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Woods Bowman, *DePaul University*

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The Importance of Corporation Law to Civil Society

Woods Bowman

Abstract

The thesis of this paper is that transactions costs related to formation of nonprofit corporations are restraining the size of the nonprofit sector in Europe. An unfettered ability to incorporate is an important determinant of nonprofit formation. The point is illustrated with historical data from the United States. Given that an increasing number of nonprofits have transnational goals, the lack of a common regulatory regime for nonprofits in Europe raises transactions costs and stifles development of the nonprofit sector—just as the lack of a common regulatory regime for commerce prior to founding of the European Union had retarded business activity.

KEYWORDS: transactions costs, corporation, history, law

Introduction

Scholars, attempting to explain variation in the size of the nonprofit sector across countries, have focused on social, religious, and political differences. Weisbrod (1975) found a positive association between cultural heterogeneity and size. James (1993), studying the education sub-sector, found support for his finding. Salamon and Anheier (1998) and Anheier and Salamon (2006) developed an ambitious social origins theory of the sector based on national socio-political characteristics. The Johns Hopkins Comparative Nonprofit Sector Project (Salamon et al, 1999; 2004) likewise focused on these characteristics.

This paper introduces transactions cost into the picture. When a legal system causes non-negligible transactions costs it “will have a profound effect on the working of the economic system and may in certain respects be said to control it” (Coase, 1992, p. 718). Therefore the relative costs of compliance with legal requirements should be a key variable in determining the size of the nonprofit sector in a country but I have been unable to find research that examines a possible relationship. Of course, laws themselves are products of social and cultural forces, but they are worthy of separate study because culture changes slowly with no one giving direction but laws can be amended by a simple legislative act.

Our thesis is that an unfettered ability to incorporate is an important determinant of nonprofit formation. Historical data from the United States will illustrate the point. Given that an increasing number of nonprofits have transnational goals (Hondius and Van der Plogg, 2006), the lack of a common regulatory regime for nonprofits in Europe raises transactions costs and stifles development of the nonprofit sector – just as the lack of a common regulatory regime for commerce prior to founding of the European Union had retarded business activity.

The next section explains the advantages of incorporation and why it is important to the nonprofit sector. It is followed by a short section on the history of nonprofits as corporate entities, which describes how they pioneered this legal framework and questions de Tocqueville’s interpretation of cultural differences between the United States and Europe. Another section shows how liberalization of incorporation laws in the United States in the latter half of the 20th century had contributed to nonprofit formation. Finally, this paper addresses the complexity of European law related to recognition and regulation of nonprofits and argues for a common liberal legal regime.

Why Nonprofit Corporations?

“Whether an association will function satisfactorily in relation to third parties is to a very high degree a question of whether it becomes a [corporation], i.e., a body which is regarded in law as having a personality and existence distinct from that

of its members...” Corporate status greatly enhances the ability of an organization to own, manage, and defend property in all of its forms (Hemström, 2006, p. 27).

All corporations are legal persons possessing a minimal set of common attributes (Vikramaditya, 2005):¹ (1) They have an indefinite life, i.e., self-perpetuating self-government, (2) They are able to sue and be sued in their own name, (3) They are able to own property in their own name, (4) They have centralized management empowered to act in their name, subject to laws regarding fiduciary responsibility, (5) Liability for their debts is limited to their own capital. The last characteristic – called *limited liability* – is extremely important because it absolves persons associated with a corporation from personal financial responsibility for negligent acts of the corporation itself or its agents. Without this protection, potential transactions costs of doing business would be far higher and persons would understandably be reluctant to become actively involved.

Imagine a wealthy individual wanting to begin a socially valuable project and wanting it to continue beyond his or her lifetime. Entrusting property to a loyal friend does not solve the continuity problem and the likelihood of misappropriation is higher without the mutual accountability a group, like a board of directors, provides. Entrusting it to a partnership would provide mutual accountability and partnership agreements can be updated periodically to provide continuity but transactions costs associated with updating and monitoring are likely to be quite high.

Furthermore, it might be impossible to find people willing to participate as partners without the protection of limited liability. A corporate charter provides this protection and requires no such updating. In the long run, incorporation is simpler and has lower transactions costs.² Laws typically grant all corporations considerable flexibility to govern themselves through bylaws of their own devising. Business corporations can change their line of business and nonprofit corporations can change their mission, provided they follow whatever process their bylaws require.

Nonprofits as Corporate Pioneers

A few paragraphs of history will suffice to emphasize the importance of empowering citizens to form corporations because it was eleemosynary institutions and

¹ I have taken the liberty to reorganize and renumber Vikramaditya’s list.

² There is another possibility: a trust, which has many features of a corporation except that the fourth point above must be amended to read, “it has a centralized management charged with faithfully executing the trust instrument.” Any deviation from the trust instrument requires approval by a court of competent jurisdiction. Transactions costs are probably highest for trusts.

membership associations – not business enterprises – that led the way in developing the corporation as a legal framework.

The first corporations emerged in 1st century Rome (Avi-Yonah, 2005, p. 772). Their principal use was for municipal governance, guilds, religious cults, and philanthropic foundations. Romans did not use corporations for business enterprises. Precisely when the first application of the corporation to for-profit business occurred is unknown but medieval companies of significant size were quasi-permanent partnerships involving multiple partners (Hunt 1994, 76). However, by the year 1283 C.E. family corporations had become “common” in Florence.

In 1650 Massachusetts awarded the first corporate charter in America to Harvard College (O’Neill, 1989, p. 54). The first commercial corporation was not chartered until Connecticut took the step in 1732 (Micklethwait and Wooldridge, 2003, p. 43). “By the end of the 18th century many states had general incorporation laws for religions, academies, and libraries, but *not business corporations*”(Roy, 1997, p. 48, emphasis added). “General acts provided incorporation for a broad range of charitable, religious, and literary purposes in Pennsylvania in 1791 and for libraries in New York in 1796 and in New Jersey in 1799. Fire companies could be chartered under general acts of Virginia of 1788 and of Kentucky of 1798” (Hurst, 1970, p. 134).

Alexis de Tocqueville’s *Democracy in America*, first published in 1835 and still in print, is considered one of the most insightful commentaries on early American society. Some oft-quoted phrases are: “Americans of all ages, all conditions, and all dispositions constantly form associations.... Wherever at the head of some new undertaking you see government in France, or a man of rank in England, in the United States you will be sure to find an association.” (De Tocqueville, 2007, p. 452) His observations are often taken as “timeless truths about charity, philanthropy, and voluntarism in American life” (Gross, 2003, p. 30) but perhaps he was merely observing the consequences of differences in the relative ease of forming corporations in the United States compared to Britain and France.

In the half-century before de Tocqueville’s visit, it was difficult to incorporate in Britain and France. In Britain organizers of charitable enterprises either had to endure a lengthy process of obtaining Parliamentary approval or find individuals to act as their agents for holding the organization’s property – “men of rank.” The French counterparts of English men of rank would have been members of nobility but the Terror (1793-94) decimated their numbers, leaving the government as the default option for charitable works.

Unfortunately de Tocqueville (2007) showed little interest in legal forms. The words “corporation,” “corporate” or “joint-stock” appear incidentally only 5 times; the word “charter” is likewise rare and not on point. Much more research is needed before we can be confident about the relative importance of law and culture in the nascent American nonprofit sector but differences in laws should be

investigated as a cause of differences in social behavior. In any case, nonprofit institutions have been pioneers in the evolution of corporation law from the earliest times.

Recent U.S. Experience

Granting of a corporate charter is done at the state level. Unfortunately there is no notional registry of nonprofit corporations. The most comprehensive source of data is records of federal tax exemption so before we examine data on nonprofit organization we should explore the relationship between incorporation as a nonprofit and federal tax exemption.

Incorporation as a nonprofit is neither necessary nor sufficient for federal tax-exemption. Nonprofit organizations must seek exemption by submitting form 1023 or 1024 to the IRS, which then “recognizes” their exempt status provided they are organized for an exempt purpose (the organization test) and that purpose actually guides their operations (the operations test). Unincorporated associations may be recognized as tax-exempt but the application process is more complicated for them. Religious congregations are exempt *per se* and are not required to seek recognition of exemption.

Grønbjerg et al (2008) found that only one-third of Indiana’s secular nonprofits are both incorporated and exempt from federal income taxation. (See Table 1.) Alternatively, only half of incorporated nonprofits are federally tax exempt.³

Table 1

Relation of Incorporation and Federal Tax Exemption

(proportion of all nonprofits; may not add to 1.0 due to rounding)

		State Incorporated	
		Yes	No
Federally Tax-Exempt	Yes	0.33	0.26
	No	0.33	0.08

Source: Grønbjerg, Liu and Pollak (2008)

³ The upper right-hand cell may be high. According to a statistician at the IRS, 17 % of recognized public charities are unincorporated associations (Brody 2008).

When one considers that corporations are avatars of high-stakes commercial activity, it may be surprising that nonprofits are *more likely* to be incorporated than for-profit businesses. According to Table 2, one-third of the estimated 9 million nonprofits are incorporated compared to one-fifth of all 28.7 million for-profit businesses. Many for-profit businesses consist of self-employed persons whose personal finances are so intertwined with their business finances that they may see no advantage to incorporating. Nonprofits are inherently group activities which may explain their greater propensity to seek corporate status.

Table 2
Nonprofit Organizations and For-profit Businesses in 2005
(number)

Nonprofits	Total*	Small Orgs.**
Federally tax-exempt public charities	876,164	310,683
<i>Including religious congregations (est.)</i>	<i>1,176,164</i>	<i>610,683</i>
Federally tax-exempt nonprofits	1,401,454	528,023
<i>Including religious congregations (est.)</i>	<i>1,701,454</i>	<i>828,023</i>
Nonprofit corporations (est.)	3,503,635	<i>unknown</i>
All voluntary nonprofits (est.)	9,000,000	<i>unknown</i>
For-profit Businesses		
Publicly traded corporations (est.)	18,000	18,000
For-profit business corporations	5,558,000	4,241,000
All for-profit businesses	28,696,000	12,090,000

* For nonprofits, this is the number registered with the IRS in 2005. For businesses, this is the number filing tax returns with the IRS (with or without reportable net income) in 2004.

** For nonprofits, this refers to reporting entities, which automatically excludes nonprofits with less than \$25,000 of revenue. For businesses, it is tax filings that report gross receipts of more than \$25,000.

Sources Wing et al (2008), Tables 1.1 & 5.1 (estimates by author based on Grønberg and Smith), *Statistical Abstract of the United States, 2008 edition*, Tables 721 and 722. Religious congregations are the author's estimates based on *Religious Congregations and Membership in the United States 2000*, available through the Association of Religious Data Archives (<http://www.thearda.com/mapsReports>), accessed September 26, 2008. The number of publicly traded corporations is estimated from the Dun and Bradstreet Million Dollar Database and ReferenceUSA.

The civil rights movement in the mid-20th century prompted liberalizing judicial decisions, followed by widespread legislation that eliminated the requirement of prior state approval. “By the mid-1960s, approval of a nonprofit charter had become in all states an entitlement for virtually any group asserting that it would operate in a legal manner and according to formal rules of governance and distribution of revenues that were laid out in either special nonprofit laws or general incorporation laws” (Silber, 2001, p. 115).⁴

This change is evident in the number of tax-exempt nonprofits on Chart 1 (next page) which uses data from 1946 to 2005 published in Historical Statistics of the United States, although some years are missing data (Lamoreaux, 2006). To create Chart 1, the missing years were filled in assuming a constant compound growth rate between the closest known dates. This method produces a straight line segment on Chart 1.⁵

Chart 1 compares the natural logarithms (log) of (1) the number of taxable business corporations, (2) all tax exempt entities, and (3) the subset of tax-exempt membership associations. This is the first presentation of historical data to compare nonprofits with for-profit businesses and to display data logarithmically transformed. With natural logs a constant compound growth rate is manifest as a straight line. When data are charted logarithmically, changes in growth rates clearly show as changes in the slope. An upward bend indicates the rate is accelerating; a downward bend indicates it is decelerating.

In Chart 1 the top line is the natural log of the number of taxable business corporations and the middle line is the natural log of the number of tax exempt nonprofits. The top line is smooth and gradually curving down indicating a very gradual deceleration in net formation of business corporations under some persisting factor or factors slowing the rate of formation of business corporations.

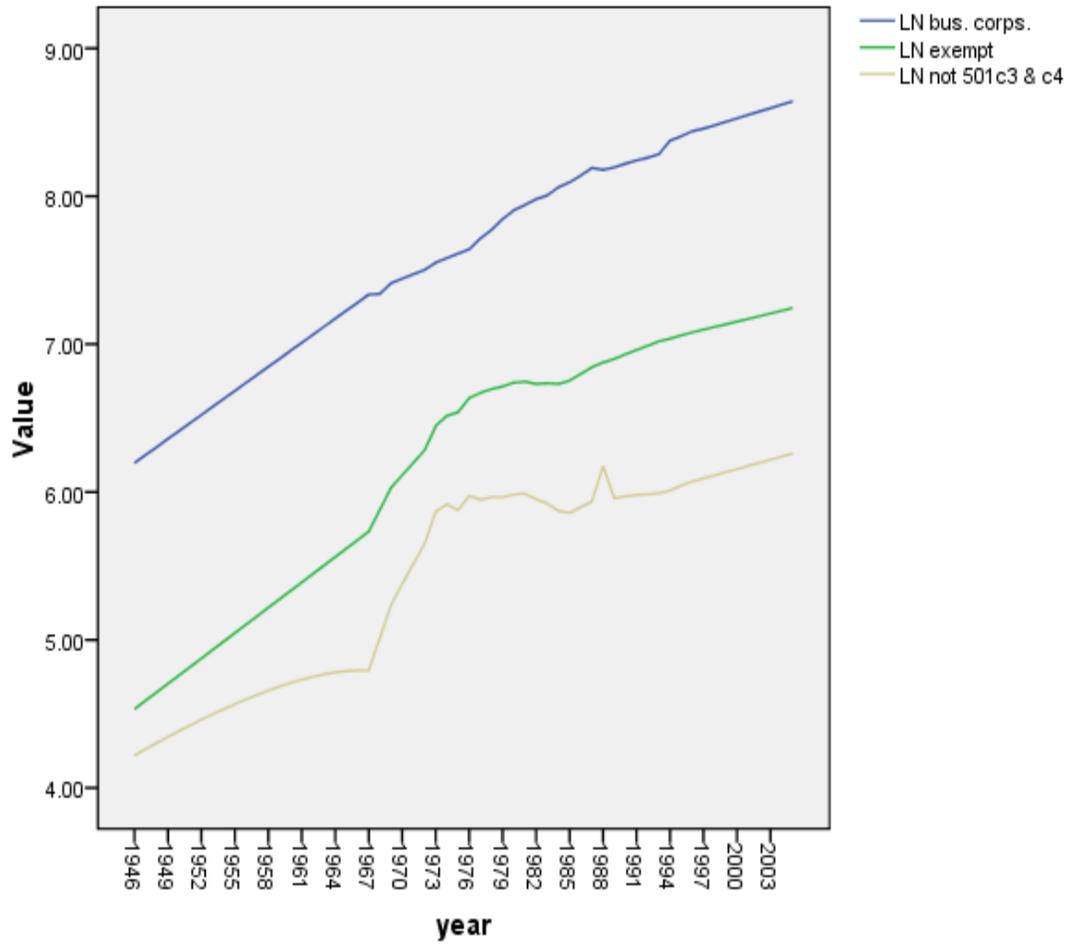
The middle line, showing the total number of tax-exempt nonprofits, has a clearly discernable bulge between 1967 and 1985. It is clear that something happened in the 1960s that had a powerful effect on the growth rate in the number of nonprofit organizations which extended well into the 1980s. The question is: what happened?

⁴ In 1987 the Subcommittee of the Business Law Section of the American Bar Association finally codified the case law in a Revised Model Nonprofit Corporation Act; there have been no updates.

⁵ This method was used between 1946 and 1967, between 1969 and 1972 and between 1997 and 2005.

Chart 1

**Natural Logarithm of Number of Business Corporations,
Exempt Entities, and Entities Other than 501c3 and 501c4**



Source: Lamoreaux (2006). Data given in Appendix.

A permanent change in funding can be ruled out. An increase in funding at a particular point which then persisted – say, due to a new program benefiting the nonprofit sector – would cause the slope to become consistently steeper after that point than before. To illustrate: a chart of the natural log of federal spending (not shown here) breaks sharply upward when Medicare and Medicaid go into effect and continues in a straight line until the presidency of Ronald Reagan when it bends down gradually throughout the eight years of his presidency.⁶ If a substantial subsidy had been given to nonprofits and then withdrawn, the middle line on Chart 1 line would break upward at the subsidy's inception but then break down when it was withdrawn, but this is not observed.

The middle line turns upward sharply, then levels off and remains on a plateau until it intersects the long-term trend line. This is the signature pattern of a one-time structural change. In the short-term the change is disruptive but it does not affect the long term trend. An obvious candidate for structural change is the liberalization of state laws regarding incorporation that swept the nation in the late 'sixties as described by Silber (2001) above.

Because the change is once-in-a-lifetime event, we cannot test the hypothesis formally but we can look for corroborating evidence. It is found in the bottom line, which shows membership associations only and displays an even larger bulge during the same period of time. If the reason for the sudden surge in nonprofit organizations is discriminatory denial of application for nonprofit incorporation because of perceived threats to the existing social order, one would expect that membership associations would be seen as posing a greater threat than nonprofits that produce goods and services. The combination of liberalized incorporation laws and heightened interest in advocating for civil rights and social change generally would be likely to affect the growth of membership associations more strongly than the growth of service providers. Indeed, this is observed.

Before we can be confident that liberalized incorporation laws caused a surge in nonprofit incorporations, we must rule out statistical artifacts. There are two measurement issues to consider: (1) the file of tax exempt entities likely contains many defunct organizations because the IRS made no effort to purge them during the period displayed on Chart 1, and (2) the graph is based on Internal Revenue Service (IRS) records and, as we have seen, tax exemption is not synonymous with incorporation.

⁶ The retrograde change is neither as abrupt nor as strong as the change which occurred in the 'sixties.

A growing presence of defunct organizations in the registry of tax-exempt entities introduces an upward bias in the trend line. If we can assume that the mortality rate remains constant over time, this bias will have a constant effect on the line but it will not create a bulge. There is no obvious reason why mortality rates might suddenly decline in 1967 and then return to the long term trend. The relationship between incorporation and federal tax exemption is more problematic. If states denied application for incorporation, the federal government may nevertheless recognize the denied organizations as tax exempt. It is easy to imagine that limited liability might be so important that when an organization is denied a corporate charter, it might disband rather than pursue federal tax exemption independently. Although neither argument is conclusive, it seems unlikely that the bulges in the middle and bottom lines are statistical artifacts.

After eliminating several alternative explanations, liberalization of U.S. incorporation laws in the 1960s is not only plausible but probable. In economic terms, there was a pent-up demand to form nonprofits prior to the late 'sixties, once it was satisfied, new growth followed the long term trend.

European Policy Toward Voluntary Associations

Increasing economic integration of Europe has not been accompanied by a more uniform legal framework for creation and operation of nonprofit organizations. "The European Union has been hesitant in its approach to the non-profit sector and civil society. This set of institutions was neglected by the Treaty of Rome [1957]" (Archambault et al, 1999, p. 95). This was not an oversight: nonprofit organizations were specifically excluded from the notion of "company" or "firm" (Hondius and Van der Plogg, 2006).

The EU's Charter of the Fundamental Rights (like the U.S. Bill of Rights) defines the rights of individuals. It does not specify rights of organizations. The law governing nonprofits is national law, even where a body is named 'international' or 'European,' it is either constituted under the law of a given country, or it is (part of) an international intergovernmental organization, (Hondius and Van der Plogg, 2006, sect. 9-17). Furthermore, there is a notable lack of uniformity in national law. The most important matter on which systems are divided is the question of whether the existence of a nonprofit is subject to state approval.

Where courts or supervising authorities are empowered to determine whether a purpose is charitable, confusion is inevitable. "They may accept a benefaction for a communal sports ground as charitable but refuse such recognition when it concerns a sports club with as very select membership" (ibid., 9-15). Within civil law countries requiring registration or licensing there is a division:

some countries recognize a nonprofit only after it has amassed a certain amount of capital, whereas others have no such requirement. “In France, the condition posed for the recognition of a foundation are so severe that only a very few candidates pass the test. This has proved to be a serious deterrent to philanthropic giving” (ibid., 2006, sect. 9-41).

As regards membership associations, “Constitutional rights in one legal system may be afforded to nonprofit organisations as such, while in others such rights are afforded to the natural persons active in those organisations” (Hemström, 2006, sect. 8-65). In France and Germany citizens have the right to create membership associations but these groups do not automatically attain full legal personhood without undertaking a formal process of recognition (ibid., sect. 8-55). By contrast, Denmark, Norway, and Sweden, have no general law governing membership associations (ibid., sect. 8-45). France restricts the rights of membership associations to own real property, but Italy allows them to own any type of property. (ibid., sect. 8-66).

The European Charter of Active Citizenship (ACN/FONDACA 2006), a document produced by private organizations dedicated to promoting civil society points to a “normative gap” in the European legal framework – “while EU documents contain several references to the activity of citizen’s organizations in the public arena, they completely lack legally binding texts defining the roles, rights, and responsibilities of nonprofits, as well as the related obligations of public institutions.”

Unfortunately the European Charter of Active Citizenship does not promote a right for nonprofits to incorporate. This exclusion is no small matter because, as this paper argues, nonprofits find incorporation valuable as a means of protecting other rights. An incorporated nonprofit with the right to sue and be sued would automatically have the same right as any other corporation to submit claims to secure recognition of the other rights, a right to appeal to national courts, and to appeal to the European Court of Justice (articles 13-15 of the Charter of Active Citizenship).

Given that an increasing number of nonprofits have transnational goals, the lack of a uniform regulatory regime for nonprofits in Europe raises transactions costs and stifles development of the nonprofit sector – just as the lack of a common regulatory regime for commerce prior to founding of the European Union retarded business activity.

Conclusions

Governments throughout history have been ambivalent about nonprofit organizations and membership associations. The ancient Romans created the first corporations but Emperor Trajan, fearing that they were incubators of sedition, banned them all – even volunteer fire brigades. Beginning in the late middle ages monarchs raised prohibitions to land passing by bequest into the hands of institutions. This policy (*mortmain*) was even imported into the early United States. Revolutionary France banned all associations. Although France showed increased toleration for associations, the ban was not repealed altogether until the late 19th century. The United States introduced general incorporation laws – beginning with various kinds of nonprofits.

Incorporation is critically important to nonprofit institutions. Indeed, they have been pioneers in the evolution of corporation law throughout history. Evidence adduced from the United States supports the contention that arbitrary exercise of discretion by state authorities in granting corporate charters restrained development of the nonprofit sector. Today nonprofit institutions and membership associations enjoy widespread acceptance on both sides of the Atlantic but the pendulum may yet swing back again. This is a propitious moment for the European Union to adopt a uniform law guaranteeing the rights of citizens to organize institutions of civil society and investing those institutions with the rights of legal personhood through incorporation without prior state approval.

Further research on the impact of national laws on nonprofit formation is warranted. A deeper understanding of the transactions costs will better inform future policy making.

Appendix: Number of Entities in 1,000s

Year	Business Corps.	Exempt Orgs.	501c3 & c4 Orgs.	Other Exempt
1946	491	93	25	68
1967	1,534	309		
1968	1,541	358		
1969	1,658	416		
1972	1,812	535		
1973	1,904	630		
1974	1,965	676		
1975	2,023	692		
1976	2,082	762		
1977	2,241	789	406	383
1978	2,376	810		
1979	2,556	824		824
1980	2,710	846	449	397
1981	2,812	851		
1982	2,925	838	454	384
1983	2,999	842		
1984	3,170	838	483	355
1985	3,277	858		
1986	3,428	897		
1987	3,612	939	560	379
1988	3,562	969	489	480
1989	3,627	992	605	387
1990	3,716	1,024	632	392
1991	3,802	1,055		
1992	3,869	1,085	688	397
1993	3,964	1,118	718	400
1994	4,342	1,138	730	408
1995	4,474	1,164		
1996	4,631	1,188		
1997	4,710			
2005	5,671	1,400	876	524

Source: Lamoreaux (2006)

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