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Non-profit Organizations and Patrons' Protection: A Comparative Legal and Economic Analysis of Civil Law and Common Law Systems

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Introduction

In everyday life, people constantly experience economic transactions. The majority of these are simple in nature as they are accomplished and agreed upon in the same moment. For example, buying a newspaper or a pair of shoes does not actually require particular skills for contractual parties pursuing their interests.

In cases such as this, the market itself offers information that is necessary and sufficient to track a safe trading environment.

Unfortunately, it does not always work like that. More complicated economic operations need the intervention of third parties. These are normally represented by highly skilled professionals or/and by the public authority.

The most classic instances are the operations that involve economic institutions such as large business companies. Shareholders put their own money into directors hands as they know that the latter have been educated to run organizations and, therefore, to maximize *owners* wealth. Moreover, according to mainstream economics, the presence of a separated body charged with the administration of the firm is thought to be a necessary element for the survival of the firm (Hansmann and Kraakman, 2004).

Assuming the information asymmetry among parties, scholars deem the relationship management/shareholders as burdened by an "agency problem". For this reason, literature attempts to conceive tools that could reduce the transaction costs born by the weaker contractual party. In the opinion of the neo-liberal thinkers (Fama and Jensen, 1973), the most efficient devices to align the conflicting interests can be set by the parties themselves as they are expected to be rational enough to look after their own affairs. In simpler terms, those are represented by:

a) a free market for corporate control;
b) the presence of a board of [non-executive] directors;
c) the functioning of the principle of free transferability of shares.

As 2002 financial scandals (Enron, Worldcom, Parmalat, etc.) have suggested, this very liberal approach has not actually ensured fair allocation of resources and protection of weaker economic actors.

That explains why the exigency of welcoming another "party" into the relationships between directors and shareholders became necessary.

Easily guessable, such a "contractual party" is represented by the public authority through its statutory intervention's power. Such an approach considers that legislatures act in the name of people interests; therefore, they aim at reaching greater efficiency as well as a more equitable distribution of economic risks. In this sense, in the United States, the SOX Act (July 2002) attempted to restore investors' trust; however its provisions have not been exempt from a hard critic (Romano, 2005).

In the light of the foregoing brief discussion, this paper is meant to investigate how the interests of those who finance a *non-profit* organization are protected. In particular, this study is meant to find out to what extent a public intervention into private affairs may be viewed as efficient.

To pursue this, the analysis will at first sketch out the peculiarities that characterize such organizations and compare the legal devices that civil law and common law traditions rely on for resolving the relevant agency problem.

It is assumed (Tamburrini, 2009) that the main mechanisms directed to ensure that the money provided by *patrons* is effectively employed in accordance with the purposes expressed in the by-laws and with the social values implicitly promoted by the organization itself are:

a) a clearer legal definition of the *fiduciary duties*;
b) the acknowledgment of the right to sue on behalf of *patrons*;
c) an improved functionality of external controls.

Because of space limits imposed for the realization of the paper, the study will focus the attention only on point b), implying a detailed discussion about the contractual dimension of [*non-profit*] corporations.

The motivations that have led to take into account the *non-profit* sector rely on the fact that this is currently experiencing a proliferation of organizations (Gibelman and Sheldon, 2000; Cima, 2001) that, becoming more and more business-like, have been involving a significant part of money in certain national economies.

The samples of civil law and common law traditions that will be considered are the Italian and US jurisdictions.

1. The Economic Nature of Non-profit Organizations

Non-profit organizations are *unowned*. This makes it quite complicated to assess to whom management is liable. That happens above all in those structures where the agency problem is more pronounced; that is donative and commercial "entrepreneurial" *non-profits*. For such reason, this paper leaves aside donative and commercial "mutual" *non-profits* where *patrons'* participation in the administration of the organization ensures them a satisfactory degree of protection (Hansmann, 1980).

The truth is, the problem to understand is how legal principles of common and civil law traditions frame [deal with] the economic transactions through which *patrons* provide funds to *non-profit* organizations.

The first thought one might have may be the smallest and most insignificant case of a person who inserts a little money into a box placed in a bar, motivated by the recent announcement. Yet, one might even think to the biggest and most spectacular donation made by a business corporation.

Moreover, fundraising does not involve only gratuitous gifts. *Non-profits*, in their most up-to-date and business-like structures, may also receive their incomes by selling goods or services.

Whether donation or purchase of service/goods, one aspect characterizes the category of *non-profits' patrons*: they do not become part of the organization [unless the organization is a “mutual” *non-profit*, but it has been already specified that this form is taken into consideration by this Note] and in that way distinguish themselves from the shareholders of a business corporation.

The most important consequence of this action is that *patrons* have fewer tools to exert control over organization's activities and, in particular, to be aware if their money is fueling directors' personal ambitions or it is being effectively used for organizational purposes. That is why law, both Italian and US, establishes a *nondistribution constraint* (Hansmann, 1980) that is, a provision that forbids distributing any profits to directors, officers or members of the organization.

The disallowance becomes necessary in the face of what Hansmann (1980) defines as *market failure*. This represents the impossibility of *patrons* to evaluate the performance of the *non-profits* they are financing.

That is particularly true for what concerns donative entrepreneurial *non-profits*, for example the Red Cross or WWF, which normally provide services for third parties. In short, donors will hardly know if the organization is actually delivering food to African children or looking after the stray dogs of the community, etc. So it is, the *nondistribution constraint* helps the donors out where the market alone is not sufficient to ensure a fair employment of the resources.

In the case of commercial entrepreneurial, for example a hospital or a university, even if the consumer is in a position to personally see the performance (the goods/services) for which he/she is paying, he/she still may not be able to evaluate its worth (Hansmann, 1980). A patient can see the doctor and the structure where the doctor operates, but a patient is barely expert enough to assess the quality of the visit performed by the physician. In the same way, the student who pays the fee to enroll herself in a university does not actually know which is going to be the quality of the classes she will attend. The *nondistribution constraint*, therefore, again serves to supply market insufficiency, ensuring consumers that the price they are paying will be re-invested on behalf of the organization, facilitating an improvement in the quality of the performances or, at least, to keep them at a certain level.

The above discussion suggests that donative and commercial *non-profits* develop themselves and, consequently, get into competition with conventional *for-profit* firms in those sectors where *patrons* feel that market alone cannot ensure them enough protection (Hansmann, 1980).

What this paper can question is the effectiveness of the *nondistribution constraint* itself. In particular, one may ask: is that provision suitable to deter whoever exerts control over the *non-profit* organization from misappropriation of funds or any kind of self-dealing behavior? May *patrons* [donors and consumers] easily rely on it?

There is a school of thought that offers a negative answer (Ortman and Schlesinger, 2002). Such authors give much more importance to the reputation of the *non-profit* firm. For instance, a student chooses a *non-profit* university not because of the *nondistribution constraint* but rather on the basis of the opinions and feedbacks about the educational rank that the institute has so far received.

Regardless of the key element which justifies the burgeoning of *non-profit* firms, whatever the *nondistribution constraint* or the reputation element or even other economic factors, the scope of this Note remains to investigate which legal tools *patrons* may enforce against directors' opportunistic behaviors.

Bad directors may be pursued by crime law, but this kind of publicistic control is limited to cases of mere misappropriation of funds. Most of the time, directors perform self-dealing behaviors which, although not breaking any crime rules, do not respect either what is expressed by the articles of association and the social values implicitly promoted by the *non-profit* organization itself.

2. US Law

2.1 Development of US Decisions

In common law, jurisdictions surrounding the exigencies of legal certainty and justice are basically resolved by the binding precedent principle, that is, *stare decisis*. Although important scholars have underscored how the *age of statutes* (Calabresi; 1999) has put an impossible burden on the courts, judicial doctrines still set the basis of most fundamental common law principles.

The chief consequence of such an approach is that in Anglo-Saxon legal experience, the *remedies precede rights* [*ubi remedium ibi ius*]. This principle expresses the primary position of civil procedure and of judicial decisions in the acknowledgement and enforcement of a right claimed by a person (De Franchis; 1984). The concession of a remedy confers legal relevance to the situation that otherwise could be only something moral, religious, social, or literary, but definitely not legal (Corapi; 2006).

For these reasons, the investigation is meant to find out if *patrons* of *non-profit* corporations are entitled to sue directors for *breach of fiduciary duties* needs as well as to look for the relevant case law. The analysis takes into consideration decisions regarding modern charitable trusts and to what extent these and charitable corporations resemble each other more closely than their respective historic counterparts (A. C. G, 1978).

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 duties* lies only with the beneficiaries.

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, has 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 *patrons* 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 *patrons* keep an economic interest that must be protected.

To put it differently, when courts are asked to deal with *non-profit* financing, 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 *patrons* 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 *patrons* 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.

2.2 Legal Discussion

The difficulties to acknowledge *patrons* 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 paper. 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.

3. Italian Law

3.1 Normative and Judicial Overview

All Civil law jurisdictions share the guiding principle according to which the sources of law constitute a closed system whose dimension is given by the statutes and by the systematic interpretation of the statutes themselves.

Judges, therefore, are expected to be supported by a *complete* legislative structure that allows them to deal with every case that deserves the application of law.

The most distinctive element of such tradition is the Civil Code. This represents the indispensable systematic framework where the fundamental values of the society are transplanted as principles of the legal order (Corapi; 2003).

The main function of the Civil Code, and of all the Statutes that surround it is to guarantee to private actors an equilibrium among justice and legal certainty. This requires a determinate degree of flexibility that is reached through the presence of mandatory rules, default rules, and *suppletive* rules.

Setting out from such perspective, the very first step that a scholar educated in a civil law country is expected to do, when faced with hypothetical fact situations, is to look for answers within statutory provisions. He/She is supposed, successively, to countercheck his/her findings through an investigation meant to identify those judicial decisions that have been possibly taken on the topics concerned.

Accordingly, the approach of this paper takes chiefly into consideration the norms that the Italian Civil Code provides for *non-profit* organizations, in particular those included between Article 14 and Article 35.

To begin with, Italian legislation distinguishes among “associazioni” and “fondazioni”. It is not the purpose of this study to master the relevant differences, unless they are fundamental to assess the protection that *patrons* are provided with, under Italian law.

By one side, article 25 disciplines the control over “fondazioni” [foundations] expressly establishing that it must be exercised by the governmental authority.

By the other, as regards the “associazioni”, article 23 deals with the decisions of the general meeting, specifying when they can be contested. The norm, actually, does not state who has the right to bring the relevant suits before the courts. Yet, in the opinion of a notable literature, the “Pubblico Ministero” is expected to apply when public interests are at concern (Galgano; 1969).

The public control over the “fondazioni” and “associazioni” differs in nature (Berlucchi, 2001). In the case of the former, the control is essentially meant to protect the (private) interest of the organization. Concerning the latter, instead, public intervention is supposed to look after the interests of the community.

Such difference would have undoubtedly deserved a more detailed analysis if the public authority itself had effectively exerted the power envisaged by the law. In the lack of such activity (Galgano, 1969), this research has therefore attempted to uncover if there is any institute of the Civil Code that may offer a private protection for *non-profit patrons*.

In order to follow such goal, the scholar must examine the statutory provisions as she wants to confer a legal dimension to the financial contributions bestowed to *non-profit* organizations.

On one side, if the contribution is accomplished through the intervention of a notary, then the articles concerning “the donation” and the “obligations in general” apply. In particular, to the extent the donor specifies in the *deed* the conditions under which the fund he/she provides must be employed (art. 793), he/she is entitled to bring suits before the Court for the termination of the contract and for the compensation (Cass, 1994; n. 5983) whereas *non-profit* directors do not respect contractual terms (art. 1218).

On the other hand, if the contribution is executed through a mere transfer of money on behalf of the *non-profit* organization then, at first glance, the question comes up rather problematic since no specific article of the Civil Code is directly concerned with the issue. In addition, no Supreme Court judgment that could shed some light has, so far, been passed.

3.2 Legal Discussion

Assuming that a legal solution must exist, as the system is complete, the idea that is promoted by this research sets forth the legal reasoning on conceiving these *patrons*’ contributions as “*donazioni indirette*”, underscoring the very important role that legal literature plays in civil law traditions.

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 *patrons’* 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 everything but 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 *patrons*, 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.

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.

Conclusion: Comparative and Law and Economics Analysis

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.

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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