theft - In a recent case involving a chapter of a prominent national youth-serving group, an employee obtained one of the non-profit's blank checks, created counterfeited copies, forged the signature of an authorized signatory, and attempted to pass the checks. An observant bank employee recognized the phony checks and stopped the embezzlement scheme. Although no dollars were stolen, the non-profit has spent thousands of dollars on legal expenses and countless hours to investigate the theft and take steps to prevent its recurrence. According to one source, 500 million checks are forged annually in the United States generating losses in excess of $10 billion. The odds are against you.

Credit Card Fraud - In another recent case, a non-profit's accountant was caught applying customer refunds to her own credit card account. Credit card fraud can also occur with respect to use of the non-profit's corporate credit card. A dishonest employee may believe that the non-profit won't notice the use of the card for a personal, unauthorized purchase. In some cases the employee may view the use as a loan, and intend to pay the non-profit back in the future.

Theft of Cash Receipts - Perhaps the simplest form of fraud committed by insiders is the pocketing of incoming cash receipts. Countless non-profit organizations have been victims of theft by staff who pocket cash receipts at the bake sale checkout or special event ticket booth.

Identity Theft - Although the principal victim of identity theft is an individual, non-profit organizations can also suffer when the workplace provides the setting for these schemes. The organization could be held liable for failing to adequately protect the personal information of its employees. Despite the widespread belief that identity thieves are principally computer hackers working out of dark basement offices in far-off locations, each year thousands of Americans are victimized by co-workers. According to the director of security at an international pharmaceutical company, a common scheme is for a support staff member to respond to a credit card offer addressed to his or her boss, simply changing the address to which the card is mailed. Other workplace-based identity theft schemes involve theft of human resource department reports that contain employee names, social security numbers, annual salaries, addresses and more-documents that were left lying around, such as on the desk of a management employee.

> All of the schemes described above can be perpetrated on a larger scale, and by volunteers in addition to paid staff members. A larger-scale embezzlement might involve a wire transfer of funds from the non-profit's to the thief's bank account. Some thieves believe it's safer to drain their employer's bank account in small but regular amounts. Others make bolder attempts, stealing large sums in one or more transactions." (Herman, 2004: *web page*)

b) ***self-dealing transactions***

The second category of opportunistic behaviors, self-dealing, is a transaction between the corporation and one of its directors or officers, or between a corporation and another organization in which one of its directors or officers has an interest [Hansmann, 1981].

For-profit literature is replete of examples concerning such transactions. Some of these transactions present aspects which may also be relevant to non-profit corporations, and they include: (a) misuse of corporate property for personal gain; (b) kickbacks; (c) individual tax violations related to self-dealing.

The first type of transaction, (a), refers specifically to receiving executive loans with no intention to pay back, and also to extraordinary personal expenses charged to the company. Instances of transaction (b) are represented by the award of business contracts in return for personal compensation. Finally, transaction (c) involves the failure to report forgiven loans or reimbursed personal expenses as taxable income.

With a large margin of approximation, examples considered by point (a) and point (c) concern transactions between the corporation and one of its directors or officers, while those considered by point (b) concern transactions between a corporation and another organization in which one of its directors or officers has an interest[46].

[46] Through these descriptions, one may notice among the categories of examples, that the case of the insider trading has been left aside, presenting the latter aspects which are typical only to business corporations, notably the involvement of shares in the transactions.

Reasons of Opportunism.

Both the categories of opportunistic behavior, in one way or another, represent a real danger to the efficiency/efficacy of the firm. This explains why neo-classical economists have extensively studied the circumstances in which corporate agents tend to make determinate decisions. In particular, scholars have been interested in investigating the preferences of economic actors, attempting to find out which are the factors that shape them.

With this understanding, the scope of this paragraph is to borrow literature's assumptions and to analyze how they play out in the very atypical world of non-profit organizations. Such theoretical conceptions will be taken into account in the light of two fundamental empirical data.

The first concerns the fact that most of the opportunistic behaviors are due to greed [Gibelman and Gelman, 2000], thus the study will keep points 2, 3, and 4 of the list concerning "theft motivations" aside.

The second is that public scandals basically involve top management incumbency in NPO boards of directors [Gibelman and Gelman, 2000]. This means that the study will not consider opportunistic behaviors performed by simple employees, but only those performed by executives with significant authority and discretional power.

Arguing that various psychological factors characterize the economic behavior of non-profit agents somehow implies a revision of the original and extreme rational choice assumptions according to which all economic actors act to maximize wealth. Indeed, the idea that individuals take a large number of reasons into account when making decisions, which extend well beyond the stereotypical self-interested motive, is now largely accepted among rational-minded students [Sacconi and Grimalda, 2002]. This may lead one to think that directors of a non-profit organization do not necessarily act to maximize their wealth, but instead may reach levels of satisfaction for simply having accomplished the interest pursued by the organization.

In fact, some literature claims that, for what concerns the non-profit sector, agents might lean more towards presenting altruistic motivations rather than self-interested ones

[Ackerman, 1987]. One of the arguments presented in such literature is that managers attracted by charities are generally more interested in pursuing an ideological aim than an economic one. Another is related to the fact that the selective process of managers could imply the choice of individual whose reputation reflects high altruistic and ethical standards other than administration skills [Young, 1983]. For instance, one can refer to a traditional non-profit corporation needing to hire business educated managers to face the financial difficulties that have been discussed above. Most likely, the board of directors will address only managers whose reputation does not conflict with the purposes of the organization. Accordingly, managers are expected to accept the engagement only if they share the same social values and ideas.

Although these arguments present a logical and coherent rationale, it still seems difficult to match them to the empirical data demonstrating the existence of public scandals due to opportunistic management behavior [Gibelman and Gelman, 2000]. Consequently, the simplest solution to this discussion would be to accept that not all the economic actors behave to maximize their wealth and, at the same time, to neglect the fact that all the agents working in a non-profit organization are necessarily driven by ideological motivations. That is like saying: sometimes managers behave opportunistically and sometimes they do not.

The weakness and simplicity of this observation risks to remain as such until one does not investigate the specific circumstances which actually drive agents towards a determinate performance, opportunistic or ideological. Only through a deeper study it shall be possible to answer the question: what has shaped the preferences of directors involved in public scandals?

To begin with, one can take on the study developed by Sacconi and Grimalda [2002]. These scholars start from the assumption that human behavior is affected by a stable preference represented by the self-interested motivation. Yet, they sustain that this stable preference is accompanied by a conditional one which depends on conforming to other people's decisions. In particular, they conclude that the disposition to comply with moral principals is more likely when the other participants to social interactions are also doing so [Sacconi and Grimalda, 2002].

Therefore, it could be guessed that public scandals due to opportunistic behaviors would reveal that the first and stable preference of some members has not been influenced

by other colleagues' performances. This may emphasize two aspects: the first one concerns the fact that the self-dealer has a personality so strong that the behaviors of the "others" do not truly interfere with his decisions; the second one regards the fact that the "others", instead, play a role so passive that the self-dealer feels free to pursue his own personal interests.

It is therefore interesting to apply such findings to the governance systems of modern non-profit corporations, with particular focus on the board of directors. The latter, pursuant of the organizational need to hire professional managers, has experienced significant changes in its composition and functioning.

As for composition, it has been earlier observed the conditions set by business trained managers according to which they would likely accept the office only in exchange of being appointed members of the board. That management penetration into the body would imply an increasing ratio of executive [inside] directors, among whom the CEO would stand out.

Notably, the changes related to the functioning are tightly connected to the ones related to the composition. Indeed, the board's role is no longer limited to a monitoring function or, rather, there is no longer the famous separation between management and governance claimed by Fama and Jensen [1983]. Through the executive committees, the board of directors looks after the day-to-day operations.

On the basis of such description it is therefore possible to develop both the arguments indicated above. First of all, they take into account a very important observation offered by for-profit literature which acknowledges that the strong personality of the CEO positively affects the financial performance of the firm [Unquoted author, 2005]. Given this assumption, one would argue that if the business-like CEOs pay attention to market forces without losing sight of their organization's underlying missions, and seek to use the language and skills of the business world to advance material well-being of their members or clients, then there would not be any reason to expect opportunistic actions from the other members of the board. The CEO's philanthropic behavior may be explained by the will to conform to other CEOs involved in other NPOs, at the same time improving and defending his reputation, thus satisfying his primary stable interest.

This hypothesis would be further confirmed by the school of thought in literature which focuses the attention on the "leadership" question [Wallis & Dollery, 2005]. Such school, in fact, highlights the role of the leader of the board and his/her charismatic aspects that frequently influence other peers. The study brings forward several factors, as for instance those related to emotions and to the ways the leader uses to express himself during his speeches.

On the other hand, when the professional CEO is meant to run the non-profit firm exclusively relying upon his business education, then the fear of self-dealing behaviors becomes more actual. This is basically due to three reasons. The first, most obvious one, regards the actions of the other members of the board who might follow their leader's example. The second, which is particularly true for non-profit organizations, involves the passive role of non-executives, who, expected to monitor top management activities, lack either the incentives or professional skills to do it. The third, which is directly correlated to the second, takes into account the incompetence of executives themselves, who, educated to run business corporations, are not able to vary from their self-dealing behaviors. The latter, indeed, may be efficient for a for-profit organization but not efficient for a charity.

The question related to the incompetence of both executives and non-executives, however, will deserve a deeper discussion through the next chapter. For now, by referring to the public scandals data, one is ready to point out just the answers to the previously posed questions.

First of all, the fact they were public scandals already suggests that a large amount of money was involved and, therefore, that CEOs with strong personalities were in charge of the operation of such firms. This, in fact, is explained by the previously quoted theory according to which the strong personality of a CEO positively affects the economic performance of the firm. It would be right therefore to justify the prevalence of the stable preference setting foundation on the fact that: directors did not receive the proper influence to develop their conditional preference from the CEO; and directors, being aware of the scanty monitoring action on their operations, felt freer to pursue their first preference.

Of course, in the case – which is in actuality the most common – within which the self-dealer is represented by the CEO himself, one could sustain that his stable preference has dominated because of the passive role of the other members of the board.

Incompetence (duty of skill). Other than opportunistic behaviors, also the incompetence of directors implies agency costs. The costs of incompetence in a business corporation contexts are represented by the wrong commercial choices adopted by the officers.

Assuming that directors are expertise and with a professional background, their incompetence may be uncovered only *ex post*.

In fact, only after a certain decision has been taken the shareholder – on the basis of the value of her dividend – shall be able to judge if directors have been competent or not.

Obviously, the negative effects of a managerial decision may not depend exclusively on their incompetence, but also on the other external factors that influence the market forces.

In a non-profit corporation context, the costs related to the incompetence are higher. In fact, other than being represented by the wrong commercial choice taken by the director, they involve also the managerial decisions that do not comply with the social values promoted by the organization.

As many times underscored, these managers are educated and prepared to run a business corporation so that they are supposed to tend to support a profit seeking approach, overlooking the efficacy conditions of a non-profit organization: quality and quality obtained through the respect of social values.

Evidence of this problem is the belief of Robert Kasdin, treasurer and investment officer of the Metropolitan Museum of Art, who had underscored the many difficulties encountered by business trustees to there being asked to play roles, that in his words, “raise unfamiliar types of normative questions” [Bowen 1994].

The incompetence of business directors managing a non-profit corporation is easily detached within those occasions where the director has to choose between short or long-term solutions. Obviously, the institutional dimension of the non-profit corporation would be expected to drive the managerial decisions towards the second option, for the (long-lasting) survival of the firm represents a primary interest (of the patrons and of the stakeholders).

Yet, the business director – notably one whose background and whose school of thought adhere to neo-classical conceptions of the corporation – could reason as if he were running a for-profit corporation and, with the intention of pursuing the interests of the

shareholders, he could opt for the first solution. Shareholders, in fact, are supposed to prefer the short-term solution for the following reasons:

a) their dividend is significant;
b) they may always sell their shares as soon as they see that the corporation is poorly performing in the long-term.

As regards non-profit corporations, point a) can not be discussed as there are not shareholders; point b) discloses the crucial difference that when non-profit corporations shall prove poorly performing because of a short-term decision (but also for any other economically wrong decision) there will not be any investor, any market force in general, capable to restructure them.

Anyway, the short-term oriented choice may not depend exclusively on a question of (economic) culture. As Bowen [1994] suggests, directors could take short-term decision for personal agendas, "to brag about what the foundation is doing", so that in this case the choice falls within the opportunism problems and the relevant conflict of interests.

Bowen [1994] continues to underscore how the business culture of non-profit directors could be synonymous of agency costs by stating that "individual familiar with (business) corporate financial accounts may find it difficult to penetrate the intricacies of fund accounting. They are certainly far from alone in this respect, but because they are presumed to be experts in such matters, they may be especially embarrassed to acknowledge that they don't quite understand the financial statement of the non-profit organization".

Another argumentation brought by Bowen [1994] regards the decision of professional directors to renounce to take a business oriented action – such as an aggressive fund raising campaign – because they are not actually supported or, rather, motivated by the non-executive directors. Moreover, as it shall be seen in the next chapter, courts might tend to hold non-profit volunteer trustees on a high level of standards, so that they can simply walk away as soon as they realize the bad financial situation of the corporation.

Bowen adds that the "non-profit incompetence" of professional executives is not anyway the only incompetence that comes out the board of directors.

The non-executive boards, in fact, may show a too traditional approach that drive them to defend the values and the missions of the organization to the extent to which they end up to kill it. For example, a non-executive might fire a good professional executive

whose job has produced on behalf of the corporation much more benefits – not only economic – than those that it would have produced if she had strenuously complied with the social values of the corporation.

Negligence (duty of care, duty of diligence). This kind of behavior also implies agency costs. It represents a directors' performance that is actually neither opportunistic nor a result of her incompetence, still it can involve an opportunistic and incompetence dimension.

It can just be considered as a performance or a non-performance through which the director did not show the due attention.

As regards non-performance, one may refer to an action that the director was supposed to take but that she did not take, entailing a loss for the corporation. In cases like these negligence has to be measured against director's competence: did the director not pay attention or was she not so competent to understand that she had to take the decision?

A non-performance can also be synonymous of laziness as long as the action was not taken because the director was not in the mood to work. In cases like these, the negligence is voluntary and as such it fully reflects an opportunistic behavior.

As concerns performance, negligence is expressed by decisions that have proved not beneficial for the corporation (or shareholders). In cases like these, the negligence has to be measured against both the director's competence and director's opportunism.

In the first circumstance, the operation might be so complicated that the competence of the director was not expected to consider the negative effects. In the second, the damage to the corporation could have been the result of an opportunistic behavior of the director.

By the way, "negligence is not measured against an abstract, but rather expectations and standards. These expectations and standards may be difficult to articulate, but they do exist. The standards may be established by generally accepted practices in the sector (or evolving ones after the Panel's report), by the common law or by statute" [Burgeois, 2004].

CHAPTER V

THE LEGAL PROTECTION OF THE PRINCIPALS

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§ 1. SCHEME-ORDER

The foregoing discussion on the causes of agency problem is to be completed with an analysis of the protection devices envisaged by law.

These devices are manifold and work in different ways. For this reason, it is necessary to set an order/scheme from which the analysis must be developed.

To begin with, one may refer to the above mentioned Hansmann and Kraakman [2005] categorization that suggests to divide the legal devices for the reduction of agency costs in two categories: regulatory and governance strategies.

In particular, regulatory strategies involve:

a) rules and standards;

b) initiation and termination terms of the relationship;

while governance strategies involve:

a) selection and removal;

b) proposal and ratification powers;

c) trusteeship and reward strategies.

Moreover, according to the authors, regulatory and governance strategies themselves may be referred to another categorization which is based on "*ex post*" and "*ex ante*" criteria, that is criteria considering the moment within which the mechanism works, before or after the action taken or expected to be taken by the director.

Assumed that this scheme/order is also worth for a non-profit corporation context, the analysis might well be set forth by studying each of these strategies and hence enriched by verifying if they belong to *ex post* or *ex ante* criteria.

However, the attention shall be focused also on the important external controls of the non-profit corporation.

For external controls one means the right to sue on behalf of p*atrons* and the power of the Attorney General to intervene in certain matters of the non-profit corporation; thus to the extent to which the business parallels part of p*atrons* is represented by shareholders and to the extent to which these are part of the corporate structure, then the relevant right to sue in their own name or in the corporation name (through derivative action) can fall within the category of governance strategies.

The right to bring suits against non-profit directors represents a legal device that only lately has been acknowledged by case-law and, moreover, has been acknowledged only within peculiar circumstances. Before such acknowledgment, the external control has always been exerted by the General Attorney.

At this point it is important to observe that the regulatory and governance strategies indicated by Hansmann and Kraakman [2005] are anything but the procedures, parameters and any sort of functioning criteria that the internal and external controllers have to refer to.

In other words, law attempts to reduce agency costs first by setting monitoring devices – internal or external – and then by establishing how these devices have to work or function.

As the first are represented by human beings (the board members, the p*atrons*, the Attorney General) and by an overseeing human activity, they can be deemed as monitoring devices from a strict point of view whereas the regulatory and governance strategies can be deemed as monitoring devices only to the extent to which they "assist" the human controller to carry on their activities.

Thus, at first the study shall consider the board of directors. In particular, while at chapter IV, this body had been presented as a monitoring device and then studied as a cause of agency problems, it shall now presented as a cause of agency problems and studied as monitoring device.

The examination of the board of directors and of the relevant non-profit governance strategies, the attention shall move on the regulatory strategies and, finally, on the external controls.

§ 2. BOARD OF DIRECTORS

According to Hansmann and Kraakman [2005] the board of directors represents one of the five distinguishing element of corporations[47].

That all the corporations must have a board of directors can be demonstrated by referring to paragraph 141 a) of the Delaware General Corporation Law and § 701 of the NY-BCL, both establishing that the business and affairs of the corporations shall be managed by or under the direction of a board of directors. Similarly, section 154 of the Companies Act 2006 provides that public companies are required to have at least two directors.

The compulsory presence of the board of directors is due to:

a) the fact that it would be impossible for thousand shareholders to look after the day-to-day administration of the corporation, or it would be unthinkable to decided a resolution for every single transaction;
b) the shareholders lack the professional skill and knowledge to run the business [Berle and Means, 1932].

It is true, if shareholders merely empower a board of directors for the management of the corporation, then management behavior may well arise the agency costs analyzed earlier: opportunism, incompetence and non-diligence[48].

To avoid these problems of agency, shareholders should devise a system-mechanism for which the managerial decisions are more shaped on their own interests. In particular, they should intervene into the decision process which, according to Fama and Jensen [1983] is represented by the following steps:

a) initiation-proposal;

[47] The other four are:
a) legal personality
b) limited liability
c) investors' ownership
d) free transferability of shares.
e)

[48] This is what happened in early twentieth century US corporations. There were actually scholar thinking that the powers enjoyed by managers represented an increase of democratization in the American society, while others like Berle and Means already understood that the managerial discretion would have instead brought to the increase of agency costs to be bore by investors [Mizruchi, 1983].

b) ratification;

c) implementation-execution;

d) monitoring.

Where all the steps are taken by the same agent, then point b) and point d) do not make any sense as it is difficult to think that an agent ratifies and efficiently monitors her own choices. The only agency costs that shareholders could save in this situation would be represented by those related to the incompetence: as shareholders shall choose the directors, they shall be expected to choose competent and skilled ones. Still such competent and skilled directors could be opportunistic and non-diligent.

Because of the information asymmetry between shareholders and managing directors, the former could barely exert control over the decisions of the latter. Shareholders could realize bad-management behaviors only when they are called to decide on the financial year. As it is much cheaper to avoid agency costs rather than lowering them when they are already incurred, shareholders would better device mechanisms that restrain point a) and c).

One of these mechanisms is to separate management decisions (point a and c) from control decisions so that the board shall involve management and non-management directors.

Therefore the function of the board becomes basically twofold: manage and control. This concept is confirmed also by other scholars maintaining that the board has three primary roles - control, advise/counsel, and strategic [O'Neal, 1995] and others according to which the function of the board is monitoring, executive and instrumental [Baysinger and Butler; 1985]. It is clear in fact that the threefold dimension conferred by these scholars is anything but a more articulated reflection of the twofold one.

Now, there are different ways for separating the management and control decisions:

a) the shareholders elect non-management directors and management directors;

b) the shareholders elect non-management directors and empower these to elect management directors and, hence, to include them in the board;

c) the shareholders elect management directors and empower these to elect non-management directors.

Option a) is commonly adopted by shareholders to the extent to which they provide in the by-laws that the first directors shall have to appoint as managing directors one or

more of their body. Still, nothing hinders the possibility that shareholders themselves appoint non-executives and executives directly. So option a) may be divided into a-1) and a-2).

The option b) basically differs from a) only for the fact that the managing directors can be other persons than the body initially chosen by the shareholders.

While solution a-1) and b) are often adopted by the practice, it is interesting to understand why a-2) is expected to be high cost solution.

This can be explained assuming that shareholders may basically accomplish three different reasoning.

The first may be developed as follows:

> *we shareholders have incorporated our business organizations and now we have to establish who shall run it. Fama and Jensen suggested us that we better separate the functions within the board, some members shall make decisions control and some other shall make decisions management. As we actually are not expertise and, hence, we are not in a condition to divide these functions by ourselves, we better choose a certain number of directors and then we shall let them decide who shall exert control and who shall manage the day-to-day operations. Hence, if we were expertise we actually would have chosen by our own who among the members had to exert the monitoring function and who the management one. In fact, in these conditions of scarce information and competence, the agency costs we bear by leaving discretion to the board in relation to the choice of management and monitoring function, shall be surely lower than those that we would bear if we did this choice by ourselves.*

The second reasoning may be developed as follows*:*

> *we shareholders actually believe that the executive of our corporation has to be Miss X. As we are convinced that he is the right person, theoretically it would be convenient for us to elect him directly. In fact, in such way we would save those (little?) agency costs that we would bear if we delegated another person.*
>
> *Yet, we know that other than electing Miss X, we have to elect also who shall control her. Assumed that we succeed to find who is happy to be the non-executive director in our corporation managed by Miss X, we actually have to consider some agency costs that could arise and that could be higher than those we have saved by electing directly Miss X. In fact, if Miss X does some bad thing to our corporation, we are expected to go before the non-executives we elected and say: "hey, weren't you guys supposed to control Miss X activities"; they could answer: "actually yes, but it is not our fault that you chose an incompetent, opportunistic and not diligent executive".*
>
> *Moral of the story, if we shareholders directly elect the executive incur in two high agency costs represented by:*
>
> *a) the low quality of non-executives. The best non-executives shall be willing to elect the managing director by their own. Those who shall accept to be*

monitors of an executive chosen by shareholders are likely to be the less experienced or motivated;

b) *the scarce accountability of non-executives. Although it is possible for we shareholders to claim their breaches of duties, still it shall be harder to the extent to which we asked them to control someone who was chosen by ourselves.*

Hence, if we shareholders are so convinced that Miss X has to be our managing director, then we can try at least to save the agency costs related to point b). We can do it by opting for a-1) solution. That is, we may elect Miss X among the other members of the board and then exert some pressure and thus drive the board of directors' decision to select her for the managing function. In this case, the board of directors would result more accountable to Miss X performances.

The third reasoning can be developed as follows*:*

we shareholders have not the lowest idea of who could be the managing director of our corporation. We actually know this group of persons and we trust in them. We believe that we better appoint them as board of directors and leave them free to pick the managing director wherever they think fit.

We shareholders know that if we do this choice we incur in a duplication of agency costs represented by the two-steps choice of monitoring and management function. In fact, we have to bear not only the costs that are implied in the relationship between us and the non-executive directors but also we have to bear the costs of the relationship between non-executives and executives. While in solution a-1) the board of directors have to select the managing director, the costs of this choice are for us shareholders "well discounted" by the fact that for sure they shall select someone that we have already chosen; in solution b) the costs of the second selection do not involve any discount so that are fully bore by us. Actually, the costs we incur in this second layer of directors, may be recovered by rendering directors more accountable before the management decisions. In fact, if management does something bad to our corporation we shall be prepared to say: "you guys of the board of directors have selected in fully discretion the managing director" and, as a consequence, it shall be easier for us to demonstrate a breach of fiduciary duty.

Option c) does not make much sense to the extent to which executive directors shall appoint non-executive directors that shall barely exert an efficient and true monitoring function.

The articles of association may contain further indications related to the size and configuration of board, inclusive the balance between non-executive and executive directors.

According to Fama and Jensen [1983] the separation of decision management and decision control represents a fundamental strategy also for non-profit corporations. In particular, while the scholars claimed that such separation in a business context was indispensable only for *complex* business organizations, they specified that as concerns non-

profit sector, the said separation is necessary either for *complex* and *non-complex* organizations[49].

The scholars set out from the idea that the agency problem in non-profit corporations is more pronounced than in business corporations for three reasons:

a) p*atrons* do not come involved in the corporate structure;
b) the inexistence of the external pressure exerted by the market for corporate control;
c) boards are self perpetuated as consequence of point a).

This explains why even in *noncomplex* and small nonprofit organizations it is necessary to pay attention to the decision processes.

Along with the hypothesis of Fama and Jensen, the agency problem incurring between patrons and board of directors should be resolved by the mandatory provision of independent directors in the board, just as it has been provided by the SOX Act for business corporations[50].

Before trying to convince the legislative power to adopt this idea of public policy, it should be important to verify two conditions:

a) that the FJ thesis is tested empirically, that is to verify that non-profit corporations run by a board of directors involving the separation of decision management and decision control are efficient;
b) that the practice of involving non-executives is not commonly adopted by non-profit corporations; in fact, whereas the practice were represented by the involvement of non-executives, then there would not be the need to impose it through a mandatory statutory provision.

As concerns the verification of the b) condition, the answer can be found in both the history of non-profit sector as well as in recent surveys.

In the history told in the previous chapters, it has been seen how the presence of non-executive directors represented actually the normality of the circumstances. In fact, during

[49] In the opinion of Fama and Jensen [1983] " *noncomplex* means that specific information relevant to decisions is concentrated in one or a few agents. (Specific information is detailed information that is costly to transfer among agents.) Most small organizations tend to be noncomplex, and most large organizations tend to be complex, but the correspondence is not perfect. For example, research oriented universities, though often small in terms of assets or faculty size, are nevertheless complex in the sense that specific knowledge, which is costly to transfer, is diffused among both faculty and administrators".
[50] The UK Company Act does not distinguish between executive and non-executive directors.

the stages before the proliferation of non-profit corporations in the 60s, there was not any separation of decision control and decision management for the non-profit sector was burdened by an agency problem related only to opportunistic behaviors. These behaviors were not contrasted by separating control and management but simply by applying high fiduciary standards to the directors (who were actually seen more as trustees).

When other than the opportunism, the agency costs began to increase for the incompetence of directors to raise funds, the directors themselves decided to hire and sometimes to include into their boards business professionals.

The peculiarity of non-profit organizations in relation the presence of non-executive directors is even much clearer if one compares non-profit corporations with business corporations. In the latter, in fact, the circumstances that characterized the board composition proved just the opposite: it was the executive directors began to be flanked by non-executives and not the other way round.

Recent studies [Callen, Klein, Tinkelman, 2003] have demonstrated that large US non-profit organizations are run by a wide board of directors whose composition envisages that not more than one member is an executive director.

The historical analysis plus the recent survey would not leave room for a statutory intervention aimed at imposing non-executive directors so that it would be even useless to verify condition a).

However, if the verification of condition a) would disprove FJ theory, it would hence mean that law should not have regard of the balance executive/non-executive, but rather of other aspects has revealed by the verification test.

The first author that has disproved FJ theory has been Fishman [1987]: he observed that when a board makes a decision the information is often incomplete, for non-executive directors do not spend enough time looking after the corporate activity and for the latter having reached a very complex dimension so that a high level of expertise should be required to ratify and monitoring an executive decision.

In fact, what it is incorrect in FJ hypothesis does not concern the two-fold dimension of the decision process: one cannot argue that splitting control and management lower the costs of agency related to opportunism diligence and competence. The shortcoming of Fama and Jensen concerned actually their idea that non-executive directors would have been

provided with incentives for doing their job properly. These incentives would be represented by reputation and by personal visibility in the light of important job offers.

As a consequence, the aim of the law becomes “simply” to provide mechanisms that render directors more accountable. Such mechanisms are represented by the HK scheme/order suggested earlier.

The literature advocating a multiple constituency approach to understanding nonprofits has suggested that there is no single organizational or board effectiveness criterion that all stakeholders perceive similarly. Rather, each group measures effectiveness on the basis of criteria and impressions most relevant to it. This literature has provided significant motivation for our study that investigates whether the data are consistent with donors on the board using ratios as effectiveness measures to influence the organization toward the donor point of view.

§ 3. STANDARDS

The standards are general clauses which shape the agents' behavior so that their choices prove as much as possible aligned with the interests of the principals.

Because of the broad definition of the behaviors, they fall within the idea of *ex post* devices. In fact, only after a certain performance of the agent it is possible to establish if she/he complied with the direction provided by the standards themselves.

Standards are normally detachable in common law and equity rules, in the statutes as well as in the terms of the agreement.

The importance of the standards is crucial whereas one has to consider that they represent the parameters to which the judge shall refer to evaluate the responsibility of controlling and managing directors.

As regards the corporate context, common law standards are represented by the duty of care, diligence and the duty of skill while equity standards are those referring to the duty of loyalty and are defined as fiduciary duties; statutory standards basically reflect the common law and equity ones.

For example, the Companies Act 2006 has codified the duties of directors with the label of general duties:

a) the duty to act within the powers (s. 171);
b) the duty to promote the success of the company (s. 172);
c) the duty to exercise independent judgment (s 173);
d) the duty to exercise reasonable care, skill and diligence (s 174);
e) the duty to avoid the conflict of interest (s 175);
f) the duty not to accept benefits from third parties (s 176);
g) the duty to declare an interest in a proposed transaction or arrangement (s 177).

The reading of the above provisions clearly reveals how only the point c) falls out the equitable concept of loyalty. All the other duties must be indeed considered as fiduciary duties. However, this distinction is confirmed by section 178 which provides:

Civil consequences of breach of general duties
(1) The consequences of breach (or threatened breach) of sections 171 to 177 are the same as would apply if the corresponding common law rule or equitable principle applied.
(2) The duties in those sections (with the exception of section 174 (duty to exercise reasonable care, skill and diligence)) are, accordingly, enforceable in the same way as any other fiduciary duty owed to a company by its directors.

Actually, subsection 1) reveals that the remedies available for breach of fiduciary duties have not been subject to codification, despite the recommendation of the Law Commissions. In fact, the provision states that the same consequences and remedies as are currently available should apply to the statutory general duties. Where the statutory duty departs from its equitable equivalent, the court must identify the equivalent rule and apply the same consequences and remedies. The Solicitor General summarized the position as follows: "the consequences of a breach of fiduciary duty can include damages, compensation, restoration of a company's property, rescission of a transaction or a requirement of a director to account for any profits made as a result. They may also include injunctions or declarations, although those methods are primarily employed when a breach is threatened but has not yet occurred. The consequences of a breach of duty of care and kill may include the court awarding compensation or damages" [Morse, 2007] .

Subsection 2) may indicate that the remedies for breach of section 174 will be assessed on common law, not equitable principles, thus laying to rest the debates in that area [Morse, 2007].

The spirit of Section 2) may be explained by referring to *Bristol and West Building Society v. Mothew*, where the Counsels Jonathan Sumption Q.C. and Glenn Campbel reminded that "although a solicitor has a number of fiduciary obligations to his client, not every duty which is owed in the context of a fiduciary relationship is a fiduciary duty [*Girardet v. Crease & Co.* (1987)]"

If one applies this obiter dictum to the corporate context, then one has that the directors have a number of fiduciary obligations and other kind of obligations to the corporation (assumed that the corporation is the principal).

Now, if the law considers the duty of care, skill and diligence as other obligations then remedies available for the principal can not be represented by those indicated above by

the Solicitor General. In fact, the Counsel continue: "the expression "fiduciary duty" is properly confined to those duties which are peculiar to fiduciaries and the breach of which attracts legal consequences differing from those consequent upon the breach of other duties".

Thus, for the duty of care falls within the category of "other duties", then the available remedies are those provided by the common law as for example damages and not the equitable ones that are primarily restitutionary or restorative rather than compensatory.

The consequence is that where there is a negligence performed by a director then the corporation is not entitled to recover the whole amount of the loss, as for the common law rules of causation and remoteness the corporation should demonstrate that the whole amount of the loss depended on the directors' decision.

If the violation of the duty of care were instead considered as a breach of trust or fiduciary duty, then in similar circumstance the corporation would have been entitled to restore its previous situation.

Differently from the Companies Act, the General Delaware Corporation Law does not provide a list of the standards of behavior to be followed by directors.

However, at § 144, the Act disciplines the transactions within which the director has an interest, shaping therefore the content of the fiduciary duty of loyalty.

Moreover, in the name of its declared liberality, the Act contains a section – 102(b)(7) – which authorizes companies to adopt an exculpatory provision protecting directors from personal liability for breach of the duty of care and the vast majority of publicly traded companies adopt such provisions. Of course this would not be possible under the Companies Act 2006.

As concerns the NYBCA, section 717 provides that directors have the duty to consider the interests of the corporation and of the shareholders, so that even in this case there is a statutorization of the duty of loyalty. The section continues to specifies which interests of the corporations deserve a particular attention from directors. The content of the duty of loyalty is shaped also by section 713 which disciplines the conflict of interests between directors and corporation.

A peculiar difference with the Companies Act 2006 concerns the independent judgment in so far as in the UK legislation (Section 173) the discretion of the director must

not be fettered by others unless company's constitution provide otherwise. Moreover, section 717 codifies the duty of care.

As one would expect, law provides different standards for non-profit corporation. For example, at section 181 the Companies Act 2006 provides that the provisions of section 175, that is the duty to avoid conflict of interests, and section 180(2)(b) are modified in certain respects. In all the other respects, the provisions of Chapter 10 of the 2006 Act apply to companies that are charities in the same way they apply to companies that are not.

As regards the New York Non-Profit Corporation Act, section 717 codifies the duty of diligence, care and skill as well as the duty of loyalty which basically does not differ from the black letter of section 717 of NYBCA.

Once illustrated the sources and the nature of the fiduciary duties and the other duties, the aim becomes to analyze their content, that is what a duty loyalty or a duty of care implies for non-profit directors. This shall allow to understand if these standards – rather, the application of them by the Courts – effectively succeed to reduce the agency costs arising in a non-profit corporation context.

§ 3.1 Duty of Loyalty (Opportunism)

According to some literature [A.C.G. 1978] “the legally required standards of conduct for charitable fiduciaries are generally ill-defined and often unrealistic. The explanation for this shortcoming in the law of charitable organizations is the failure of the law to keep pace with the rapid evolution of the large and complex modern charity”.

This observation proves indeed absolutely true for what concerns the duty of loyalty. In fact, to measure the standards implied by the duty of loyalty in non-profit sector it is necessary to consider both the law of corporation and the law of trust.

The first would apply as non-profit corporations have been for a long time organized as charitable trusts. This means that for a long time the law of private trust has been applied to the trustee of a charitable trust: the trustee of a private trust and the trustee of a charitable trust shared the same standards of behavior.

The second would apply as non-profit corporations, for the fact itself that have been incorporated, are corporations. Thus the director of a business corporation and the director of non-profit corporation would share the same standards of behavior.

Theoretically, the identification of the applicable standard would be possible simply after having assessed if the non-profit corporation resembles more a charitable trust or a business corporation.

If one’s opinion is that the non-profit corporation resembles actually a charitable trust, then one must consider that in this case the trustee owes a strong fiduciary duty of loyalty to the beneficiaries of the trust and must administer the trust solely for their benefit.

This strength or highness of the standard of loyalty means that the Court shall enforce the fiduciary duties of loyalty in a very strict way. In fact, for the fiduciary relationship is a matter of moral and conscience rather than a matter of market, the trustee/directors are forbidden to perform many behaviors that would be permissible in a workaday world for those acting at arm's length [Judge Cardozo in A.C.G. 1978]. In particular, the high standard trust rule establishes that a trustee breaches his duty of loyalty whenever he engages directly or indirectly in any sale, purchase, loan, or similar transaction between himself in his capacity as trustee and 1) himself as an individual or 2) a member of his family 3) a corporation in which he has significant interest.

If one's opinion is that the non-profit corporation resembles instead a business corporation, then one must consider that the director of a corporation owes her fiduciary duties of loyalty to the corporation and the relevant administration of corporate assets may also imply an accomplishment of director personal interests'. However, as it shall be seen below, corporate law is very strict concerning the conflict of interests: the interest of the director must be disclosed so that the board, the committee or the shareholders, may decide to approve or not it. If the director does not reveal is interest and the transaction is approved, this is voidable unless the director demonstrates that the transaction was taken in a good faith and for the benefit of the corporation. The strictness of this principle proves any way relaxed whereas one considers that the transaction of the interested trustee is instead always void.

It is true, initially the duty of loyalty of corporate directors referred to the high standard envisaged by the trust law. The rationale of this norm was represented by the fact that law was meant to secure an unprejudiced advice and to avoid embarrassment to the remaining directors.

When the dimension and the activities of corporations increased, the idea that interested transactions could actually be fundamental for the affairs of the firms began to influence the minds of the judges.

In fact, as concerns the transaction between the corporation and the director, it was established that the contract could be allowable if a majority of disinterested directors had approved it and if it was fair to the corporation.

Successively, as concerns the transaction between the director and a corporation within which she had an interest, the Court maintained that even only the requisite of fairness was sufficiently important for the validity of the transaction.

Finally, it was established the general common law rule according to which the interested transaction was valid if fair to the corporation; still the Court could make a fairness test. The Court could even decide to validate the transaction by ordering the board or the shareholders to vote on it.

The standard applied to non-profit corporation reflected the business corporation standard and therefore its story. This means that from the early application of the high trust standard, Courts moved toward the more relaxed one of corporation.

For example, *In re Taylor Orphan Asylum* [1875] the Court voided a directors' transaction without even considering if the transaction itself were or not fair to the corporation. The transaction was voided only for being interested.

Successively, although there is evidence that the trend moved to the more relaxed business standard, Courts have not actually always specified which standard applied.

In particular, in two cases-law *Fowle Memorial Hospital v. Nicholson* [1925] and *Eurich v. Korean Found* [1961], while the Court validated the interested transactions, it showed a very relaxed approach in evaluating the relevant fairness. In other words, the application of the corporate standard was demonstrated by the fact that Courts would have voided only transactions that represented an egregious breach of duty or an enormous lack of fairness.

Yet, between the above mentioned cases, the Court, in *Gilbert v. Mcleod Infirmary* [1951] made a more explicit reference to the corporate standard. In fact, it held that "the relation of trustees to the eleemosynary corporation is analogous to that of directors and stockholders in a business corporation. Their ability to sue for vindication of a right in the corporation is universally recognized when the corporation, through its executives, fails and refuses to so proceed" and that "the directors or other members of the managing board of a charitable corporation are sometimes called trustees. Their legal position is the same no matter by what name they are called, whether directors, trustees, or governors".

The legally acknowledged idea that charitable trustee were subject to the same duties of their corporate counterparts implied that the managerial decision had to be held voidable only in case it would not have been fair to the corporation.

In the matter of facts, the Court had considered the two rules related to the procedural and to the fairness requirements.

As regards the first, the Court held that although the interested director did not vote the transaction, he still behaved like exerting pressure on the other board members. In fact, the Court relied on the principle according to which:

"the influence of the interested director is not measured by his vote alone, but his participation in the meeting, his arguments, and the weight of his judgment may have prevailed mightily with his colleagues, so that in substance he should be deemed to have made the contract, in part at least, on behalf of the company as well as on his own behalf".

Other than the violation of procedural aspects, the Court noted that the transaction even did not comply with the fairness requirement. The terms of the purchase of the Hospital's land accomplished by the director involved a price which was considered inferior to the one that could be offered by the market.

In *Gilbert v. Mcleod Infirmary,* therefore, although the Court applied the corporate standard and although it expressly maintained that the transaction did not present fraudulent perspectives, it found a breach of fiduciary duties from the interested directors for these did not comply with the procedural aspect and did not prove that the price agreed for the purchase of Hospital land was actually a fair price.

The study of these cases has demonstrated how the hybrid position of the director/trustee of a non-profit corporation has basically driven judges to apply the standard of the duty of loyalty by referring alternatively to the law of trust and corporation law, entailing a scar within the principle of legal certainty.

This explains the above mentioned claim of A.C.G. [1978] for clearness and, particularly, for a separate body of law applicable to non-profit corporations.

It is true, although the author underscored the difficulties to tailor a standard for non-profit corporations, he held that the best solution would have been represented by the opinion of Judge Hedrick in *Mountain Top Youth Camp, Inc. v. Lyon* [1974].

In order to vent abuse of fiduciary relationships, the court enumerated three principles governing business transactions between a charitable corporation and its directors:

1. The conveyance of the property must be authorized by the corporation or ratified by it.
2. The law presumes that such conveyances are invalid and imposes upon the purchaser the burden of establishing that the purchase is fair, open, and free from imposition, undue advantage, actual or constructive fraud.
3. Such conveyances will not be declared void as a matter of law, but it is a question for the jury to determine upon all the evidence as to whether the vitiating elements enter into the particular transaction.

According to A.C.G. ,

> "this standard emphasizes the principles of openness, fairness, and full disclosure that should govern all dealings between a director or trustee and the charity. Under these rules, the disinterested directors would have to approve the transaction to validate the action. Without such approval, the transaction would be void, unlike under the pure corporate standard where fairness may

> still be asserted as a defense even without disclosure. In addition, requiring disclosure and approval reduces the burden on state attorneys general of detecting self-dealing transactions in general. Furthermore, the rules minimize the enforcement burden for those transactions that are not disclosed by making them void as a matter of law. The presumption that the transaction is invalid requires the trustee to show that the charity is not disadvantaged by the bargain. Jury determination of the fairness of the transaction ensures that dealings will not be approved that do not meet the public's standard of openness and honesty. This modified corporate rule of loyalty best meets the needs of the modern charity. It provides directors the flexibility and discretion needed to operate a charity efficiently. The corporate rule, unlike the trust standard, does not discourage responsible businessmen and professionals from serving on the boards of charitable organizations. Finally, the rule, with its mandatory disclosure requirement as well as the presumption against the validity of any transaction, safeguards the public's interest in protecting charities against the occasional untrustworthy director".

As indicated, the opinion of the Court was issued in 1974 while the note of A.C.G in 1978, dates that precede the adoption of Revised Model Non-Profit Corporation Act as well as other business and non-profit corporation acts which would have been concerned with the duty of loyalty: UK Companies Act 2006, New York Non-Profit Corporation Act and Delaware General Corporation Law.

While it is hence interesting to compare the opinion of Judge Hedrick with the statutory provisions contained in these Acts, it is important to remind that the comparison with the UK Companies Act 2006 follows objectives that are merely connected with the research method of this work.

Thus, as regards the UK Companies Act 2006, the attention must be focused on sections 175 and 177 and therefore on section 181. The latter in fact envisages the modifications that apply to charitable corporations.

Section 175 basically establishes that the director has the duty to avoid to be involved in situations where her interests are in conflict with those of the corporation. Yet, the board of directors may authorize this kind of matters in accordance with the company's constitution. Moreover, the section provides that the duty does not apply to a conflict of interests arising in relation to a transaction or arrangement with the company. This latter circumstance is in fact disciplined by section 177 which prescribes that directors have to declare if they have any interest in the transaction.

The difference between the circumstances related to sections 175 and 177 may be explained as follows:

> A director of Company X wants to buy some shares in Company Y which is on a list of preferred suppliers of Company X. This general relationship may give rise to a section 175 Duty on the part of the director if it can "reasonably be regarded as likely to give rise to a conflict of interest" between the director's interests as a director of Company X and as a shareholder of Company Y. If it can, then this will need board authorisation under section 175[51].
> However, if Company X and Company Y then agree to enter into a supply contract with one another, this will become a situation which is caught by section 177 (as the director may then be indirectly interested in a proposed transaction with Company X) and the director will have a duty to declare the nature and extent of his interest to the other directors of Company X before the supply contract is entered into. However, under section 177 a director does not need to declare an interest "if, or to the extent that, the other directors are already aware of it (and for this purpose the other directors are treated as aware of anything of which they ought reasonably to be aware)". Since the director has already disclosed the situation and had it authorised under section 175, he will be able to rely on this exception in section 177 and not make a further declaration unless the terms of the authorisation he was given require disclosure to be made in the circumstances or if the facts on which the authorisation was given have now changed. This underlines the need for companies to keep appropriate records of conflicts and authorisations on a continuing basis as such records will provide evidence of interests of which the directors of the company are aware (Norton Rose Website).

Now, for charitable corporations, section 181 specifies that the duty to avoid conflict of interests does not apply to a conflict of interest arising in relation to a transaction or arrangement with the company if or to the extent that the company's articles allow that duty to be disapplied, which they may do only in relation to descriptions of transaction or arrangement specified in the company's articles.

[51] This circumstance actually assumes that the director still has to buy the shares of company Y and for this reason, the potential situation of conflict of interests might oblige her to obtain board authorization. This dimension of the rule is actually just a codification of the common law principle according to which the agent can not take that action. It imposes a negative duties.
However, section 175 adds another dimension to that common law principle, establishing that the director has also a positive duty to avoid the conflict of interests. For example, if director of a company X may be appointed as director of company Y on the basis of the approval of company X board of director. This, indeed, deem that company Y is not a competitor of company X so that there is no reason to disallow the director to hold the two offices. However, if by any chance company Y is bought-out by a competitor of company X, then section 175 imposes to the director a positive duty to require the board authorization to continue holding her offices.

In other words, the business corporation director has the duty to avoid conflict of interests. Yet, if the conflict of interests concerns a transaction of the company, she has not the duty to avoid the transaction. In fact, she may well promote the transaction as long as she declares her interests to the board of directors. This shall make the relevant evaluations and shall decide to accomplish or not transaction.

The director of a non-profit corporation must avoid the conflict of interests even if the interest concerns a transaction with the company.

For example, whereas the non-profit corporation X is about to reach an agreement with a supplier Y, whereas the CEO of company Y is the uncle of the CEO of company X, the latter has the duty to not promote the transaction, unless the company articles of association provide otherwise thorough a detailed description of the permissible transactions.

Secondly, section 181 provides that while the duty will not be infringed if the matter has been authorized by the directors, such an authorization may only be given by the directors where the company's constitution includes provision enabling them to authorize the matter, and the matter is proposed to, and authorized by, them in accordance with the company's constitution.

In other words, whereas the director of the business company X has a conflicting interest in a certain situation, his duty to avoid this situation can be resolved by the approval of the board of directors. As concerns charitable corporations, the approval of the board would not be sufficient to exclude the duty of the director unless the by-laws provides otherwise.

A comparative analysis between the provisions of the UK Companies Act 2006 and the opinion held by the Court in *Mountain Top Youth Camp, Inc. v. Lyon* [1974] points out that the first imposes a higher standard of duty of loyalty to charitable directors.

In fact, while for judge Hedrick the interested director may promote all the dealings to the extent they are fair, open and disclosed, the second forbids these kinds of transactions. The strict approach of the Companies Act is mitigated only by the possibility to validate those transactions if accurately envisaged by the by-laws.

As regards the New York Non-Profit Corporation act, the provisions contained in section 715 envisage standards of loyalty that resemble those established by judge Hedrick.

In fact, point a) says that a transaction of an interested director shall not be either void or voidable for this reason alone. Rather, they are void or voidable if the interested director voted the transaction without declaring her interests. Therefore, also the NY non-profit corporation act envisages an authorization from the board of directors for these kind of matters, paralleling in that way the provisions contained in the NYBCA.

It is true, the resemblance of the section 715 of the N-PCL with section 713 of the NYBCA has arisen some criticism among those policy makers who believe that the non-profit scandals are (also) due to insider operations accomplished by executive directors. In particular, the committee on non-profit organization of the association of the bar of the city of New York led by senator Leibell has approved a bill for the abrogation of section 715.

The proposed statute provides that the transaction involving an interested director may be voided or modified by the corporation or the Attorney General unless the interested party and the approving directors affirmatively establish that the transaction is fair and reasonable to the corporation at the time of the transaction. It further provides that the Attorney General may seek restitution to the corporation (plus interest) from the parties to the transaction if it was not fair and reasonable[52].

[52] Proposed N-PLC §715 would replace current N-PLC §715 in its entirety. The proposed legislation contains section (a) through (h), described as follows:
(a) A transaction between a not-for-profit corporation and a director or officer or an entity in which a director or officer is a director or officer or has a substantial financial interest, is void or voidable by the corporation or the Attorney General unless the interested director or officer or any approving director makes an affirmative showing that the transaction was fair and reasonable at the time it was entered into.
(b) A presumption that the transaction was fair and reasonable is created if the following conditions are satisfied:
(i) the transaction was approved in advance by the board or board committee by a sufficient vote not counting the vote of the interested party, and by the members, if any, entitled to vote on the transaction, with knowledge of all material facts by those entitled to vote on the transaction;
(ii) appropriate data as to comparability was obtained and relied upon, and was provided to all individuals entitled to vote on the transaction; and
(iii) the basis for approval of the transaction was adequately documented, which documentation must include the terms of the transaction and the date it was approved, the names of those present when the transaction was discussed and those who voted on it, the comparability data relied upon and a description of how it was obtained, and any actions taken with respect to consideration of the transaction by the interested party.
Subsection (b) also provides that grants between corporations exempt from tax under Internal Revenue Code section 501(c)(3) otherwise falling under this statute must only meet the provisions of subparagraph (i) above to establish presumption of fairness.
(c) The corporation or Attorney General may void or modify the transaction (unless that action would put the corporation in a worse position) in the following circumstances:
(i) the interested director or officer or approving director failed to meet their burdens under paragraph (a) or failed to comply with paragraphs (e) or (f); or
(ii) the interested party or approving directors failed to establish the fairness of the transaction. Proposed N-PLC §715

Directors of non-profit corporations organized under the General Delaware Corporation Law shall necessarily be subject to the relaxed standards of loyalty envisaged for business corporation by § 144.

As regards the Revise Model Non-Profit Corporation Act, section 8.31 other than providing that a transaction of an interested director may be approved by the board of directors or committee, entitles the Attorney General and the State Court to approve the transaction either before and after the transaction itself has been consummated. This norm reflects the judicial review that had been suggested by judge Hedrick in *Mountain Top Youth Camp, Inc. v. Lyon* and is based on the idea that the capacity of the standard of loyalty to reduce the agency costs related to opportunistic behavior depends on its enforcement other than its strictness.

However, for opportunistic behaviors involving expropriation of money represent a crime rather than a breach of fiduciary duties, they must be prosecuted as such. For example, if someone [that can be either a manager or a director] is found stealing, the criminal action will be brought before the court because it breaches criminal law and not only because it breaches corporate [*non-profit* or *for-profit*] fiduciary duties.

Criminal law therefore also is involved in (non-profit) corporate matters providing rules (and not standard) aimed at avoiding *ex ante* certain director behaviors.

(c) allows the corporation or Attorney General to seek restitution from the interested director or officer or the approving director in amounts equivalent to those available to the Internal Revenue Service under §4958 of the Internal Revenue Code of 1986, as amended ("IRC"), regardless of whether the corporation is subject to IRC §4958 and regardless of whether the Internal Revenue Service pursues its remedies under IRC §4958. Restitution under IRC §4958 requires repayment of consideration in excess of reasonable amounts. IRC §4958 also provides for penalties on the parties, which are not applicable under the bill.
(d) The corporation, through its certificate of incorporation or by-laws, may place additional restrictions on contracts or transactions between a corporation and its directors, officers or other persons and provide that contracts or transactions in violation thereof will be void or voidable.
(e) Compensation to directors or to officers (in capacities other than sitting on the Board), including for services performed on behalf of the corporation as a director or officer of another entity, must be set by the Board or by a Committee of the Board comprised solely of non-compensated directors, or if relevant, by a majority of the members, and such compensation must be fair and reasonable in accordance with the standards of Internal Revenue Code section 4958.
(f) Compensation of directors for serving on the Board or any Committee must be approved by at least a majority of the entire Board, and must be fair and reasonable in accordance with the standards of Internal Revenue Code section 4958.
(g) This subsection sets out definitions of terms used in the bill.
(h) With the exception of compensation of directors or officers, the law is inapplicable to any contract or transaction of which the director or officer has no actual knowledge and which does not exceed the lesser of one percent of the gross receipts of the corporation or one hundred thousand dollars.

§ 3.2 The Duty of Care, Skill, Diligence (Negligence, Incompetence)

The other standard of behavior provided by law to shape directors performance on principals' interest is represented by the duty of care, skill and diligence.

As said earlier, this standard does not fall within the concept of fiduciary duty for it does not involve matters of moral and conscience. In fact, differently from the duty of loyalty, the duty of care, diligence and skill is not really aimed at reducing the costs related to opportunistic behaviors, that is those behaviors that are performed while knowing that they are jeopardizing the corporation, rather this duty is concerned with the costs of incompetence and low diligence or negligence. Of course, where the negligence is voluntary, the performance of the director can violate both the duty of loyalty and the duty of care, skill and diligence (CSD duty).

In order to measure the content of the CSD standard, it is necessary to repeat the reasoning adopted for the duty of loyalty, that is considering the law of trust and the law of corporation. The comparison of the judicial opinions and the statutory provisions shall confirm that also for the CSD the provision of a standard specifically tailored for non-profit corporations is needed.

If one's opinion is that the non-profit corporation resemble the charitable trust, then one reflects the old opinion held in 1742 *The Charitable Corporation v. Sutton* [1742] where it was established in substance that a director of a company owes duties to the company in the same measure and quality as does a trustee to a trust.

In particular, the duty of CSD of trustees had to be measured according to standards which took into account:

a) the level of care exercised by the trustee in managing his own property;

b) caution and conservation of capital [Lee, 2003].

The high standard of the trustee in relation to the duty of CSD, was accurately described by A.C.G. [1978],

> "the trustee also is bound by the duty to exercise reasonable care and skill in administering the trust. This duty is often expressed in terms of the "prudent man" rule, holding a trustee to be "under a duty to the beneficiary in administering the trust to exercise such care and skill as a man of ordinary prudence would exercise in dealing with his own property .... ". This rule translates into a

> requirement that the trustee be held liable for breaches of trust that amount to simple negligence.' The duty of care also requires that a trustee be cautious in investing the funds of the trust." He may not delegate responsibility for administering the trust or selecting investments. The strict interpretation given these duties by the courts holds the trustee to a high fiduciary standard[53]".

If one's opinion is that the non-profit corporation reflects rather a business corporation, then the duty of care of directors should apply. It is true, just as it happened for the duty of loyalty, initially corporate directors were treated as trustee and, as such, they had to comply with the above mentioned high standard.

However, as professor Horsey [1994] underscored, "courts recognized the need for judicial restraint against imposing liability on corporate fiduciaries for mere errors of judgment. Here, too, the concept of limiting the liability of directors by exonerating them for judgemental error had its origins in English common law as old as the common law duty of care. The English 1742 case earlier referred to, *Charitable Corp. v. Sutton*, may also be the "father" of what is commonly referred today in this country as the so-called business judgment rule".

The different approach of the courts was due to the consideration that corporate directors had many areas of responsibility so that they need to be acknowledged with greater discretion. The traditional trustee, in fact, was often charged only with the management of the trust funds and could therefore be expected to devote more time and expertise to that task.

Accordingly, in the United States, courts began to deal with directors' decisions bearing in mind the *business judgment rule*. This functioned as "a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company" [*Aronson v. Lewis*, 473 A.2d 805, 812 - Del. 1984]. The BJR implied that it was the interest of the principal to demonstrate the breach of duty. The BJR was even recently confirmed by the Supreme Court of Delaware in occasion of the famous *In re Walt Disney Derivative Litigation*, Case No. 411, 2005.

[53] The fact that the scholar says that the trustee is hold to a high fiduciary standard has not to be interpreted that the duty of care, skill and diligence is a fiduciary duty, but simply that it is connected to the circumstances of a fiduciary relationship.

It is true, in England courts had never expressly established the *business judgment rule*. Yet, its elements and the general understanding of its functioning had been implicitly recognized, providing, at least facially and psychologically, a low degree of certainty to the directors [Berkowitz, Pistor, Richard, 2003]. This approach lasted at least until the decision of the Companies Act 2006 which, as it shall be seen below, codified the subjective and objective test of the managerial decision.

By the way, also concerning the duty of care, diligence and skill, the courts have alternatively followed one or the other approach. More accurately, from the application of the high standard of trust, they have ended up to approach the lower corporate standard and, therefore, the business judgment rule.

According to Fishman [1987], Courts had likely adopted a result oriented approach, that is judges had decided according to the "circumstances of the case".

To demonstrate this Court attitude, the US scholar has introduced the instance of Sibley Hospital, a charitable corporations whose liquid assets were maintained in savings and checking accounts rather than in treasury bonds or investment securities.

These investment decisions were made by the treasurer and approved by the board as a matter of course.

If the opinion of the Court were that the Hospital resembled more a charitable trust than a charitable corporation, then it would have decided that under the trust standard is not possible to delegate responsibilities. The directors, therefore, would have been easily found in breach of their duty of care.

However, the Court considered the Sibley Hospital more as a charitable corporation than a charitable trust, above all because of the wide size of the hospital itself.

Thus, as the corporate standard allows to delegate some of the responsibility to the extent to which the delegator maintains control over the delegated, the Court had simply to establish if directors did or not commit a gross negligence in the exertion of their function.

Having surveyed the authorities and weighed the briefs, arguments and evidence submitted by counsel, that is the "circumstances of the case", the Court decided that the directors had breach their fiduciary duty to supervise the management of Sibley's investments.

While by either applying the trust or the corporate standard the directors would have been found accountable, Fishman [1987] took the chance for arguing that the legal reasoning that distinguishes on the basis of the size of the charitable corporation had not to be the rule.

Fishman actually agreed on the principle that trust or corporate standards are to be applied according to the "circumstances of the case", however the distinguishing element had to be represented by the nature of the supervisory or managerial function involved rather than the size of the organization.

In particular, he argued that when the managerial decision involved matters related with the administration of the funds such like investments, then the director had to enjoy the same protection conferred to the business corporations colleagues.

Whereas the managerial decision was concerned with the purposes and, hence, the effectiveness of the non-profit corporation, such like merger, dissolution, change of the purposes themselves, then the trust standard had to apply.

Fishman [1987], moreover, underscored how this shifting standard theory had been also adopted in the business corporation context to distinguish the standards related to bank directors from those related to ordinary corporations.

The Supreme Court of Delaware in *Oberly v. Kirby* [1991] seemed to not follow Fishman's findings, rather it continued the process towards considering business and non-profit fiduciaries on the same level. In fact, it confirmed that the business judgment rule applied also to non-profit corporations by stating: "a court cannot second guess the decisions made by wisdom of facially valid decisions made by charitable fiduciaries, any more than it can question the business judgment of the directors of a for-profit corporation".

As regards the statutory approach to the duty of care of non-profit directors, it can be seen how the UK Companies Act 2006 has extended the corporate standard to charitable corporations.

In fact, differently from the duty of loyalty, whose norm for charitable companies has to be drawn from the joint reading of section 175 and 180, the low(er) standard of the CSD duty contained in section 174 applies without distinction to business and charitable companies.

In particular, the Companies Act 2006 has shed light on the common law rules established in *Re Brazilian Rubber Plantation & Estates ltd* and *Re City Equitable Fire*

Insurance Co ltd. In these decisions, in fact, the court employed either a subjective and a subjective/objective criteria to evaluate if a certain managerial decision violated the duty of care. The doubt was firstly resolved by judge Hoffmann in *Normann v. Theodore Goddard* [1991] who maintained that the common law test of a director's duty of care was the same as the one stated at section 214 (4) of the Insolvency Act 1986 which was a subjective/objective test. As the Law Commission charged with drafting the Companies Act 2006 thought that Hoffmann finding was the law, it promoted the codification of the mentioned principle.

Under the subjective test the less knowledge and experience the director has, the less skill is expected from him, and the less likely he has to be held liable when something goes wrong.

Under the objective test, a director must possess the skill that may reasonably be expected from a person undertaking those duties.

Unfortunately, so far it has not been possible to identify UK court decisions applying s 174 of the Companies Act to charitable directors.

As regards the NYBCL, section 717 confirms the rule of prudent man which is corroborated by the binding precedent of business judgment rule. This is paralleled by the provisions of section 717 of the N-PCL.

The Delaware General Corporation Law, at § 141 defines the standard of care as reasonable.

The Revised Model of Non-Profit Corporation Act at section 8.30 provides that the standard of care must be represented by both the prudence and reasonability.

While the concepts of prudence and reasonability express the same degree of standard, they have not to be confused with the concept of rationality.

In fact, if one had to void a director decision only when it would prove not rational, then it would be very hard to judicially challenge such behavior. While it is common to characterize conduct as unreasonable, it is rare to characterize it as irrational. In these cases, decisional liability would attach only where the decision itself cannot be rationally explained and the directors fail to provide a single rational reason for conduct such as developing a plant that they knew could not be operated profitably. Liability does not attach merely by

reason of an unreasonable decision; rather, the decision must be irrational. Otherwise, the process itself is the proper focus [Bishop; 2008].

On one side, a high standard of CDS would move away professional directors from the non-profit context; and it is important to note that in many cases they are even not paid.

On the other side, the lower standard adopted by US law for business corporation would put at risk the public interest followed by the non-profit corporation as well as the economic interest of the p*atrons*; and it is important to note that only lately the latter have been acknowledged with the right to sue directors. That is, a low standard plus a weak *ex post* control could leave directors with too discretion.

According to Fishman [1987], that goal could well be reached if law were more concerned defining standard of behaviors, in particular the duty of care.

§ 4. RULES

Differently from the standards, rules discipline *ex ante* agent behaviors. The most important rule concerning non-profit corporations is undoubtedly the non-distribution constraint.

In UK this is provided by the Charity Act 1993 at section 64 other than the opinions held by Judge Pennycuick in *Construction Industry Training Board v. Attorney General* [1973] and by judge Slade J. in *Liverpool District Hospital for Deseases of the Hearth v. Att. General* [1981]. The latter case-law actually confirmed the non-applicability of sections 558 and 597 of Companies Act 1985. These sections, in fact, allowed the envisagement in the by-laws of clauses concerned with the distribution of the dividends.

As concerns the New York N-PCL, the *NDC* is provided at § 102, subsection 5. The Delaware General Corporation Law does not contain provisions concerned with the *NDC*, so that the non-profit status of a corporation is relevant only for tax purposes.

The Model Non-Profit Corporation Act forbids distribution of incomes at § 13.01.

Rules may also be seen as devices for assessing the level of the standards related to the duty of loyalty and the duty of care, diligence and skill. For instance, as regards the first, the prohibition (and so the rule) for the trustee to accomplish interested transactions is signal of a high standard of behavior.

In addition, rules aimed at preventing certain agent behaviors are also those provided by crime law.

§ 5. INITIATION AND TERMINATION TERMS OF THE RELATIONSHIP

The second regulatory strategy is represented by rules of law that discipline the conditions for which the principals enter and terminate the relationship with the agents, while the standards and rules are concerned with the development of the relationship itself.

This kind of regulatory strategies anyways makes sense only in a business corporation context where investors need to know certain information before purchasing the quantity of stock desired and where investors unhappy with the management wish to get out from the ownership structure of the corporation.

Business corporate law in fact compels listed firms' to make specific *disclosures* and ensure to shareholders the right to recede or to sell their shares.

§ 6. EXTERNAL CONTROLS

The enforcement of the non-profit directors fiduciary duties has normally relied on the Attorney General. Yet, a recent tendency of the US courts has recognized on behalf of p*atrons* the right to bring suits against non-profit management. To be accurate, the judicial doctrines have recognized to donors the right to bring contractual actions while only for consumers it has been acknowledged the right to bring action for breach of trust.

In order to understand the different legal reasonings developed by the Courts it is necessary to get briefly back on the law of trust.

In private trust, the settlor has no right to enforce the terms of the agreement. This result stems from the historical perception of trusts as a conveyance of property, which viewed the settlor's role as complete once the property was conveyed in trust [Houston, 2005]. The right to stand for *breach of fiduciary duties* lies only with the beneficiaries.

Accordingly, as in charitable trust beneficiaries are not certain or determined, in cases of mismanagement there would not be anybody entitled to bring trustees before the courts.

To comply with such a problem, in *Carmichael v. Bibb* (1937), the Supreme Court of Alabama, recalling what said in 22 Encyclopaedia of Pleading and Practice, 205, reminded that

> where a trust is for a public charity, there being no certain persons who are entitled to it so as to be able to sue in their own names as *cestuis que trustent*, a suit for the purpose of having the charity duly administered must be brought in the name of the state or the attorney general, and it seems that in all cases the attorney general may maintain the suit with or without a relator. Charitable trust is of public concern and the attorney general is the protector of the interest of the public, or, what is the same thing, of the indefinite and fluctuating body of persons who are the *cestui que trust*. In fact, the attorney general is the only one who can properly invoke the superintending power of the courts over the administration of such trusts.

This approach has been further confirmed by decisions (*O'Hara v. Grand Lodge I.O.G.T.* (1931) 213 Cal. 131, 139; *Brown v. Memorial Nat. Home Foundation* (1958) 162 Cal.App.2d 513, 538.) underlining that in common law, indeed, it is well established that the

settlor of a charitable trust who retains no reversionary interest in the trust property lacks standing to bring an action to enforce the trust independently of the Attorney General.

Because of the conventional resemblance among the settlors of a charitable trust and the *patrons* of *non-profit* corporation, it follows that neither of the latter would be allowed to bring suits before the courts.

In the matter of fact, the activity of the Attorney General has not proven efficient [Hansmann, 1981] The scarce reliability of that public office has moved legal scholars and courts to take into consideration solutions that reflected the private nature of *patrons* interests.

With this perspective, judges have been setting forth a path clarifying that in precedent cases the principle according to which the Attorney General were the only party entitled to bring *non-profit* directors before courts was not established. In 1977, the Supreme Court of Alabama, in *Jones v. Grant*, stated that in *Bibb* [1937] itself, "the question of whether anyone else has standing to institute a suit against a charitable trust has never been answered in Alabama. Thus, this is a case of first impression. […] The prevailing view of other jurisdictions is that the Attorney General does not have exclusive power to enforce a charitable trust and that… a person having sufficient special interest may also bring an action for this purpose".

So, according to this, the question would have been resolved only by demonstrating that p*atrons* keep a special interest. That is everything but simple. In *Women's Christian Association v. Kansas City et al* [1898], for example, the Court of Missouri clearly stated the common law principle that once a gift is accomplished "all right and interest therein or thereto is gone forever".

The legal reasoning meant to recognize a special interest on behalf of *patrons*' category had to therefore be set forth from another perspective. In *L.B. Research and Education Foundation v. UCLA Foundation* et al. [2005], the Court of Appeal of California observed that "although a donation may have a charitable purpose, it does not necessarily mean that it constitutes a charitable trust. Thus, the owner of a property may, rather than create a trust, transfer it to another on the condition that if the latter should fail to perform a specified act, the transferee's interest shall be forfeited either to the transferor or to a

designated third party. In such a case the interest of the transferee is subject to a condition and is not held in trust".

This decision has fundamentally embraced the neo-classical trend that conceives the [*non-profit*] firm as a *nexus of contracts*, where in the matter of fact p*atrons* keep an economic interest that must be protected.

As seen in chapter III, when courts are asked to deal with *non-profit* corporations, they may follow two tendencies.

The first that is more traditional simply considers *patrons* contributions as instituting charitable trusts. In such cases, applying the law of trust, donators lack the standing to sue. The *non-profit* organization is pictured in a public dimension where only the Attorney General has the power to intervene to settle [public] conflicting interests.

The second, updated with mainstream economics, regards the relationship between *patrons* and directors as based on a contract. Therefore, applying contract law, *patrons* would be allowed to sue directors but, obviously, the remedy would be against the *breach of contract* and not against the *breach of duties*.

In the last quoted case [2005], for instance, Judge Hess has deemed a donation of $ 1 million as a conditioned gift as it was intended to establish an endowed chair at a school of medicine. In this situation the donor could have based her civil action on the basis of forfeiture remedy, as directors did not meet the terms of the agreement.

Such legal reasoning, however, is not always workable as not all the p*atrons* are actually donors.

A great number of the resources stem from *consumers* who purchase the services/goods provided by the *non-profit* organization. In such cases there is no doubt about the contractual nature of the relationship between parties. The consideration is represented by the exchange of the promises: payment for service/good. From a strictly legal point of view *patrons* are entitled to bring suits against directors solely for breach of the contract related to the transaction.

For this category of p*atrons* there has no been equitable remedy for breach of *fiduciary duties* until the famous controversy *Stern v. Lucy Webb* (1974). The US District Court for the District of Columbia practically introduced the principle according to which a class of users has a sufficient special interest to challenge the conduct of the trustees

operating the charitable institution on a theory of breach of trust. The problem of the uncertainty of beneficiaries had to be resolved through the certification as a class under Rule 23(b)(2) of the Federal Rules of Civil Procedure.

The difficulties to acknowledge p*atrons* with the standing to sue, however, are not still completely resolved. In fact, courts are not really free to conceive a gift as a contract.

To begin with, the analysis must take on the common law principle according to which a contract necessarily involves *consideration*. Truth is, donors of *non-profit* organizations barely provide funds in exchange of something on their behalf – otherwise it would a bargain and contract law would apply. They rather provide funds in exchange of something to be done on behalf of third, uncertain beneficiaries.

The logical solution to the question would be to consider all donations as *consideration* lacking and, therefore, to deny their contractual nature. Yet, there can be some exceptions.

One is represented by the pledge of donation contained in the *deed*. The sanctity of the act may help the donor to specify his/her own wishes about the administration of the funds he/she provides without worrying about the lack of *consideration*. Charitable donations accomplished in that way, in fact, are "valid contracts even though there is no valid *consideration*" [Lloyd, 2007].

In other words, if the organization accepts the gift, it binds itself to observe and respect what was envisaged in the agreement. The protection of the donor against directors' abuses would be ensured by the application of gift law. In the very famous case of Lee Brass' donation on behalf of Yale University, the former was entitled to rescind the donation when the latter admitted it would not have respected the conditions agreed [Brody, 1996].

The second exception concerns the material transfer of the gift. In these cases the donations are deemed as executed contracts, regardless of the presence of *consideration* [Sloane, 1913]. These contracts are therefore conceived as complete, since the donation is absolute and mere. Donors are not legally acknowledged with right to sue directors, as the latter have no obligations to perform at all. The contract is executed and not *executory*, meaning that the relationship ends with the transfer of the gift.

The last exception regards a specific norm envisaged by US legislation. The relevant provisions (section 90, subsection two, of the *Restatement [Second] of Contracts*) establish

that, in determinate circumstances, significant promises concerning charitable donations are to be considered binding, notwithstanding the lack of *consideration* [Archibald, 2004]. In other words, the discipline provides that contract law applies regardless of the use of the *deed* and the material transfer of money. Accordingly, the donor who does not put *under seal* his/her pledge to restrain the employment of the funds will be anyway acknowledged with the same protection as if he/she had made a *deed* promise. An unrestrained promise will otherwise not guarantee to donors the protection for breach of contract.

None of the mentioned exceptions reflect the actual problem posed by this work. The hypothetical fact situation that is at issue concerns a mere donation, materially accomplished without any solemn form (*deed*) and the basic point defended in this discussion, is that such donation is not an executed contract but rather an *executory* one, as the donor expects a performance in exchange of her contribution.

The extent of the legal effort directed to identify a consideration into the transaction realized by the donor is quite evident. In fact, common law traditions have always based the whole system of analysis of contractual relations on the *parole evidence rule*, which imposes on the interpreter to draw the terms of an agreement by using only the written document and its literal meaning [Peratoner, 2003]. Such an approach implies that if the donor him/herself does not specify his/her preferences, or specify just some of them, then the directors' fund administration is not restrained at all, or it is restrained only in part – to the extent of the specified clauses.

This principle has been confirmed in the quoted Judge Hess decision where it is openly argued that courts will generally construe a conveyance as one upon condition rather than upon trust only if the donor clearly manifests an intention to make a conditional gift. Only in these cases will the intention be honored.

To conclude the discussion it is worthwhile to point out two fundamental findings:

a) *patrons* who are donors are legally entitled to sue *non-profit* directors for breach of contract. The acknowledgment of the contractual dimension of the relationship hinges on certain legal circumstances;

b) *patrons* who are consumers are legally entitled to bring suit against directors for breach of *fiduciary duties* under the condition they represent a certified beneficiary class having a special interest.

CHAPTER VI

ITALY

COMPARATIVE LAW ANALYSIS

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§1. HISTORICAL BACKGROUND

Italy reached its unification only in 1861 whereas the Kingdom of England, as sovereign State, dates back to 927. The latter originated from the kingdoms of the ancestral English, the Anglo-Saxons, which were carved out of the former Roman province of Britannia. In 1033 William I of Normandy defeated Harold II and commenced a process of feudal (re)organization that would have strongly influenced the English legal system. William I was the last "ruler" that succeeded to invade the Isle. Even Napoleon and Hitler failed to do so.

The relationship between the law (the comparison) and the moment of the formation of a united kingdom (history) is clear: while Italy would have continued to apply Roman and Canon law until the adoption of the Civil Code in 1865, in England the Courts of Westminster would have developed a distinguished legal tradition since the XII century.

This implies that until the establishment of such courts the discipline of charity in England and in Italy had to be the same. Thus, in both the countries the Church was expected to dedicate a quarter of the almsgiving to the poor and in both the countries the Codex Theodosianus and Iustinianus had to apply with their provisions concerning the primirary role of the Church in the administration of the charitable funds and concerning the right to sue administrator, acknowledged to all those who had an interest in the charitable fund.

Actually, the reading of an article written by Foresi [2001] would suggest that during the Early Middle Age, in the Italian territory, the role of the Church in providing charity might be even more important than in the English one. In fact, as the author [2001] underscored

> "the socio-historical context where the investigation of our Pontifex is set, is characterized by a very bad crisis. The Italian peninsula had been hardly damaged by the twenty years gothic war conducted by Belisario and Narsete for emperor Giustiniano's will. The latter was indeed eager to reorganize the Roman Empire in its integrity. On one side, the successful conclusion of the conflict in 553 freed Italy from the Ostrogoths domination, yet on the other

side the Constantinopoli unification of Italy had left a deeply devastated land, first of all because of the abandonment of the agricultural activities and following famines that had reduced population in malnutrition conditions.

After only fifteenth years of peace, in 568 another invasion upset the peninsula: directed by King Albonio, the Lombard after having given the Pannonia up, penetrated into Italy and extended the already existing scars brought by the previous war.

For many years Italy was characterized by a follow one after the other military campaigns, single actions of guerrilla and short and unstable periods of peace. The crisis state of the Byzantine Empire even worsened the Italian conditions.

In fact, the majority of the resources was finished in the previous re-conquest campaign so that the Byzantine Empire was more concerned with the Persian threat than with the protection of the Italian peninsula.

In such circumstances, the only institution able to face the incumbent Lombard pressure was the Church. This committed itself in defending Italy from the barbarians, directing military operations, negotiating peaces and prisoner ransoms, and looking after people spoiled by war events.

The best Church commitment was represented by the direction of Gregorio Magno (590-604), whose pontificate coincided with the crucial period of the mentioned crisis. The Pope personally managed the military operations, appointed the captains of Nepi and Naples (592) garrisons, negotiated peaces and paid the ransoms to rescue prisoners, replacing in these duties the absent Empire.

Further, it is worth to underscore that Gregorio went beyond war and political actions: he attempted to relief the distresses of the victims caused by such situations, not only poor classes victims but also upper class ones.

The Pope followed the latter purpose basically through charitable entities called *diaconie*, whose first evidences are contained in the Gregorio Magno Encyclical and whose name is thought to come from directly from the Greek verb *diaconeo*, which correspond to the Latin word Minister (to supply, to provide), therefore no linkage with the Latin word Diaconus which since the III century has referred to a particular Holy Order.

The first *diaconia* certified in the Encyclical results to be located in Pesaro: in February 595 the Pope wrote to the notary of the Roman Church, Castorio, who was staying in Ravenna as responsible of the local archbishop. The letter asked to Castorio to resolve a testamentary case-law occurring in Pesaro. Here, in fact, a certain Adeodato was died and had bequeathed all his properties to the poor.

Difficulties showed up in relation to the execution of the will as some individual were eager to illegally take possession of the *decuius* resources.

Castorio was therefore charged with ensuring the correct execution of the will and, therefore, with ensuring that the properties were donated to the local *diaconia* in order to be assigned to the assistance of poor. It is then clear that such *diaconia* was supported by private citizens legacies.

Another *diaconia* is certified in the city of Naples: in March 600, the Pope Gregorio sent a letter to claim against the prefect of the “pretorio d’Italia”, Giovanni. The Pope argued that

> Giovanni had suspended the supply of the *annonae* (foodstaff) and of the *consuetudines* (cash money) destinated to the Napolitan *diaconia*.
>
> The Napoletan *diaconia* had not to be thought as depending on the financial administration of the province, directed by Giovanni: the argumentations of the Pope were indeed based on a custom rather on a administrative law irregularity.
>
> In December 600, Gregorio Magno appoint as director of another *diaconia*, whose location is not specified, the religious Giovanni. This looks like to be immune from the ecclesiastic and imperial authority control. The qualification of "religious" does not allow to establish if he was a lay or an ecclesiastic, as such term is employed by Gregorio for both the categories.
>
> The total immunity that Giovanni benefited seems to suggest that the *diaconia* did not depend on the Roman Church and for this reasons we would imagine he was a lay man. As the *diaconie* of the Gregorio period did not belong to the imperial financial administration, probably these were institutes founded by local authorities and, because of their charitable purposes, they were under the protection of the Pope".

The discussion of Foresi [2001] other than underscoring the important role of the Church in providing assistance within the Italian peninsula, mentioned an institution that this study did not come across in occasion of the analysis of the English history: the *diaconia*.

It seems these institutions were originally established in Egypt by the cenobitics for the provision of social or public services.

According to Bertolini [1947] the *diaconie* were established in the Italian peninsula during the VI century and survived only until the VIII century. The reasons of such transplant were represented by the need of decentralized and independent institutions. In fact, the several ecclesiastic structures that had been existing since the early middle age, such as *xenodochia*, *orphanotrophia*, *brephotrophia*, *nosocomia*, *gerontocomia*, were all administered by the central office of the Church.

Thus, on one side the *diaconiae* actually exerted the same functions of their ecclesiastical parallels, that is supporting the poor, providing food and assistance. On the other side, the *diaconiae* differed from the ecclesiastical structures in that they were financed either by the State and by private or ecclesiastic legacies. Moreover, even Pope Gregorio Magno demonstrated a certain favor for these institutions.

However, it is still unclear who established and who administered them. They probably were established by the monastic orders and administered by some of these ecclesiastical officers.

In Rome the situation was different from the rest of the Italian territory. The *diaconiae*, were introduced only in the VII century and actually they took the name of *monasteria diaconiae*. In this case there are no doubts that they were created by monks who also elected the administrator. This was chosen among those that the monks deemed as the fittest to exert that kind of functions. Although they had legal personality and, therefore, they were independent from the monasteries, their administrator was usually a monk of the monastery.

The Church welcomed the independence of these institutions for it was – for the first time – experiencing very difficult financial situations.

The *monasteria diaconiae* became even more fundamental in the following century (the VIII), when the Roman Government sought private resources for the provision of social services and when the Church had resolved its economic problems and decided to get directly involved in the administration of the *diaconiae*.

Although the most important among the social/public services was the assistance and charity of the poor, the roman *diaconiae* – differently from the Egyptian-like ones – were concerned also with the other classes of the population that hardly succeeded to obtain foodstaff. By the end of the VIII century anyway the *diaconiae* were totally absorbed into the ecclesiastical system.

Differently from England, where in 1528-1536 King Henry VIII completed the process of Reformation and secularization of charity, in Italy the ecclesiastical system continued to exert a leading role in the provision of relief.

This is demonstrated by a Terpstra [1994] article which told how in the period between 1490 and 1530 a small group of patrician families took control of the Bologna's confraternital hostels, infirmaries, orphanages, and foundlings homes. In fact, set aside these forty years and the peculiar situation of Bologna city, that is apart such exception, since the early Middle Age the charity activity had always been exerted by the Church throughout the whole Italian territory.

This meant that while in England the discipline of charity had to develop along with the need of ensuring a fair administration of the funds, in the Italian territory the Roman and Canon law remained more concerned with the right of the Church to obtain the administration of charity resources.

For example, in the Foresi [2001] account, one can identify the case that occurred in Pesaro in 595 when a certain Adeodato drafted a will according to which his son and his house servant were designated as heirs.

As they were still underage, the testator charged a certain Tommaso with being the executor of the heritage and with transferring it to the heirs as soon as they reached the legal age.

Most importantly, the will contained a clause according to which if the heirs died when still underage, Tommaso would have had to give the properties to the poor.

As the heirs died before the legal age, certain people held that the will of the *decuius* could not be satisfied so that Tommaso was not legally permitted to administer the properties [Gregorio Magno, 595].

For this reason, Pope Gregorio Magno sent a letter to his Notary Castorio asking him to protect and to defend Tommaso for this succeeding to comply with the Adeodato will. In addition, in his letter the Pope specified that there were some rumors about the fact that Tommaso was meant to buy something in the *Diaconia* established in the city and urged Castorio to do his best for allowing Tommaso to accomplish such task.

It is clear how the request of Pope Gregorio Magno did not aim at enforcing Tommaso obligation to employ Adeodato resources on behalf of the poor. Rather, the intention of the Pope was to make the resources flowing into the Diaconia, that is an institution which presented strong linkages with the Church. Since the early Middle Age, therefore, the concern of the Church remained to devise legal solutions to ensure that charitable bequests did not remain in secular hands.

This did not represent an easy task for the Church. The figure of Tommaso, in fact, as a person between the testator and the heirs was not conceivable under the Roman Law. Tommaso was a tutor of the heritance, but such qualification of tutor had not to be meant in a legal sense.

The Roman Law institutes that the most approached to the function of the tutor were the *fedecommesso* and the legacy burdened by a modus.

The first was an institute according to which the testator begged the heir or the beneficiary of a legacy to do something on behalf of another person. The second implied a

legacy whose function was to involve an action on behalf of the testator itself (for example to pay the funeral, burying etc.).

This means that according to the Roman Law, Tommaso had to be necessarily considered as a heir or as a legatee. The problem for the Church was just the fact that both the heir and the legatee had only a moral obligation to comply with the intentions of the donors.

The Church therefore had to devise a new legal institute capable to render enforceable the obligations of the tutors.

Initially, the Church codified a Canon Law rule according to which the bishops had the right to enforce the *fideicommissarios*. Yet the ecclesiastical authority actually never exerted a right of control. Rather, very often the testator expressly forbade the bishop to interfere into the function of the will [Melchiorre, 1913].

Thus, to contrast the excessive powers of selfish tutors, the Church introduced the institute of the *esecutore testamentario*. In particular, according to the Capitulum XIX Titulus XVI of the *Liber Extra* (1234), that is a collection of Canon law rules published thank to the intervention of Pope Gregorio IX, the "*exsecutor testamentarius, qui suscepit illud officium, exsequi compellitur*".

On one side the introduction of this legal institute did actually facilitate the Church in obtaining resources to be destined for charitable purpose; on the other side, it did not prove as capable as the English trust to be employed to constitute secular charitable institutions.

In fact, while at first glance, the figure of the *esecutore testamentario* could in many respects resemble the figure of the trustee, there were fundamental differences because of which secular charitable institutions proliferated in England whereas in Italy they did not.

As underscored by Manes [2002] both the institutes involved fiduciary obligations, both were concerned with the administration of properties on behalf of third parties, both implied the split of the personal properties from the properties received in trust.

Yet, there were crucial differences which were related to this third aspect.

To begin with, the trustee at common law was the legal owner of the properties while the *esectuore testamentario* had only the possession of them.

In particular, the trust fund (or the trust assets) involved a complex of legal relationships which, although belonging to the trustee, because of their specific purpose

were considered by the law as distinguished from all the other legal relationships belonging to the trustee himself [De Guglielmini, 2006]. The Canon Law also treated the assets entrusted to the *esecutore testamentario* as distinguished by his personal properties, but this only to the extent to which personal his personal creditors might not boast any claim on the bequests. The legal owners of the latter were indeed the heirs. Thus, if the testator had indicated that an executor would have had to administer the goods on behalf of the poor, as the poor could not be the owner for they were an uncertain class, then the heir would have been the Church.

Thus, it is clear that the institute of trust allowed testators (but also donators) to entrust their properties to secular trustees who, for they were legal owners, would not have had any legal questions with the heirs (if any designated) and would have complied with the intentions of the testators only according to their personal good sense.

Most importantly, the institute of trust would have permitted the perpetuity of the charitable donation. It is true a donation could be represented by different objects. For example, the donor could simply require to the trustee to employ the £ 500 to buy food for the poor of the county. In that case, he would not have established a permanent charitable trust, rather this would have finished once the sum had been spent. The donor could also device lands or incomes stemming from these for charitable purposes and not provide any term in the will/deed. In cases like these, the *settlor* would have specified not only who were the trustees but also the mechanisms to perpetuate the control over the charity. In case the donor did not mention anything about that, still the survivors of the trustees, as heirs, would have taken the control of the charity. Whereas this was not possible or the survivors did not want to, the Court of Chancery would have thought to fill the vacuum up.

The perpetuity of the charity was therefore rendered possible by the peculiar legal nature of the property which could pass from a hand to another, still it remained burdened by the charitable intentions of the donors.

As seen, this could not be obtained through the institute of *esecutore testamentario* as the Church would have advanced a claim stating its right of succession.

Still a citizen of the Roman Republic or the pagan Empire who wished to found or to endow a hospital, an almshouse, or a school, could (only) do so by indirect means.

This indirect mean was represented by the bequest on behalf of already established "corporations" as they were for example the towns or more in the past the *collegia*, *solidated* and *universitates*. Since these "corporations" were permanent institutions, then bequests on their behalf would have lasted for all their existence.

Of course, as one would easily imagine, another solution for instituting secular "charitable trusts" was represented by establishing a foundation. Yet, foundation is a legal concept whose meaning is as new as the legal personality of corporations.

The institute of foundation had to involve the acknowledgment of the legal personality on behalf of the assets entrusted to a secular administrator. The late middle age Roman Law was still not that theoretic for accomplishing this important step. Only physical persons could be subject of private law. In fact, the towns, *collegia*, *solidated* and *universitates* mentioned above, represented a very exception for these were kind of public institutions.

Sanfilippo [2002] maintained that in the late middle age, the Canon Law set the basis for the personification of the assets – *universitas bonorum* – in relation to the already discussed *pious causes*. By the way the concept of foundation was introduced in Italy only with the civil code of 1942.

The strong influence of the Church and the lack of a proper legal device to establish secular charitable entities were the fundamental cause for which the non-profit sector maintained in Italy an extended religious charity dimension until the unification occurred in 1861.

Such historical event brought somehow the same consequences that had brought the process of Reformation in 1533-1536.

In fact, also in Italy the government began to pass laws aimed at expropriating Church properties.

The first of these laws was decided in 1866. This led to the expropriation of about 1,800 religious institutes and allocated the relevant properties to local public authorities.

The second law was passed in 1867 and other 25,000 institutions saw their estates confiscated and sold at auction.

A third and last law even more reduced the influence of the Catholic Church on Italian society and created a welfare system controlled by the State. It was approved in 1890

and became known as the Crispi law, after the prime minister in office when the law was passed [Barbetta, 2000].

The Crispi law subjected the *Opere Pie* that provided health, welfare, educational and vocational training services to governmental control.

The attempt made with these laws to secularize Italian society was nevertheless far from being sufficient; in fact the religious élite and the welfare services that they managed retained a considerable degree of autonomy in the decades that followed.

Such autonomy was actually secured during the fascist period on the basis of the agreement that Church and State reached in 1929 (*Patti Lateranensi*).

In the matter of facts, what happened was that the religious institutions acquired a semi-public religious/secular status.

The very great difference with the Reformation promoted by Henry VIII during the XVI century was that in England, the Statute of Charitable Uses set the legal basis for establishing private secular charity. Also in Italy the attempt was to secularize charity, yet the secularization did not go towards the private side, rather towards a major involvement of the Government into charity activities. To sum up, while in England the poor laws aimed at establishing a private-public partnership, in Italy the 1860-1890 laws and the *Patti Lateranensi* aimed basically at centralize the charity services in the hands of the State.

Along with the "Italian Reformation", the pre-modern era conception according to which the "needy" were defined as those suffering poverty when this gives rise to extreme and generic manifestations of distress changed dimension. In fact, the needy became to be defined according to their more specific manifestations: war and labor invalidity, old age, unemployment and hardships of children, that is pathologies whose cure had to rely with the intervention of the State.

At least from a legal point of view, this pure public dimension of charity lasted until the adoption of the new Constitution in 1948, where at art. 38 the freedom to provide social services was finally acknowledged.

The constitutional article actually was expected to automatically abrogate the Crispi law whose art. 1 expressly prohibited to private bodies to provide social services. Yet, this did not happen until the 1998 as, according to Cavaleri [in Barbetta, 1997], "the

contradiction was tolerated for so long by the Church as the Crispi law itself had provided IPABs with many advantages".

The *Istituzioni Pubbliche di Assistenza e Beneficienza* represented in fact the nationalization of the *Opere Pie*, but far from being "secularized", they substantially continued to be run by ecclesiastical authorities in accordance with governmental directions.

The freedom of establishing private and secular charitable institutions consecrated by a constitutional norm and the civil code discipline on the foundations and associations theoretically set the basis for the development of a new non-profit sector in Italy.

Yet, this did not actually happen.

The non-profit sector in Italy is one of the smallest if considered on a world-wide dimension. Its employees represent under 2 percent of total employment, and the sector's share is estimated at 1.1 percent of the GDP. The Italian sector does have a significant number of volunteers, whose hours increase total employment to 3 percent [Hodgkinson, 1999].

The Italian tradition that has seen a significant participation of the State in the provision of social services must be taken in consideration for explaining the increase, although as already mentioned small, of the private and secular non-profit sector since the 70's.

In fact, in that period there was the first real crisis of the social state whose lack of resources obliged to rely on private efforts for replacing the provision of social services. Literature [Borzaga and Fazzi, 2000] has defined that period as the period of contribution, meaning that the public authorities chose to support private non-profit organizations in way that did not actually comply with stable and rationally defined criteria. In other words, the governmental units used to finance the non-profit supplier in consideration of the generic social utility of the provided services.

Since the 80s' onwards, the period of contribution gave way to the period of contract, that is a more rational and scientific way to finance private non-profit institutions. This strategy would have implied competition among the suppliers and, thank to the contractual specifications, it would have reduced the agency problems – related to both efficacy and efficiency – between the State and the organization itself.

The participation of the State in the financing of non-profit organizations uncovers the different role played by the Italian non-profit sector in comparison with the US one. In particular, in Italy non-profit organizations are more likely called to resolve the *government failure* described by Weisbroad [1988], while in the US they are more bent to resolve the *market failure* described by Hansmann [1981].

This difference is extremely important in relation to the agency problems whereas one considers that the State – as p*atron* – might have different interests from those of the US donors and consumers.

§ 2. THEORETICAL FRAMEWORK

§2.1 Functional Approach

In chapter III it has been introduced the approach aimed at uncovering the interests involved in the non-profit corporation. In particular, setting out from the general definition of the interest provided by Jaeger – that is a "relationship acknowledged by the law" –, through the functional and structural approach it has been studied which relationships are or should be acknowledged by the law within the corporate context. Put it differently, the investigation on the legal nature of the corporation, had to disclose the interests involved.

This approach cannot be adopted if one has the objective of finding out which are the interests that directors have to pursue within Italian non-profit organizations. That is because, in Italy, as in all the civil law countries, legal persons are not distinguished on the basis of the process of incorporation, rather on the notion of *causa*.

Hence one has two consequences.

To begin with, to have legal personality in the United States means inevitably that one has a corporation, whereas to have legal personality in Italy means many things. For example one can have a foundation, association, *società per azioni*, *società a responsabilità limitata*, impresa sociale, cooperative, etc.: all these represent different legal structures/schemes.

The second is that while in the US the legal dimension of the interests identified through the functional approach – the investigation on the role of the non-profit sector – must be supported by the theories on the nature of corporation, in Italy the legal dimension of the interests identified through the functional approach must be supported by the legal device adopted in a certain circumstance. In other words, while in US the role (and so the interests) of non-profit sector is in function of the theories of the corporation, in Italy it happens just the other way round: the theories of the legal device adopted to constitute a certain non-profit are in function of the role of the non-profit sector.

That means in Italy, the choice of the legal device shall depend on the role exerted by the non-profit sector. In fact, once identified the legal devices through the study of the role of the non-profit sector, the structural analysis of those shall reveal which are the interests involved.

In order to have a general understanding of the role of the Italian non-profit sector, it must be noted that in Italy there are around 221.000 non-profit organizations whereas in the US the number is approximately 1,5 million[54].

Despite the great difference in terms of quantity, there is a very important aspect which is common to the two countries. This is the circumstance for which the institutions that generate more incomes are hospitals, schools and social service organizations. The latter anyway represent just a small percentage if compared with the first two. Moreover, in both the countries, these structures represent a minor share in terms of quantity of established units.

Another meaningful observation regards the non-profit impact on the GDP. In the US it accounts for 5.2% while 8.3% of paid salaries and wages. In Italy, the impact on the GDP is 2.1% while 1.8% of the employment[55].

These data already suggest that the Italian non-profit sector does not occupy an important share in the market. This is supported also by what has been said in the previous paragraph, that is the fact that the existence of Italian non-profit organizations is better explained on the basis of a *government failure* rather than a *market failure* theory.

In particular, the *government failure* in the education field represents a phenomenon that only lately has shown up.

Especially important is the situation concerning the Universities. In Italy the Universities have been normally public institutions. The private ones have presented a strong public authority interference. Just to give a quick example, the by-laws of a famous private University, the LUISS Guido Carli, at art. 3 clearly establishes that the supervision of the activities is exerted by the Minister of Education.

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[54] See http://foundationcenter.org/getstarted/faqs/html/howmany.html and http://www.oltreventure.com/public/files/il%20non%20profit%20in%20italia.pdf

[55] See http://www.urban.org/uploadedpdf/311373_nonprofit_sector.pdf and http://www.espertidi.it/it/info.php/view/noprofit

According to the art. 6 of the Legge 9 Maggio, 1989, the Universities, either public or private are disciplined by statutory provisions that make express reference, other than their own by-laws and internal regulations. The Act, moreover, at art. 1 specifies that Universities have legal personality under art. 33 of the Constitution of the Republic. The Italian Universities therefore have a special legal status that can be defined as "cultural institution" as provided by art. 1 of the LUISS by-laws.

However, this situation might change very soon. In fact, the regular inefficiencies of the public structures have reached an unsustainable degree after the global financial crises. The impossibility for the Italian government to further intervene for the restoration of the financial stability has led policy makers to adopt the art. 16 of the Decreto Legge 19 Dicembre 2009 according to which public Universities can be transformed in private foundation.

This is the first example that demonstrates how the role of the non-profit sector (to replace the state in its fundamental duties) identifies and suggests which legal structures could best express its functions.

The functional approach in relation to the University field would therefore lead to identify the interests involved through the investigation on the nature of the foundation, with the important reminder that so far the transformation has not taken place yet.

Another example of how the non-profit sector has suggested and selected legal devices still concerns the field of education, and in particular the primary, secondary and high school education.

In fact, also this sector of the education has normally been characterized by a public administration. This is proved by the fact that until the decision of the Legge, 10 Marzo 2000, n. 62, private schools could not issue diploma with legal validity. They could offer educational courses but the students would have had to sit before a public panel in order to obtain a legal diploma.

The above mentioned Act actually represented a chance for entrepreneurs to penetrate deeper or to start a business into the market of lower education.

Differently from the legislation concerning the University, the law did not mention or choose any particular legal structure, neither it mandated private schools to have a "non-

profit" status. Yet, those firms that would have presented the latter, would have received a special fiscal treatment.

Also as regards the health care sector the *government failure* is nearer and nearer. In particular, a political debate on the need to adequate the public hospital performances to the changed demand of health has been hold among policy makers. The demand in fact goes more and more beyond the simple first necessity services. The debate sets forth the necessity to implement a serious process of reorganization of the structures, introducing managerial criteria that allow to ensure a high quality and great quantity of services/goods.

The solution might well be represented by "going private" as in the case of University and lower education schools. Therefore, the legal model to be referred would be represented by the foundation.

Yet, a very important remark has to be made in relation to the health care. The right to the health indeed is by no means the most fundamental among the rights ensured by the Italian Constitution. The right of health is the only one expressly labeled as "fundamental right" (art. 32 Cost.).

This means that insomuch the health goes private, the State shall be always expect to maintain the primary role in providing such service.

Along with this perspective, the model proposed by Bellezza, Meneguzzo and Zanetta [NoYearSpecified] is defined as *Fondazione di Partecipazione*, that is a foundation participated by the State as well as by private economic actors.

The preoccupation underscored by the authors in elaborating such model resembles the one already detached in US non-profit corporation, that is the one characterized by a conflict of culture which renders very hard the identification of an equilibrium between efficacy and efficiency.

In fact, the model implies a foundation administered by public and private subjects. The foundation shall constitute a profit-seeking company and shall hold the majority of the shares. The rest of the shares shall be distributed among the investors. The constituted company shall of course provide the health care services.

On one side the foundation's control shall ensure the respect of the public and social values from the company. On the other side, the presence of investors in the economic structure of the company shall exert the necessary pressure to keep the firm efficient.

The capacity of the legal device foundation of being adapted for the efficient administration of schools, universities and hospitals is basically due to the change of its function.

In fact, whereas foundations were traditionally marked by a charitable element, since the '50s their by-laws more and more often began to contain clauses that other than identifying a public purpose, indicated a strong involvement of the founders into the administration.

As Zoppini [1999] reminded, from a concept of *Fondazione-Erogatore* ("Supplying –Foundation") the legal literature commenced to speak about *Fondazione-Organizzazione* ("Organizational Foundation"). Such expressions aimed indeed at specifying that from foundations that represented just an asset established *mortis causa* and bound to a charitable scope, the attention had to be focused on the foundations constituted by business firms through *inter vivos* acts for egoistic purposes rather than charitable.

The change of the function of the foundation leads to two observations:

a) it confirms the above mentioned thesis according to which in Italy the role of the non-profit sector chooses and defines the legal device. In fact, in the United States the concept of corporation has not experienced a change. The institutional or contractarian theories represent established points of view: even if the institutional scholars have always thought the corporation as an institution while the contractarians as a contract, the function itself of the corporation has never changed. Thus, in the US the employment of the corporate structure from non-profit organizations meaningfully shapes the interests involved, whereas in Italy the interests are determined by the *causa* of the contract or the legal act. Therefore, if the *causa* of the act of foundation was to pursue charitable purposes, the interests involved shall be different from those involved in a foundation whose cause was represented by (also) an egoistic purpose;
b) it confirms the non-applicability of the theories on corporation to identify the interests involved in the Italian non-profit sector. In particular, the discussion on the legal personality must be taken into consideration only to the extent to which it allows the foundation to act as a person. The ideas of *fictio juris* or *real person* can

not be employed for identifying the interests involved as they specifically referred to corporations, that is structures with a well defined function.

The last field of the non-profit sector included into those that generate more incomes is represented by units that provide social services. These firms are normally constituted as social cooperatives and their role is represented by mutual benefit.

§ 2.2 Structural Approach

As seen in the previous paragraph one of the legal devices identified by the role of the non-profit sector is represented by the foundation.

Soon it can be observed a fundamental difference between the US and Italian legal concept of foundation.

Whereas in the first country the foundation not necessarily has a legal personality, in Italy a foundation must be a legal person.

The reasons of such difference are evidently related to the existence of the trust institute. This common law device in fact renders possible a separation of ownership rights according to which certain assets of an individual shall be – obviously, in case of foundations – characterized by burdens concerning the administration.

As this separation of ownership cannot be conceived by a civil law system, then the solution is represented by acknowledging the asset itself with the legal personality and, therefore, rendering it capable to be subject of rights and obligations.

Although the difference is very crucial, the fact that US foundations normally apply for incorporating renders more feasible the comparative study with Italian foundations. In other words, it is possible to verify if the Italian legal personality of the foundations and the US corporate foundations imply legal differences in relation to the interests to be pursued.

To begin with, the acknowledgement from the Italian order of the legal personality implies both the limited liability of the administrators[56]and the accountability of the latter to the organization [art. 18 Codice Civile] just like it has been provided by § 717 of the New

[56] See DPR 10 febbraio 2000, n. 361

York Not-for-Profit Corporation Act or Section 8.30 Revised Model Non-Profit Corporation Act.

In order to establish when directors are accountable to the foundation it is therefore necessary to identify which are the interests – the "legal relationships acknowledged by the law" – implied by such legal device.

It is true, before the adoption of the D.P.R. 10 *Febbraio*, 361/2000, it was possible to constitute a foundation only by obtaining the concession of the public authority. Such an approach involved that the interests to be pursue had necessarily to be public [Nuzzo, 2006].

With the adoption of the mentioned Act, foundations acquire legal personality simply by filing in the *registro delle persone giuridiche*, assumed that the scope is lawful, possible and that the amount of the assets is sufficient to pursue the scope itself. Put it differently, the foundation may now pursue whatever scope.

Thus, if the by-laws confers to the foundation a traditional (charitable) function – *fondazione erogatrice* –, then the administrators shall manage the funds in the interests of an indefinite class of beneficiaries; if the by-laws confers to the foundation a egoistic function – *fondazione organizzazione* – then the duties of the directors shall be due to the a well definite class of beneficiaries who are normally represented by the funders.

This ductility of the legal device foundation depends on the fact that differently from the Internal Revenue Code, according to which foundations (must) pursue charitable purposes, the Civil Code does not longer give any hint about the purpose for which the fund has been established. Hints were actually provided by articles 12, 16 paragraph 3, 17, 23, 25, 26, 27 paragraph 3, 28, 31 of the Civil Code; yet, after the adoption of the DPR 361/2000, some of these have been abrogated; the surviving ones, being now systematically interpreted with the DPR provisions, cannot be red as to express public interests anymore.

These observations clearly demonstrate how the Italian discipline dedicates now less attention to the public dimension of the foundation structure.

Suppose for example that an American entrepreneur decides to establish a hospital and to envisage in the by-laws the *NDC* for she thinks the this clause, as Hansmann [1981] suggests, shall provide to the firm a competitive advantage. As seen, for the law, the *NDC* plus the charitable purpose shall characterize the firm as a foundation. Moreover, the

complexity of the activity shall lead the entrepreneur to incorporate, so that one has a corporate foundation.

According to Hansmann [1981], and to the *contractarians* of the non-profit sector, the interests that have to be protected are only those represented by the quality and quantity of the goods/services. These interests basically belong to the donors (a future buyers) and to the consumers, as buyers.

Such an approach would imply that self-dealing transactions, short term and anti-workers decisions cannot be challenged so long as the output is ensured. In addition, according to this approach, the only person that could have an interest to initiate this kind of challenges would the Public Attorney. Donors and consumers, indeed, are supposed to be interested into the firms' output.

Yet, the belief that donors do not do benevolence as future buyers of the services/goods and that the choice of the private entrepreneur to employ a non-profit structure cannot deny the very nature of the foundation, can be supported on a legal background.

In particular, the statutory duty of the director to follow the interest of the corporation, the statutory provision that identifies in the foundation a charitable element and, finally, the unquestionable public dimension of the charitable purpose that derives from the definition offered by the old Statute of Charitable Uses 1601, would allow the Public Attorney, and in particular cases also the other stakeholders, to challenge an economic-based managerial decision taken in detriment of the non-profit efficiency.

This solution could not be devised on the basis of Italian law. Similarly to the US entrepreneur, the Italian entrepreneur can establish a foundation to provide health care services. Also in this case the choice of a non-profit entity depends on the fact that the *NDC*[57] can ensure a higher level of output in terms of quantity and quality with the consequence that the structure proves an ideal partner for the State in filling the vacuum left by the *government failure*.

Whereas the directors of such foundation take decisions of the kind quoted above, it is going to be very hard to challenge them for they do legally not jeopardize any interest.

[57] It is interesting to note that the NDC for foundation is only implicitly envisaged by the Civil Code. The norm can be drawn from an *ex adverso* reading of art. 2247 of the Civil Code.

The interests involved in the Italian legal device foundation, in fact result to be only those envisaged by the by-laws and, in particular, by the *causa* of the act.

The *causa* of the act is to provide health services, therefore so long as the foundation provides health services nobody could claim a violation of interest.

The only public dimension of the Italian foundation is represented by the supervisory role exerted by the governmental authority under the art. 25 of the Civil Code. The norm establishes that the public authority can remove and appoint another director when this is found liable for not having complied with the purpose of the foundation.

Whereas such action is promoted by a public authority, still it does not imply that the interest meant to be protected is public. If the scope of the foundation is represented by providing health care services, the public authority shall initiate claims only when it realizes that directors have failed to comply with their duties.

The reasons for which such action relies in the hand of a public authority are simply due to the *unowned* character of foundations.

To sum up, where US legal order provides the structural support for identifying further interests than those concerning the purpose of the corporation, the Italian seems to be very bound to the notion of *causa* and, for this reason, it protect only the interests that the *causa* represents. Therefore, where it is hard to protect stakeholder interests in a socially, ethically and altruistically responsible conduct of a foundation established by a private party meant to obtain peculiar advantages, it shall be easier to protect the mentioned interests in a foundation established for the traditional purpose. In fact, as in this latter case, the *causa* would be represented by to do benefit on behalf of the community, then managers are expected to consider the output purpose on the same level of the respect of social values in occasion of the organizational decisions.

§ 3. The "*Impresa Sociale*"

The Code Civil discipline of foundations basically reflects the same problem deeply discussed in the chapter about the US non-profit role,that is distinguishing a non-profit organization from a business one only with regards to the *NDC*.

While in the United States such risk has been averted by relying on the legal concept of corporation and the relevant directors duties, in Italy the protection of the very nature of the non-profit sector would have been possible only by a legislative intervention.

This exigency was felt by the legislative power which, having considered the worsen of the *government failure*, thought opportune the State to be flanked by firms that would have pursued the same interests of the public firms.

Thus, through the adoption of the d.lgs. n. 155, 2006, the Parliament introduced the institute of "*impresa sociale*".

According to some literature [Racugno, 2009] the legislation did not actually introduce a new model of firm, yet the documents of the preparatory studies accomplished by the Italian parliament affirm the contrary: the "*impresa sociale*" would set forth a new "company model".

It is true, the second remark would prove more correct. In fact, in the opinion of Prof. Diego Corapi [2002 and 2003], the current Italian commercial law focuses on a distinction between types and models.

The types are those legal institutions that are clearly defined by mandatory rules. So, in civil law systems, the *società per azioni*, the *società a responsabilità limitata*, the *fondazione*, the *associazione*, all represent organizational types for their fundamental features are compulsorily envisaged by law.

The models represent the configurations that the types may present and, for this reasons, they are defined by default rules.

For example, according to the Italian Civil Code, the type *società per azioni*, other than mandatory rules that define its structure, i.e. the presence of a board of directors, the legal personality, the transferability of shares, etc. may be configured as a dualistic model, monistic model, or traditional model. It is up to the parties to choose one or the other model according to their preferences.

It is true, the "*impresa sociale*" does not introduce a new type of corporation, rather a model. In fact, all the corporation types might adopt the *impresa sociale* as a model. Therefore, the type foundation, whose fundamental mandatory rule is represented by the existence of a fund which is burdened, may well represent an "*impresa sociale*" if the founders choose it as a model.

As quoted above, the choice of the "*impresa sociale*" model confers to the foundation a public dimension that would attract a meaningful number of interests which, in turn, would flank the charitable purpose represented by the high quality and great quantity of services/goods provided.

To begin with, the model "*impresa sociale*" establishes the fundamental principle according to which the appointment of the directors can not be reserved for subjects who are external to the firm. The rationale of the norm can be explained by the following example. Suppose that an entrepreneur wants to take advantage of the *government failure* and to establish her own foundation. To look more trustworthy to the State, she chooses to adopt the "*impresa sociale*" model. Now, she has two solutions. The first one is to appoint directors which are also directors in the business firm which she controls. Such choice is expected to not be successful since the public authority, which maintains the right of supervision, might deny the "*impresa sociale*" status whereas it notes that the foundation was actually established for personal purposes. The second choice for the entrepreneur is to choice directors which have a high reputation in terms of social and ethical values. In that way she would deserve the acknowledgment of the public authority and it would be effectively working as an "*impresa sociale*". Now, if the legislation had not provided the above mentioned prohibition, the entrepreneur, once obtained the qualification of *impresa sociale* for her foundation, could well provide in the foundation by-laws that she – or her firm – would have appointed the subsequent directors. This possibility would have brought into the foundation what earlier has been defined as a conflict of cultures.

To secure and corroborate the just described principle, the legislation provides that directors compulsorily must comply with high parameters of honorability, professionalism and independence.

Very important is then the norm that mandate the *imprese sociali* with more than:

a) 50 employees;
b) 7.300.000 Euro of profits;
c) 3.650.000 of assets

to include a supervisory board (*collegio sindacale*).

This norm is particularly important from a comparative law perspective. In fact, also concerning US non-profit corporations, some part of literature has promoted the idea to

apply business corporations requirements to non-profit ones. In particular, for this literature has suggested to apply the SOX Act to non-profit corporations [Foye in Gilkeson, 2007].

Just as the Italian "*imprese sociali*" also US non-profit corporations would therefore be subject to the audit committee verifications. In addition, the application of the SOX would mandate non-profit corporations to hire an external auditing firm that would control the financial year books.

Of course, whereas the idea of extending the SOX Act to non-profit corporations is accepted by policy makers, for sure the law shall provide some minimum parameters regarding size, workers and assets.

Anyway, it must be observed that normally the audit committees' verifications, accomplished either by the internal and by the external one, would not actually concern the managerial decisions concerning the corporate policies. In fact, the audit committee is not expected to control if the managers do a short-term or a long term choice. Rather, the audit committee is more tailored for preventing abuses.

In other words, the establishment of audit committees would be more successful in reducing the agency costs related to misappropriation of money, that is a problem which in the non-profit sector has concerned much more the US than Italy.

This explains why the art. 11 of the d.lgs. n. 155 provides that the internal auditors have an affirmative duty to make verifications also in relation to the accomplishment of the purposes and social values promoted by the organization as they are clearly understandable from the reading of the Act.

Another extremely important norm that defines the interests involved in the "*impresa sociale*" model is the one provided by art. 12 that mandate the participation of the workers into the administration of the firm.

The described mandatory rules of the default model "*impresa sociale*" are not the sole aspect that would confer to the foundation a public dimension.

The further aspect is in fact implied by the legislation. In particular, the adoption of the model would render possible the application of the institutional theories of corporation. It is true, it has been seen how the Italian Civil Code distinguished the organizations disciplined in the Libro I (Associazioni, Fondazioni and Comitati) from those disciplined in the Libro V on the basis of *causa*, that is the distribution of firms' profits among the

participant in the social capital. According to this distinction, indeed, the corporate types *società per azioni*, *società a responsabilità limitata* could never be employed for purposes that would have not envisaged a distribution of profits. In other words, a *società per azioni* could never be a non-profit organization. This limitation of the Italian discipline was basically due to the fact that the *causa* of these types was represented by a "subjective profit" and not by an "objective" one.

The difference between these two kind of profit is represented by the fact that the second regards the profit of the firm.

Therefore, with the adoption of the d.lgs., the legislative power has introduced for the first time an organizational model whose *causa* is represented by the objective profit, reducing meaningfully the distance between the types disciplined in Libro I and Libro V.

Now, if the *causa* of the foundation which has been established as "*impresa sociale*" is represented by the profit of the firm, it means that the firm becomes entitled to boast an interest.

The legal personality of the "*impresa sociale*" plays the same role of the legal personality studied in occasion of the discussion about the theories of corporation.

It is true, the common law concept of corporation has normally been associated with civil law types such as *società per azioni, società a responsabilità limitata*, that is subjective profit seeking complex organizations. Thus, all the theories of corporation had to apply only to these structures.

Yet, already with the coming into force of the EU law, the concept of corporation began to be associated with the concept of firm rather than subjective profit seeking organization. In fact, art. 48 of the Treaty established that "companies or firms' means companies or firms constituted under civil or commercial law, including cooperative societies, and other legal persons governed by public or private law, save for those which are non-profit-making".

The last sentence "save for those which are non-profit-making" is, obviously, to be meant as that each organization is to be regarded as a company if it carries on economic activities, regardless of whether such organization has a non-distribution constraint [Hopt, 2006].

To conclude, if the foundations established as "*impresa sociale*" are firms and firms are companies, then it is possible to apply the institutional theories of the corporation to such entities with the consequence that directors duties shall be due also to the foundation itself.

§ 4. Agency Costs and Legal Protection of Patrons

The different role exerted by US and Italian non-profit organizations implies a likely different arising of agency problems.

To begin with, it is a question of relationships. While the US *market failure* role involves that resources are for the most provided by private parties, as donors or consumers, the Italian *government failure* role involves that the majority of the finances are provided by the State.

This means that the agency problems related to fiduciary aspects are more pronounced in the US than Italy. In the latter country, in fact, the State uses to establish contracts with non-profit organizations and, therefore, it succeeds to exert a more incisive control regarding the appointment of directors. Thus, in American non-profits patrons do not appoint directors, in Italian ones they do or at least they have the possibility of indicating them.

Maybe that explains why non-profit scandals involving misappropriation of money (so fiduciary aspects) such as the United Way, the Association for Cancer Research, the Foundation for Peace and Justice, Toys for Tots, Irish Society for the Prevention of Cruelty to Children, and the National Baptist Convention [Gilkeson, 2007 and Gibelman, 2000] have not so far threaten the Italian non-profit sector. Actually, if that shall happen the problems to be studied shall be more concerned with the corruption of public official rather than agency problems among private parties.

Set aside this difference, it can be hold that the problems not concerned with the fiduciary aspects, as for example diligence and competence, present the same characteristics: in particular, either in the US and Italian non-profits, it is rather difficult for directors to find equilibrium between efficacy and efficiency.

As seen, legal standards are expected – rather, the judicial application of legal standards is expected – to drive directors to take the most appropriate decision. While in common law jurisdictions there exists a clear as well as **traditional** distinction between duty of loyalty and duty of care, diligence and skill, in civil law jurisdictions this difference has been “acknowledged” only lately.

In France, for example, two decisions of the Supreme Court de Cassation have set the duty of loyalty:

a) *Cour de Cassation* 27/02/1996, JCP éd. G 1996 II, n. 22 665 – in this case a director bought an amount of shares of the not listed company he himself used to run; he paid each share 3.000 Francs and, some days after, he sold them at 8.000 francs each. The commercial Chamber considered that the director broke his duty of loyalty owed to individual shareholders to the extent to which he did not disclose any information;
b) *Cour de Cassation* 24/02/1998, JCP éd. E 1998 n. 17, 637 – in this case a company director resigned and then he incorporated a newco trying to involve the best employees of the company he used to run. The tribunal acknowledged liability for damages to the company on the basis of a breach of a duty of loyalty owed to the company itself.

In Portugal, the acknowledgement of the distinction between the duty of loyalty and duty of care, diligence and skill has instead occurred through legislative provisions. The former article 64, labeled as duty of diligence, of the *Codigo das Sociedades Comerciais*, provided: "Managers, administrators, or directors of a company have to execute their functions with the diligence of judicious and businesslike man, in the interest of the company, and taking into consideration the interests of the shareholders as well as the workers".

According to the new article 64 labeled as Fundamental Duties, "managers or administrators of a company must comply with:

a) Duty of care …;
b) Duty of loyalty…;

In Germany, the AktG makes just a minor reference to the duty of loyalty; in other words it provides the duty of loyalty only indirectly: § 88 hinders the competition between the director and the company he/she runs; § 93 prescribes a duty of confidentiality. Yet, legal literature and legal doctrine hold that a duty of loyalty does exist, as demonstrated by the Introduction to the German Code of Corporate Governance [Gomes, 2007]. In general, it is accepted that the duty of loyalty obliges to comply with standards of behavior which are higher to those envisaged by the general principle of good faith in the execution of contracts; yet, the duty of loyalty is limited to the relationship between directors and companies.

In sum, the duty of loyalty is currently a legal institute well acknowledged by the majority of jurisdictions, and this demonstrates how the penetration of common law dogmas into civil law orders is strong.

Also the Italian legal order has been influenced by the distinction between duty of loyalty and duty of care, diligence and skill.

While in the US the contrast between efficacy and efficiency had to be resolved through a compromise between the application of the law of trust and the law of corporation, the Italian Civil Code at art. 18 clearly establishes that the standards to be complied by the directors are those related to the discipline of *mandato*.

The article applies even if the foundation obtains the status of the "*impresa sociale*" for this model does not provide any norm concerning the liability standards. In fact, whereas the model "*impresa sociale*" was adopted by a *società per azioni*, then the standard would have been much higher for article 2392 establishes that the diligence of directors must be measured against the nature of the office (objective criteria) and against their personal competences (subjective criteria).

Therefore, similarly to the US approach, but differently from the UK one, the Italian legal order defines a quite relaxed standard for the administrators of foundations, whether "*impresa sociale*" or not.

For sure, the more relaxed standard envisaged for the foundations depends on the circumstance that, so far, there is not alarming track of great violations of the duty of diligence in the Italian case law. Indeed, whereas the non-profit sector keep growing and involving more and more quantity of money, the liability of foundation directors could be extended just as it has happened for the standards of *società per azioni* directors. The above quoted art. 2392, in fact, before the 2003 reform, also envisaged the standard of the *mandatario*[58].

[58] It is interesting to consider the norms provided by other legal orders on corporate directors standards:
Germany: §§ 73, 76 and 93 of the *AktG* (Public Company Law) set high standards: the care and diligence must be the one of a judicious and businesslike man.
Spain: articles 127 and 132 of the *Ley de las Sociedades Anonymas* provide as high standards as the German ones;
Portugal: art. 64 of the CSC (Codigo das Sociedades Comerciais) provides also high standards of performance and (as seen) establishes a clear difference between duty of loyalty and duty of care.

It is true, the discipline of the *mandato* contract provides that the responsibility of the *mandatario* – what would correspond to an agent or trustee – is that of the "*buon padre di famiglia*", that is an expression to mean prudent and reasonable man (art. 1710).

Where this norm could correspond to the common law duty of care, nothing is expressly said about the duty of loyalty. Yet, this duty is not absent from the Civil Code discipline. In fact, the Supreme Court, with the decision n. 16707, 2004 clearly explained that "the directors of a company, even when the art. 2392 provided the *mandatario* standard, can not be considered as *mandatari* of the company: they belong to a body which is fundamental for the existence of the entity and, as such, they represent the figure of the entrepreneur within the multi-individual firm. Their activity is represented by the management of a business firm and such commitment involves the professional conduct of a complex economic activity. Such professionalism is naturally connected with the duty of care and diligence. What has just been remarked implies that a fundamental aspect of the director management is as well represented by a profile of loyalty to the company he runs. This duty owed to the company is of primary importance, so that for every action or omission that is aimed at realizing a different interest or in contrast with that one, one has without fail a violation of the duty of loyalty which is inherent to his office: this violation may well generate liability for damages regardless of the fault that can be detached in the board decision and of the discipline concerned with the challenge of the decision itself (art. 2391)".

As it can be easily understood, the Supreme Court decisions was issued in relation to companies (*società per azioni*) and not to foundation. However, the discussion that has been developed earlier on the meaning of the legal personality for foundations that adopt the model of "*impresa sociale*", allows to accomplish an analogical interpretation of the Court decision and, therefore, to acknowledge the duty of loyalty also on behalf of foundations.

However, whereas it has been possible to take advantage of the Supreme Court to identify the duty of loyalty also concerning foundations, it would prove rather forced to similarly extend the discipline of interested transactions provided by art. 2391.

In fact, on one side "*impresa sociale*" foundations and *società per azioni* have in common the fact they are firms. Since according to the Supreme Court the duty of loyalty is due to the firm, the it is due to the former as well as to the latter.

On the other side, foundations and *società per azioni* differ for the circumstance that the latter, other than an objective profit, pursue a subjective profit. Thus, art. 2391 has been provided to protect both these interests. Moreover, the principle according to which the procedural elements of self-dealing transactions must be expressly provided for non-profit organization can be confirmed by the fact that US business and non-profit corporation law provide separate norms.

The conclusion is that the duty of loyalty of "*impresa sociale*" foundation's directors must be maintained at a high standard and to date it can be measured against the social values that are envisaged by the d.lgs. n. 155, 2006.

Finally, a very important remark has to be done in relation to the enforcement tools. In fact, if by one hand the legal reasoning developed throughout this work has succeeded to identify – or better uncover – interests that were somehow hided, by the other such effort could be worth zero if the protection of those interests lack judicial remedies.

To begin with, in common law jurisdictions it is much easier for a plaintiff to prove a breach of a strict sense fiduciary duty – that is a duty of loyalty – than "other duties" such as the duty of care.

As it has been discussed in chapter III, to claim a breach of the duty of loyalty one does not need to demonstrate a loss for the corporation while, to claim a breach of CSD duty one has to do so.

Therefore, in case a director takes a self-interested decision without complying with the procedural requirements provided by corporate law, the plaintiff shall have to prove only that the director had an interest in the transaction. Of course, if the plaintiff chooses this solution, the Court can only award rescission, equitable compensation or accounting for profits.

The rescission aims at a *restitutio in integrum*. Therefore, the parties involved in the transaction must restitute what they have transferred.

Whereas that is not possible, the Court may acknowledge an equitable compensation, that is a monetary value that the judge in a discretionary way recognizes to the corporation. The latter, in fact, has not suffered any loss, but for a question of conscience it is fair and just that it obtains some restoration for the breach of trust.

In addition – and not in alternative – to the rescission or the equitable compensation, the plaintiff may claim for an accounting for profits. In practice, the plaintiff asks the Court to compel the self-dealer to restitute what he has earned by acting selfishly.

Now, the above referred director's self-interested decision may well have brought a loss to the corporation. In cases like these, the plaintiff can file suits alleging both the breach of fiduciary duty (of loyalty) and the breach of the duty of CSD. Because of the BJR – which in the US applies also to non-profit corporations – it shall be quite difficult for the plaintiff to succeed in demonstrating that the loss of the corporation was caused by a negligent managerial behavior. Anyway, should the plaintiff be able to demonstrate that, then he could obtain damages other than the equitable remedies envisaged for the breach of the duty of loyalty.

Therefore, the fundamental difference between equitable and common law remedies is represented by the fact that the former are primarily restitutory and restorative rather than compensatory whereas the second are primarily compensatory.

In the light of this brief description, it is possible to discuss which would be the remedies against a violation of the social values promoted by a US non-profit corporation. Suppose for example that the non-profit director decides to fire 40 employees to preserve the financial stability of the organization.

It can be hold that such decision can violate either the duty of loyalty or the duty of SCD. As concerns the duty of loyalty, the director could be thought to betray the social expectations of the corporation in order to maintain secure her job.

As concerns the duty of SCD, the director could be thought to bring to the corporation a loss in terms of efficacy. The nature of the office of a non-profit director would indeed require that she has the due competences to understand that a non-profit corporation must pursue social values other than the mere outputs.

For the attorney general would be very hard to prove a violation of duty of SCD for the simple circumstance whereas it is extremely difficult to demonstrate a loss of efficiency, one can easily guess how much more difficult would be to demonstrate a loss in terms of efficacy.

Therefore, the only way which would be feasible for the Attorney General is to claim for a breach of duty of loyalty.

However, also the proof of the breach of duty of loyalty is not as simple as it would appear. This is due to two reasons.

The first one, is that law speaks about “contract” or “transaction” between “the corporation and one or more of its directors or officers, or between the corporation and any other corporation, firm, association or other entity in which one or more of its directors or officers are directors or officers”. Thus, a) the firing of employees is not a contract/transaction but a termination of a contract and b) even if one could consider the termination of a contract as a contract, then one has also to consider that the law does not mention contract between the corporation and officers that do not take part in the decision.

The second reason is a consequence of the first. In fact, for the interest of the director in the decision of firing is not expressly referred by the law, it follows that the relevant procedure requirements do not apply. In other words the director is not expected to show up in the board meeting and to declare: “if we do not fire these employees, my and your salaries shall suffer a significant reduction”. This depends on the peculiar nature of the interest of the director. The rationale of the norm that compels the director to disclosure an interest is based on the fact that the board meeting might not know that the decision is going to adopt shall favor the director that promoted it. In the case of the interest in securing the job and the salary, the board very well know that the decision of firing the employees shall represent a safe harbor for the selfish director.

The result shall be that in order to obtain a judicial intervention, the Attorney General shall have to consider the board decision as valid from a procedural point of view and, therefore, he himself shall be charged with proving the unfairness to the corporation.
Most importantly: in a “normal” self-dealing case where the director has disclosed his interest and nevertheless the transaction has been adopted, the Attorney General shall have only to prove that the decision was unfair; in the example concerning the firing of the workers, the decision adopted by the board does not refer to any self-dealing aspect. This implies that the Attorney General has firstly to prove the selfish element and therefore the unfairness to the corporation.

If the public authority succeeds to demonstrate both the elements, then the court is expected to issue the equitable remedy represented by the rescission: to void the firing provision.

It is true, the equitable remedy can be preferred by the Attorney General even in those cases where one is in front a clear violation of the duty of care. Suppose for example a wrong economic choice made by the director.

Since because of the BJR shall be very hard to challenge the managerial conduct, the Attorney General could actually claim a breach of fiduciary duty from the non-executive directors that authorized the transaction. As it can be seen, in this case it is difficult to find and prove a selfish element. However, a recent development of judicial doctrine has considered that the duty of loyalty implies also a duty to act in good faith. In other words, the non-executive directors are expected to seriously and actively control the executive operations. Now, there are several discussions on the correctness of such approach as well as it is debated if the duty to act in a good faith represent a third independent duty[59].

The fundamental difference between the US corporate foundation and the Italian "*impresa sociale*" foundation in relation to the judicial remedies is represented by the fact that within the latter the "Ministero del lavoro e delle politiche sociali" has strong power of inquiry and of correcting abuses. Therefore, in the above mentioned example of a managerial decision involving the firing of 30 workers, the public authority could more easily prevent the misconduct. It has to be remarked anyway that decisions against the protection of workers are even more rare in the Italian "*impresa sociale*" for the d.lgs. n. 155 provides an active participation of employees in the administration of the firm.

As regards the decisions more concerned with the economic activity of the firm, the protection against losses is ensured by the recovering of the damages, so there is not substantial difference with the common law jurisdictions.

§ 5. External Control

The discussions on the historical and functional approach have demonstrated that the agency problem between donors/customers and the managers of a non-profit corporations are less pronounced in Italy than in the US.

[59] For a detailed discussion on the triad duty of loyalty, duty of care and good faith see Strine et al. [2010].

In fact, in Italy the main funder of non-profit organizations is the State or a private party that has been contracted by the State.

However, also in Italy donors and customers finance non-profit organizations and where they are not in control of the structure, their contributions have somehow to be protected by managerial misbehaviors.

Actually, in Italy there is not any statutory provision or court decision that so far has dealt with the right to sue directors on behalf of the p*atrons*.

The legal reasoning that could lead to this opportunity is to conceive the p*atrons* contribution as a *donazione indiretta*.

A "*donazione indiretta*" is represented by a gratuitous act meant to reach a scope that goes beyond the mere enrichment of the other party [Cendon and Baldassarri, 2007]. In the case of p*atrons'* contributions to *non-profit* organizations, it is clear that the scope of the former is to provide advantages for the beneficiaries of the activities; yet *patrons* do not accomplish donations directly to the beneficiaries, they rather use *non-profit* organizations as intermediation device. In doing that, they do not realize a mere donation – that is, their act does not comply with the requirements provided by the articles (769ss) concerned with the contract of donation; instead, they set up another kind of contractual relationship that reflects the scheme of the "*mandato*" [this contractual scheme somehow presents features that in equity law are related to the relationship of *agency* and/or *trust*].

This study claims that the gifts conferred to *non-profit* organizations are just a *mandato* contract whose specific terms are contained by the clauses of the by-laws.

As such, the norms that apply to the relationship between *patrons* and directors are those envisaged by the Civil Code itself for this contractual type [Torrente, 2006].

This basically means that if directors do not execute the contract according to the (actually) low standards set by art. 1710, they can be sued for *misfeasance*, implying the termination of the contract (art. 1453) and the relevant compensation for *patrons* (art. 1218).

If on one hand this legal effort succeeds someway in recognizing a private protection to p*atrons*, by the other it could hardly justify a civil action for those *patrons* who are *consumers* of a *non-profit* organization. In fact, in such a hypothesis, the hermeneutical effort should assume that the contract has a two-fold *causa*:

a) the purchase of the performance (services or goods);

b) the funding on behalf of the organization in order to improve the performances offered.

It is pretty obvious that point b) represents an implied contractual term that is likely impossible to enforce.

As said, the Italian legal order as well as Italian courts still have not faced directly the problem of private *patrons* protection. Yet the assumption that civil law traditions are supported by a complete system of norms suggests that, should any case arise, judges will be able to find the path for enforcing directors duties.

The comparison between US and Italian approaches clearly underscores that in the former country a legal doctrine has already developed. Of course, this is because of the significant share that *non-profit* organizations occupy in the American market and the consequent greater chances that p*atrons* can be unsatisfied with non-profit managerial decisions.

With the decision taken in 2005, the Court of Appeal of California has eventually acknowledged a contractual dimension to the donations realized by *patrons*. However, the rule of law pointing out from this sentence establishes that not all the *patrons* are entitled to apply to the Court for *breach of contract*, but only those who have specified the *subcondition* of their gift.

It is likely that Courts will make another step towards a still more liberal approach, considering the *subcondition* as an implied contractual term that derives from the articles of association.

In Italy, the *non-profit* sector is still in an evolving stage. Different from the US, universities and hospitals are normally run by the state and, therefore, with public money. Whereas the trend of transforming these structures into *non-profit* organizations became more significant, civil actions against directors misfeasance are expected. As seen, according to Italian law, it would be easier to recognize the contractual dimension to the relationship between *patrons* and directors through an extensive interpretation of art. 809 (*donazioni indirette*). This would entitle the former to sue the latter for violation of the norms concerning the *mandato*.

At the same time, the legal reasoning grounded on the concept of *donazioni indirette* could not work on behalf of those *patrons* who are consumers of the *non-profit* organization. From a strictly legal point of view, their contribution merely represents the amount due for the

services or product they buy. The *causa* of their transaction, that is the socio-economic function (funzione socio-economica), is to exchange money for a specific performance. Only concerning such specific performance, a misfeasance may entitle consumers to sue the organization for *breach of contract*. This underlines how the American approach, based on the idea that those beneficiaries who keep a *special interest* may apply to the Court for *breach of fiduciary duties* (independently from the existence of a contractual relationship which would allow to apply for *breach of contract*), would ensure a more complete system of monitoring devices.

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