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# Punctilios and Nonprofit Corporate Governance-- A Comprehensive Look at Nonprofit Directors' Fiduciary Duties

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# Articles

## **PUNCTILIOS AND NONPROFIT CORPORATE GOVERNANCE—A COMPREHENSIVE LOOK AT NONPROFIT DIRECTORS’ FIDUCIARY DUTIES**

Thomas Lee Hazen\* & Lisa Love Hazen\*\*

*The law on nonprofit directors’ obligations is sparse and fragmented. Most of the discussion over the years is lore rather than law based on commentators’ suggestions for best practices. This article attempts a comprehensive and systematic analysis of the law relating to nonprofit directors’ obligations. On the one hand, there is a basis for suggesting that since nonprofits implicate public trust issues, nonprofit directors should be held to standards higher than those imposed on for-profit directors. On the other hand, in order to attract people to serve on nonprofit boards, states generally offer more insulation from director liability than is found in the for-profit world. How can this apparent contradiction be reconciled? Perhaps the solution lies in recognizing that truly altruistic motivations for serving on nonprofit boards will result in directors having their own internal incentive to do the right thing and put in the time and effort necessary for effective nonprofit monitoring. To the extent that it is too Pollyannaish to expect the best from people, this article explores nonprofit directors’ responsibilities and how they relate to the law limiting directors’ accountability.<sup>1</sup>*

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1. For a discussion of North Carolina law and some of the issues discussed in this article, see Thomas Lee Hazen & Lisa Love Hazen, *Increased Scrutiny of Nonprofit Directors*, 90 N.C. L. REV. (forthcoming 2012).

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## I. INTRODUCTION

Nonprofit organizations generally have a governing board. Members of those governing boards are regarded as fiduciaries. However, this just begins the analysis. As Justice Felix Frankfurter observed in an oft-quoted passage: “[T]o say that a man is a fiduciary only begins analysis; it gives direction to further inquiry. To whom is he a fiduciary? What obligations does he owe as a fiduciary? In what respect has he failed to discharge these obligations?”<sup>2</sup> This article explores these questions in the context of nonprofit organizations<sup>3</sup> and then evaluates the perceived need for heightened standards of responsibility, but is mindful not to discourage good nonprofit directors from volunteering because of the fear of draconian liability.

Fiduciary relationships are entered into voluntarily and are recognized as placing the fiduciary under a zealous duty of good faith.<sup>4</sup> Fiduciary relationships established by law often are mirrored by relationships established by custom reflecting positive social attributes including “loyalty, civility, self-sacrifice, vocational excellence, and high standards of honesty.”<sup>5</sup> The law thus recognizes that a fiduciary relationship entails a strong duty of the utmost loyalty.<sup>6</sup> This loyalty obligation means that the fiduciary must act solely in the beneficiary’s best interests rather than acting in the fiduciary’s own interests.<sup>7</sup> It is impossible to distill the scope of a fiduciary’s obligations into a bright-line formula. “[T]he various descriptions of fiduciary relationships share a common thread—the existence of heightened obligations” in contrast to legal “obligations resulting in non-fiduciary arm’s length transactions.”<sup>8</sup> This is reflected in

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2. SEC v. Chenery Corp., 318 U.S. 80, 85–86 (1942).

3. One way to describe a fiduciary’s obligation is the focus on others’ interests, rather than on one’s own self-interest. See Ira Mark Ellman, *Another Theory of Nonprofit Corporations*, 80 MICH. L. REV. 999, 1021 n.51 (1982) (“It has also been said that the core feature of charity is that it is not ‘self-regarding,’ but ‘other-regarding.’”).

4. See, e.g., Scott Fitzgibbon, *Fiduciary Relationships Are Not Contracts*, 82 MARQ. L. REV. 303, 304, 308–09 (1999); see also, e.g., Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 DUKE L.J. 879, 902 (1988) (discussing autonomy as a key assumption of fiduciary relationships).

5. Fitzgibbon, *supra* note 4, at 340.

6. See *infra* text accompanying notes 163–92 (discussing various aspects of the duty of loyalty held by directors).

7. See D. Gordon Smith, *The Critical Resource Theory of Fiduciary Duty*, 55 VAND. L. REV. 1399, 1488 (2002).

8. Thomas Lee Hazen, *Are Existing Stock Broker Standards Sufficient? Principles, Rules and Fiduciary Duties*, 2010 COLUM. BUS. L. REV. 710, 727 (2010). In addition, following the rule for fiduciary duties generally, nonprofit directors may not delegate or otherwise contract out of their obligations of due care. See AMERICAN LAW INSTITUTE’S PRINCIPLES OF THE LAW OF NONPROFIT ORGANIZATIONS § 320 cmt. (a)(2) (Tentative Draft

Justice Cardozo's famous mantra that fiduciaries owe a "punctilio of an honor the most sensitive."<sup>9</sup>

Most nonprofit organizations are set up as corporations or as trusts.<sup>10</sup> There are many varieties of nonprofit corporations. Some are set up for charitable purposes. Others are established to produce goods and services.<sup>11</sup> Nonprofits are found in all shapes and sizes:

The world of nonprofits has changed significantly over time; some have continued to operate as small, neighborhood charitable organizations, while others have transformed themselves into large, quasi-business operations, similar to their behemoth corporate counterparts. As with any group of this size, nonprofit activities vary widely, with organizations ranging from traditional charities, such as neighborhood soup kitchens and the Red Cross, to hospitals run in a manner similar to for-profit hospitals, to even the National Football League. Contrary to popular belief, private philanthropy is not the main source of nonprofit revenue; rather, over forty percent of nonprofit revenue is derived from fees for services performed. Although the size of the nonprofit sector has been rapidly increasing, financial support from the government has been falling over time, thereby causing nonprofits to become more "market-oriented in their operations, but at the price of posing questions about the legitimacy of the special tax and other privileges that they enjoy."<sup>12</sup>

Nonprofit corporations may be established for charitable (sometimes referred to as public benefit corporations) or religious purposes and those

No. 1, 2007) (emphasizing that fiduciaries must personally perform their duties and regulating their ability to delegate their responsibilities).

9. *Meinhard v. Salmon*, 164 N.E. 545, 546 (N.Y. 1928) ("A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior.")

10. Unincorporated nonprofits are governed in many states as unincorporated nonprofit associations. *See, e.g.*, N.C. GEN. STAT. ch. 59B (2009).

11. For a discussion of the economic role of nonprofits and evaluation of the justifications for the charitable tax exemption, see Henry B. Hansmann, *The Rationale for Exempting Nonprofit Organizations from Corporate Income Taxation*, 89 *Yale L.J.* 835 (1980); *see also, e.g.*, Rob Atkinson, *Theories of the Federal Income Tax Exemption for Charities: Thesis, Antithesis, and Syntheses*, 27 *Stetson L. Rev.* 395 (1997).

12. Denise Ping Lee, Note, *The Business Judgment Rule: Should it Protect Nonprofit Directors?*, 103 *COLUM. L. REV.* 925, 929 (2003) (footnotes omitted) (quoting LESTER M. SALAMON ET AL., *GLOBAL CIVIL SOCIETY: DIMENSIONS OF THE NONPROFIT SECTOR* 271, 275, 280 (1999)); *see also, e.g.*, *Provena Covenant Med. Ctr. v. Dep't of Revenue*, 925 N.E.2d 1131 (Ill. 2010) (denying state property tax exemption to hospital that was not providing the charitable care necessary to retain nonprofit status).

nonprofits are generally entitled to tax benefits.<sup>13</sup> There are also mutual benefit nonprofit corporations, such as trade associations, homeowners' associations and the like, which are common examples of mutual benefit corporations that are governed by the nonprofit rather than business corporation act of the state of incorporation, yet do not receive favored tax exempt treatment.<sup>14</sup> This article focuses on the obligations of public benefit or charitable nonprofit directors and does not address mutual benefit entities where the interests are purely private and there is no public mission involved. There is no single unified body of law that applies to charities and other nonprofits. Instead, the law in this area is fragmented. Although there have been repeated suggestions for a more unified approach,<sup>15</sup> legislators and policy makers have not heeded that message. Instead, the law regulating nonprofit and charitable governance remains an amalgam of trust law, corporate law, and tax law.<sup>16</sup> This article analyzes these various fragments in an attempt to provide a more unified explanation of the current law.

Given the more than two hundred year history of corporate law in the United States, nonprofit corporation acts are relatively new.<sup>17</sup> Prior to the advent of enabling laws directed to nonprofit corporations, there was considerable law governing the obligations of trustees of charitable trusts.<sup>18</sup>

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13. I.R.C. § 501(c) (2011).

14. The former version of the Revised Model Nonprofit Act divided nonprofits into three categories: public benefit, mutual benefit, and religious nonprofits. REVISED MODEL NONPROFIT CORP. ACT § 2.02(a)(2) (1988). While these are good generic descriptions of the various types of nonprofits, they never caught on as a matter of statutory distinction. Accordingly, the most recent version of the Revised Model Nonprofit Act follows the pattern of most states in having one category of nonprofit corporation. *Id.*

15. *See, e.g.*, Kenneth L. Karst, *The Efficiency of the Charitable Dollar: An Unfulfilled State Responsibility*, 73 HARV. L. REV. 433, 477 (1960) (calling for a centralized law of charities); William F. Jarvis, Comment, *The Nonprofit Director's Fiduciary Duty: Toward a New Theory of the Nonprofit Sector*, 77 NW. U. L. REV. 34 (1982) (lamenting the absence of any meaningful unification of the law of charities).

16. *See, e.g.*, Susan N. Gary, *Regulating the Management of Charities: Trust Law, Corporate Law, and Tax Law*, 21 U. HAW. L. REV. 593 (1999).

17. The movement towards dedicated nonprofit corporation statutes began in the 1950s. *See, e.g.*, Note, *The Charitable Corporation*, 64 HARV. L. REV. 1168 (1951) (discussing the evolving charitable corporation). Prior to the modern form of nonprofit corporation acts, nonprofit organizations and charities could incorporate as non-stock corporations or through a specific charter issued by the state. For example, Harvard College was incorporated in 1650. *Id.* at 1168, n.5 (citing A. M. DAVIS, CORPORATIONS IN THE DAYS OF THE COLONY 18 (1894)).

18. Karst, *supra* note 15, at 435 (noting that

[T]here is a branch of trust law applicable to charitable trustees, and an entirely separate set of rules governing officers and directors of incorporated charities. While the duties of charitable trustees have been developed in great detail over a period of centuries, the great and rapid increase in the number and aggregate

While some more recent decisions continue the trust analogy, the general view today in the context of nonprofit corporations is to refer to principles of corporate rather than trust law.<sup>19</sup>

When charitable nonprofits provide products or services like a private business or in fact operate a business, the oversight obligations of directors are clearly implicated since it is the board's obligation to oversee operations and help assure that charitable tax exempt status is preserved.<sup>20</sup> There can be confusing overlap between nonprofit and for-profit enterprises.<sup>21</sup> This confusion is exacerbated by large businesses such as nonprofit hospitals and other commercial enterprises operated through a nonprofit entity.<sup>22</sup>

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wealth of charitable corporations has taken the law by surprise. As a consequence, the managers of corporate charity are still, at this late date, without adequate guides for conduct.

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19. See, e.g., *Stern v. Lucy Webb Hayes Nat'l Training Sch. for Deaconesses & Missionaries*, 381 F. Supp. 1003, 1013 (D.D.C. 1974) (“[T]he modern trend is to apply corporate rather than trust principles in determining the liability of the directors of charitable corporations, because their functions are virtually indistinguishable from those of their ‘pure’ corporate counterparts.”); see also, e.g., Joseph J. Rucci, Jr., *Directors of Nonprofit Organizations: Litigation Exposure and Protection*, 9 CORPORATE ACCOUNTABILITY REPORT 1009 (2011) (noting that “[r]ecent high-profile litigation should be a wake up call for boards to improve their oversight of management.”).

20. See *infra* notes 89–134 and accompanying text. Cf. *Vacco v. Diamandopoulos*, 715 N.Y.S.2d 269 (N.Y. Sup. Ct. 1998) (upholding attorney general's complaint seeking to hold directors accountable for excessive compensation and mismanagement of university's assets and denying defendants' claim for advanced indemnification); see *id.* at 728 (noting that

[T]he Regents found “that Lois neglected both his duties of due care and undivided loyalty to Adelphi,” and that he “violated his fiduciary duty by failing to disclose to the board that LOIS/USA was, indeed, being paid for services rendered to Adelphi.” The Regents concluded that Diamandopoulos and Lois should be removed “for neglect of their fiduciary duties of due care and loyalty.” The Regents also found “that the full board of trustees neglected its duty of due care to Adelphi by failing to take appropriate action once it learned of Procope's and Lois' potential conflicts.” They recommended removal of the 18 trustees “for neglect of their duty of due care.” The Regents did not address whether Lois' company received excessive payment for the work which was done.

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21. See, e.g., Evelyn Brody, *Agents Without Principals: The Economic Convergence of the Nonprofit and For-Profit Organizational Forms*, 40 N.Y.L. SCH. L. REV. 457, 457 (1996) (discussing the differences between nonprofit and for-profit corporations and suggesting that this may be a situation where “a distinction long believed to be a difference of kind turns out to be a difference of degree”).

22. See, e.g., Evelyn Brody, *The Limits of Charity Fiduciary Law*, 57 MD. L. REV. 1400, 1408 (1998) (“Explosive growth and expansion into commercial activities have

There has been much debate as to whether organizations that in fact operate a business should be able to enjoy nonprofit charitable tax exempt status.<sup>23</sup> Some have argued that we should move to a new model of for-profit charities.<sup>24</sup> Others propose stricter limits on nonprofit organizations' for-profit activities.<sup>25</sup>

A specific example of the debate surrounding the federal tax exemption is the concern in recent years that nonprofit hospitals are really disguised for-profit enterprises with an undeserved tax advantage.<sup>26</sup> In

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transformed the typical charity from a perpetual fund invested by trustees into a modern enterprise subject to the management demands of a complex operating business.”)

23. Many scholars have analyzed the wisdom of the subsidy for charitable nonprofits. *See, e.g.*, Miranda Perry Fleischer, *Equality of Opportunity and the Charitable Tax Subsidies*, 91 B.U. L. REV. 601 (2011) (discussing the charitable tax exemption as a subsidy); Miranda Perry Fleischer, *Theorizing the Charitable Tax Subsidies: The Role of Distributive Justice*, 87 WASH. U. L. REV. 505 (2010) (discussing the tax exempt subsidy in terms of distributive justice); James R. Hines Jr., Jill R. Horwitz & Austin Nichols, *The Attack on Nonprofit Status: A Charitable Assessment*, 108 MICH. L. REV. 1179 (2010) (discussing the wisdom of subsidizing charitable activities that are in fact for-profit operations); Dana Brakman Reiser, *Charity Law's Essentials*, 86 NOTRE DAME L. REV. 1 (2011) (discussing the fine distinction between operating nonprofit corporations and for-profit corporations); Seong J. Kim, Note, *Hiding Behind the Corporate Veil: A Guide For Non-Profit Corporations With For-Profit Subsidiaries*, 5 HASTINGS BUS. L.J. 189 (2009) (noting the fuzzy line between for-profit corporations and certain nonprofits).

24. *See, e.g.*, M. Todd Henderson & Anup Malani, *Corporate Philanthropy and the Market for Altruism*, 109 COLUM. L. REV. 571, 571 (2009) (“[T]he government must avoid discriminating—particularly when setting tax policy—between nonprofits and corporations that do good deeds.”); Anup Malani & Eric A. Posner, *The Case for For-Profit Charities*, 93 VA. L. REV. 2017, 2019–23 (2007) (arguing that if the charity tax subsidy is retained, it should be made available for business entities that engage in good works).

25. *See, e.g.*, Brian Galle, *Keeping Charity Charitable*, 88 TEX. L. REV. 1213 (2010) (arguing that the government should maintain the current charitable versus for-profit distinction and that the cost of allowing tax benefits for the charitable work of for-profit corporations is not worth the potential benefit). This article does not address that debate. Rather, we focus on the appropriate standards for nonprofit directors.

26. *See, e.g.*, Leigh Walton, *Hospital Syndications: Opportunities and Options, or Poised for Extinction?*, 21 HEALTH LAWYER 1 (2009) (discussing financing by syndication of for-profit and nonprofit hospitals); Laura L. Folkerts, Note, *Do Nonprofit Hospitals Provide Community Benefit? A Critique of the Standards for Proving Deservedness of Federal Tax Exemptions*, 34 J. CORP. L. 611 (2009) (questioning whether the community benefit requirement adequately distinguishes nonprofit from for-profit hospitals); Roger P. Meyers, Note, *Risky Ventures: The Impact of IRS Health Care Joint Venture Policy*, 42 U. MICH. J.L. REFORM 481 (2009) (discussing the fine line between for-profit and nonprofit in the context of healthcare joint ventures). *Cf.* Julia L. Davis, *Contracts, Control And Charter Schools: The Success of Charter Schools Depends on Stronger Nonprofit Board Oversight to Preserve Independence and Prevent Domination by For-Profit Management Companies*, 2011 BYU EDUC. & L.J. 1 (2011) (discussing the fine line between for-profit and nonprofit organizations in the context of charter schools); Oksana Koltk, Comment, *Chasing Profits—Disregarding Values: Legal Persona of Elite Schools And Their Destructive Tax-Exempt Status*, 42 J. MARSHALL L. REV. 1073 (2009) (decrying the commercialization of nonprofit



2010, Congress addressed this problem when it enacted the Patient Protection and Affordable Care Act, which adopted a new section, 501(r)<sup>27</sup> of the tax code, that places additional requirements on hospitals with section 501(c)(3) tax-exempt status.<sup>28</sup> The new provisions include a community health needs assessment,<sup>29</sup> a financial assistance policy,<sup>30</sup> and limitations on charges<sup>31</sup> in order to maintain 501(c)(3) tax-exempt status.<sup>32</sup> These new requirements necessarily impact board obligations. They are added to the other aspects of the organization's activities the board must

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law schools and suggesting how it can affect their charitable status).

27. I.R.C. § 501(r) (2011) (listing additional requirements for certain hospitals, such as community health needs assessment requirements and financial assistance policy requirements).

28. Patient Protection and Affordable Care Act (PPACA), Pub. L. No. 111-48 § 9007, 124 Stat. 119 (2010) (codified at I.R.C. § 501(r) (2011)). *See also, e.g.*, James E. Tyrrell, III, *Non-Profits Under Fire: The Effects of Minimal Charity Care Requirements Legislation on Not-for Profit Hospitals*, 26 J. CONTEMP. HEALTH L. & POL'Y 373 (2010) (analyzing the proposed Illinois Tax-exempt Hospital Responsibility Act).

29. A nonprofit hospital must conduct a "community health needs assessment" at least once every three years and adopt an "implementation strategy" to meet the needs identified by the assessment. I.R.C. § 501(r)(3). This assessment must take into account input from a broad cross-section of the community served by the hospital, including those with special knowledge of or expertise in public health, and must be made widely available to the public. *Id.* *See also* Gloria J. Bazzoli & Jan P. Clement, *Community Benefit Activities of Private, Nonprofit Hospitals*, 35 J. HEALTH POL. POL'Y & L. 999 (2010) (discussing the meaning of "community benefits"); Lynnore Seaton, *Tax-Exempt Hospitals and Community Benefit*, 21 HEALTH LAWYER 37 (2009) (discussing the community benefit standard); Michele R. Goodman, Note, *Putting the Community Back in Community Benefit: Proposed State Tax Exemption Standard For Nonprofit Hospitals*, 84 IND. L.J. 713 (2009) (proposing state tax exemption for community based hospitals).

30. A § 501(c)(3) "charitable" hospital must establish, implement, and make widely available written policies regarding financial assistance and emergency medical care. I.R.C. § 501(r)(4). There must be a financial assistance policy specifying eligibility criteria (including whether the assistance includes free or discounted care) and state how the hospital calculates the amounts that are billed to patients. *Id.* *See, e.g.*, David T. Lewis, *New Billing and Financial Assistance Requirements for Tax-Exempt Hospitals*, 12 J. HEALTH CARE COMPLIANCE 6, 53-55 (Nov.-Dec. 2010) (urging the need for hospitals to develop policies required by PPACA, such as financial assistance policies and limitations on charges for emergency care).

31. A nonprofit hospital must limit charges for emergency or other medically necessary care that is provided to patients eligible for financial assistance and the charges cannot be in excess of the lowest amounts charged to insured patients. Amanda W. Thai, Note, *Is Senator Grassley Our Savior?: The Crusade Against "Charitable" Hospitals Attacking Patients for Unpaid Bills*, 96 IOWA L. REV. 761 (2011). The hospital's policy must also prohibit the use of "gross charges" when billing individuals who qualify for financial assistance. *Id.* In addition there must be a policy relating to limitations on billing and collections practices. *Id.*

32. I.R.C. § 501(r).

monitor in order to preserve nonprofit status. It is not just tax laws that have impacted hospital governance, as state attorneys general have invoked their authority under state law to challenge perceived lapses in nonprofit governance.<sup>33</sup> Hospital boards also have oversight obligations regarding the quality of the healthcare provided.<sup>34</sup>

## II. OVERVIEW OF NONPROFIT GOVERNING BOARD DUTIES

Nonprofit organizations can be established with either an advisory board or with a governing board. Unlike formal governing boards, advisory boards do not have either statutory authority or statutory obligations. In contrast, when a board is established as a formal governing board, board members have fiduciary obligations. Nonprofit corporation acts, following the pattern of business corporation acts, establish a default governing structure that includes a board of directors.<sup>35</sup> Qualification for IRS tax-exempt status is easier if the charitable organization is formed as a nonprofit corporation.<sup>36</sup> Accordingly, it is very common for nonprofits to have a governing board of directors. Nonprofits board duties are generally described as a duty of care, a duty of loyalty, and a duty of good faith.<sup>37</sup> Also, there often is reference to a duty of obedience.<sup>38</sup> While it has been debated as to how many fiduciary duties directors must in fact adhere to, the categorization is less important than the substance.<sup>39</sup>

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33. John D. Blum, *The Quagmire of Hospital Governance*, 31 J. LEGAL MED. 1, 43–45 (2010).

34. See Tracy E. Miller & Valerie L. Gutmann, *Changing Expectations for Board Oversight of Healthcare Quality: The Emerging Paradigm*, 2 J. HEALTH & LIFE SCI. L. 31 (2009) (suggesting the emergence of an emerging paradigm for board oversight of healthcare quality, and recommending increased consideration of comparative quality measures and transparency).

35. REVISED MODEL NONPROFIT CORP. ACT § 8.01(a) (2008).

36. See, e.g., James K. Weeks, *The Not-For-Profit Business Corporation*, 19 CLEV. ST. L. REV. 303, 307 (1970) (suggesting it is easier to obtain a federal tax exemption if the organization is recognized as a charitable entity under state law but also noting that such status is not by itself sufficient).

37. PRINCIPLES OF THE LAW OF NONPROFIT ORGANIZATIONS §§ 315 (duty of care), 330 (conflicts of interest) (Tentative Draft No. 1, 2007) (hereinafter ALI NONPROFIT PRINCIPLES).

38. See, e.g., *Queen of Angels Hosp. v. Younger*, 136 Cal. Rptr. 36 (Cal. Ct. App. 1977) (dealing with action brought by the state attorney general where a nonprofit breached the duty of obedience in using funds for medical clinics instead of for operating a hospital). See discussion *infra* Part IX.

39. See, e.g., Julian Velasco, *How Many Fiduciary Duties are There in Corporate Law?*, 83 SO. CAL. L. REV. 1231, 1257–76 (2010) (explaining that the existing debates are largely semantic and that fiduciary duties are too important to be oversimplified into two or three categories). Professor Velasco suggests five paradigms for enforcement that he believes will provide a better framework for analyzing directors' duties. The five paradigms he suggests are: (1) process (gross negligence), (2) conflicts of interest (fairness), (3) bias

The duties of nonprofit directors to a large extent parallel the obligations of for-profit directors.<sup>40</sup> The duty of care is basically a negligence standard as it requires directors to act in a manner consistent with reasonably prudent directors under like circumstances.<sup>41</sup> In order to live up to their duty of care, directors must keep themselves informed about the organization's operations.<sup>42</sup> The duty of loyalty is implicated when a board member has a conflict of interest and at a minimum the conflicted board member should not participate in any related decision-making.<sup>43</sup> The duty of good faith is sometimes referred to as a separate obligation but is also a part of the duties of care and loyalty.<sup>44</sup> The duty of obedience is sometimes referred to as a way of describing the board's obligation to remain faithful to the organization's purpose and mission.<sup>45</sup> These duties are discussed in more detail throughout this article. Although this article's focus is on nonprofit directors, it is worth mentioning that even in the wake of corporate governance reforms and heightened accountability, there still is legitimate concern over whether for-profit corporate boards are fulfilling their obligations in a satisfactory manner.<sup>46</sup>

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(reasonableness), (4) misconduct (intent), and (5) substance (waste). *Id.* at 1235.

40. Although this article's focus is on nonprofit directors, it is worth mentioning that even in the wake of corporate governance reforms and heightened accountability, there is still legitimate concern over whether for-profit corporate boards are fulfilling their obligations in a satisfactory manner. *See, e.g.*, MCKINSEY & COMPANY, *McKinsey Global Survey Results: Governance Since the Economic Crisis*, in MCKINSEY QUARTERLY 1, 4 (2011) (indicating that (1) 44% of respondents indicated that their boards simply review and approve proposed strategies of management, (2) only 25% of respondents characterized the overall performance of their boards as excellent or very good, (3) the number of boards that formally evaluate their directors has decreased during the past three years, and (4) only 21% of directors purport to completely understand their company's strategy). Our concerns about insufficient accountability of nonprofit directors seem to have application to the for-profit world as well.

41. ALI NONPROFIT PRINCIPLES, *supra* note 37, § 315(b) (describing standard of conduct).

42. *Id.* § 315(a).

43. *Id.* § 330.

44. *See, e.g.*, Clark W. Furlow, *Good Faith, Fiduciary Duties, and the Business Judgment Rule in Delaware*, 2009 UTAH L. REV. 1061 (2009) (discussing good faith under Delaware corporate law); Leo E. Strine, Jr., Lawrence A. Hamermesh, R. Franklin Balotti & Jeffrey M. Gorris, *Loyalty's Core Demand: The Defining Role of Good Faith in Corporation Law*, 98 GEO. L.J. 629, 673–88 (2010) (further discussing good faith under Delaware corporate law as well as "[t]he rise and demise of an independent duty of good faith").

45. *See* discussion *infra* Part IX.

46. Our concerns about insufficient accountability of nonprofit directors seem to have application to the for-profit world as well. *See supra* note 40.

## III. INCREASED CONCERN OVER NONPROFIT BOARD ABUSES

Although the use of nonprofit corporations as the entity to carry out the operations of charitable foundations is relatively new, the nonprofit form has been used by educational and religious organizations for much longer.<sup>47</sup> The state statutes enabling the formation of nonprofit corporations closely follow the for-profit model to the extent consistent with not-for-profit goals.<sup>48</sup> Although modern nonprofit corporation statutes have been around for over fifty years,<sup>49</sup> the law with respect to nonprofit directors' responsibilities remains largely undeveloped.<sup>50</sup> In 1998 former SEC Commissioner Harvey Goldschmid noted that nonprofit board obligations are more aspirational than real and asked, "Can we continue to justify or afford—and will the public continue to tolerate—the relative ineffectiveness of nonprofit corporate governance and the virtual absence of accountability constraints?"<sup>51</sup> He concluded that we cannot. However, the law and practice has been slow to heed his concern.<sup>52</sup> The past decade has witnessed corporate governance reforms and heightened scrutiny of the role of corporate directors. These reforms have focused on business corporations and have not carried over to nonprofit corporations.<sup>53</sup> This

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47. Note, *The Charitable Corporation*, 64 HARV. L. REV. 1168 (1951); see also, e.g., HENRY W. BALLANTINE, BALLANTINE ON CORPORATIONS § 2a (rev. ed., 1946) (describing voluntary, non-corporate nonprofit associations).

48. See, e.g., Robert S. Leshner, *The Non-Profit Corporation—A Neglected Stepchild Comes of Age*, 22 BUS. LAW. 951 (1967) (discussing nonprofit corporation statutes).

49. Statutes governing nonprofit corporations date back to at least 1964. See, e.g., MODEL NONPROFIT CORP. ACT (1964). Legal scholarship discussing nonprofit corporations date back to at least 1954. See, e.g., George Gleason Bogert, *Proposed Legislation Regarding State Supervision of Charities*, 52 MICH. L. REV. 633 (1954). The Model Nonprofit Corporation Act was revised in 1987 and then again in 2008. REVISED MODEL NONPROFIT CORPORATION ACT (1988); REVISED MODEL NONPROFIT CORPORATION ACT (2009).

50. See, e.g., Kara A. Gilmore, *House Bill 1095: The New Nonprofit Corporation Law for Missouri*, 63 UMKC L. REV. 633 (1995) (noting the absence of fully developed nonprofit law); Thomas H. Boyd, Note, *A Call to Reform the Duties of Directors Under State Not-For-Profit Corporation Statutes*, 72 IOWA L. REV. 725, 726 (1987) (noting that "states have failed to legislate clear and adequate general standards for not-for-profit directors' conduct").

51. Harvey J. Goldschmid, *The Fiduciary Duties of Nonprofit Directors And Officers: Paradoxes, Problems, and Proposed Reforms*, 23 J. CORP. L. 631, 653 (1998).

52. See, e.g., Melanie B. Leslie, *The Wisdom of Crowds? Groupthink and Nonprofit Governance*, 62 FLA. L. REV. 1179 (2010) (calling for reinforced fiduciary duties and enhanced limitations on self-dealing and conflicts of interest).

53. Cf. Robert A. Britton, Note, *Making Disclosure Regulation Work in the Nonprofit Sector*, U. ILL. L. REV. 437 (2008) (suggesting a disclosure system "in which state and federal governments, acting in their roles as significant donors to the nonprofit sector, withhold government grants unless potential recipients voluntarily provide enhanced

article explores nonprofit directors—the forgotten fiduciaries. There has been scant scholarly or legislative attention to nonprofit corporations notwithstanding the fact that abuses in the nonprofit world should be of equal concern as those in the for-profit world.

Massive corporate frauds during the Enron era,<sup>54</sup> and the aftermath of the 2008 financial meltdown each led to much concern over corporate governance and in particular the obligations of corporate directors. The Sarbanes-Oxley Act of 2002<sup>55</sup> and the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010<sup>56</sup> instituted various corporate governance reforms. These reforms were limited to publicly held for-profit corporations. Notwithstanding scandals<sup>57</sup> and concerns about executive

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financial and management disclosures”).

54. Cf. Saori Horikawa & John Hempill, *Serving on a Nonprofit Board in the Post Enron Era*, CORPORATE PRO BONO, <http://www.cpbo.org/archive/resources/resource1370.html> (discussing a series of corporate and accounting scandals).

55. Pub. L. No. 107-204 (2002); see also Public Company Accounting Reform and Investor Protection Act of 2002, S. Rep. No. 107-205 (2002) (regulating financial reporting, independent audits, and accounting services for public companies); Mae Kykendall & Elliott A. Spoon, Symposium, *In the Wake of Corporate Reform: One Year in the Life of Sarbanes-Oxley—A Critical Review*, 2004 MICH. ST. L. REV. 271 (2004) (discussing scholarly commentary on the Sarbanes-Oxley Act and suggesting greater enforcement of the statute).

56. Pub. L. No. 111-203, § 704, 124 Stat. 1376 (2010).

57. See, e.g., Roger Colinvaux, *Charity in the 21st Century Trending Toward Decay*, 11 FLA. TAX REV. 1 (2011) (discussing past scandals and calling for reform); Deborah A. DeMott, *Self-Dealing Transactions in Nonprofit Corporations*, 59 BROOK. L. REV. 131, 133 (1993) (describing self-dealing by directors of United Way and the San Diego National Sports Training Foundation); *Developments in the Law—Nonprofit Corporations*, 105 HARV. L. REV. 1581, 1591 n.5 (1992) (citing to a journal article dealing with the law of nonprofit organizations); Goldschmid, *supra* note 51, at 653 (discussing United Way and Adelphi University’s problems with excessive executive compensation).

A poignant example of board failure occurred with respect to Five Rivers Community Development Corporation in South Carolina Community Action Program Legal Services. See Jack B. Siegel, *CAPLAW Governance Case Studies: Case 1 The Executive Director’s Role Vis-a-Vis the Board*, (2008), [http://www.capl原因w.org/Case\\_Study\\_1\\_000.pdf](http://www.capl原因w.org/Case_Study_1_000.pdf) (discussing the demise of the Five Rivers Community Development Corp.); David Wren, *Board Not Consulted on Wages*, SUN NEWS, Dec. 10, 2006, at A1 (discussing board ignorance of executive compensation); David Wren, *Nonprofit Pay Rises Under Little Oversight*, SUN NEWS, Aug. 20, 2006, at A1 (discussing self-dealing and excessive compensation in Five Rivers Community Development Corporation, a non-profit agency in Georgetown County); see also SAMUEL P. KING & RANDALL W. ROTH, *BROKEN TRUST: GREED, MISMANAGEMENT & POLITICAL MANIPULATION AT AMERICA’S LARGEST CHARITABLE TRUST* (2006) (chronicling the mismanagement and corruption of the Bishop estate that established a charitable trust); Rachel Penski, Note, *The Case of CEO Richard Grasso and the NYSE: Proposals for Controlling Executive Compensation at Public Nonprofit Corporations*, 58 VAND. L. REV. 339 (2005) (discussing the large compensation package for a former New York Stock Exchange CEO when the Exchange was a nonprofit corporation);

compensation<sup>58</sup> in nonprofit corporations, these reforms did not apply to nonprofit corporations. Although there was some movement to mandate reform of nonprofit governance,<sup>59</sup> none came to fruition.<sup>60</sup> However,

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James J. Fishman, *Improving Charitable Accountability*, 62 MD. L. REV. 218, 272–75 (2003) (proposing charities commissions to serve as remedial function for charities' abuses). *But cf.* Johnny Rex Buckles, *Fiduciary Assumptions Underlying the Federal Excise Taxation of Compensation Paid by Charities*, 45 REAL PROP. TR. & EST. L.J. 53 (2010) (criticizing increased regulation of nonprofit compensation through federal excise tax).

58. New York is investigating nonprofit executive compensation after finding that approximately 2,000 workers at nonprofits earn more than \$100,000 per year. Michael Gormley, *NY Investigates Wages, Bureaucracy at Nonprofits*, WALL ST. J. (Aug. 3, 2011, 4:57 PM), <http://online.wsj.com/article/AP4581db54fc74471dae49c55cd0572df6.html> (discussing the investigations taking place); *see also* Russ Buettner, *Abused and Used: Reaping Millions for Nonprofit Care for Disabled*, N.Y. TIMES, Aug. 2, 2011, <http://www.nytimes.com/2011/08/02/nyregion/for-executives-at-group-homes-generous-pay-and-little-oversight.html> (detailing how two executives of mental health nonprofit received more than one million dollars per year; one charged more than \$50,000 for his daughter's living expenses).

Another recent high profile example has been the California attorney general challenging excess compensation in a charitable foundation established by the owners of the Los Angeles Dodgers baseball team. Katie Thomas & Michael S. Schmidt, *Practices of Dodgers' Charity Are Said to be Under Scrutiny*, N.Y. TIMES, Aug. 31, 2010, at B14 (describing the practices of the Dodgers in relation to charity); Katie Thomas & Michael S. Schmidt, *Questions Arise About Executive's Pay at Dodgers Charity*, N.Y. TIMES, July 8, 2010, at B10 (detailing the questions surrounding executive compensation with respect to the Dodgers' charity). Executive compensation in the for-profit world has also been a major concern. *See, e.g.*, Randall S. Thomas & Harwell Wells, *Executive Compensation in the Courts: Board Capture, Optimal Contracting, and Officers' Fiduciary Duties*, 95 MINN. L. REV. 846 (2011) (analyzing the law's ability to put a check on compensation of business executives).

59. *See, e.g.*, Ellen P. Aprill, *What Critiques of Sarbanes-Oxley Can Teach About Regulation of Nonprofit Governance*, 76 FORDHAM L. REV. 765 (2007) (discussing the areas in which the Sarbanes-Oxley Act has received a great deal of criticism); Marion R. Fremont-Smith, *The Search for Greater Accountability of Nonprofit Organizations: Recent Legal Developments and Proposals for Change*, 76 FORDHAM L. REV. 609 (2007) (discussing proposals for increased regulation of nonprofits); Dana Brakman Reiser, *Charity Law's Essentials*, 86 NOTRE DAME L. REV. 1 (2011) (calling for enhanced regulation); Dana Brakman Reiser, *There Ought to be a Law: The Disclosure Focus of Recent Legislative Proposals for Nonprofit Reform*, 80 CHI.-KENT L. REV. 559, 561 (2005) (concluding "that the ability of disclosure-based reforms to enhance nonprofit accountability may be overstated, but can be improved if legislatures recognize the limits of the for-profit analogy and refashion their reforms to complement enforcement"). For a discussion of a potential extension of the Sarbanes-Oxley Act to nonprofits, *see* Wendy K. Szymanski, *An Allegory of Good (and Bad) Governance: Applying the Sarbanes-Oxley Act to Nonprofit Organizations*, 2003 UTAH L. REV. 1303 (2003); Nichole Gilkeson, Note, *For-Profit Scandal in the Nonprofit World: Should States Force Sarbanes-Oxley Provisions onto Nonprofit Corporations?*, 95 GEO. L.J. 831 (2007); Joseph Mead, Note, *Confidence in the Nonprofit Sector through Sarbanes-Oxley-Style Reforms*, 106 MICH. L. REV. 881 (2008). *But see, e.g.*, Lumen N. Mulligan, *What's Good for the Goose is not Good for the Gander: Sarbanes-Oxley-Style Nonprofit Reforms*, 105 MICH. L. REV. 1981 (2007) (arguing that

nonprofit boards are wise to be cautious in setting executive compensation since as discussed later, there can be adverse implications with respect to tax-exempt status and investigations by the state attorney general.<sup>61</sup> Even aside from the legal requirements, nonprofit boards should carefully scrutinize executive compensation since donors may be watching.<sup>62</sup>

There has been much discussion about Sarbanes-Oxley reforms as a template for best practices for nonprofit boards.<sup>63</sup> Some commentators contend that extending Sarbanes-Oxley reforms to nonprofits is not a good idea.<sup>64</sup> Other commentators call for enhanced duties for nonprofit directors.<sup>65</sup> Although there was no legislation at the federal level to extend

Sarbanes-Oxley governance reforms would be of little use for nonprofits).

60. See, e.g., Marion R. Fremont-Smith, *The Search for Greater Accountability of Nonprofit Organizations: Recent Legal Developments and Proposals for Change*, 76 *FORDHAM L. REV.* 609 (2007) (discussing developments and proposals in state law and IRS regulations); Anne-Marie Rhodes, *Regulating Charities in the Twenty-First Century: An Institutional Choice Analysis*, 85 *CHI.-KENT L. REV.* 479 (2010) (discussing and evaluating various approaches to reforming the law governing management of charities).

61. See *infra* Part V (dealing with IRS consequences) and *infra* Part XII.C (state attorney general).

62. See, e.g., Paul B. Firstenberg & Frederick S. Lane, *Setting CEO Pay Must be Done With Care to Avoid Donors' Wrath*, *CHRON. OF PHILANTHROPY*, June 2011, at 31, 33 (discussing a number of factors that can aid in the determination of CEO compensation).

63. See, e.g., PEGGY M. JACKSON & TONI E. FOGARTY, *SARBANES-OXLEY FOR NONPROFITS: A GUIDE TO BUILDING COMPETITIVE ADVANTAGE* (2005) (discussing relevance of Sarbanes-Oxley principles to nonprofits); Dana Brakman Reiser, *Enron.org: Why Sarbanes Oxley Will Not Ensure Comprehensive Nonprofit Accountability*, 38 *U.C. DAVIS L. REV.* 205 (2004) (discussing the limits of borrowing from Sarbanes-Oxley for nonprofits); Jane Heath, Note, *Who's Minding the Nonprofit Store: Does Sarbanes-Oxley Have Anything to Offer Nonprofits?*, 38 *U.S.F. L. REV.* 781 (2004) (focusing on various tenets of the Sarbanes-Oxley Act that showcase the major themes intended by the Act to promote public confidence, and thereby investment in for-profit corporations; non-profits can also benefit from public confidence in similar ways); Ralph E. DeJong, *Update on Governance Best Practices for Exempt Organizations*, 2006 *ABATAX-CLE* 0505027, available on Westlaw (ABA Section of Taxation May 5, 2006); F. Sheffield Hale, *Public Company Best Practices for Nonprofits*, 26 *ACC Docket*, Apr. 2008, at 58 (setting forth suggested best practices for nonprofit corporations). Cf. Aseem Prakash & Mary Kay Gugerty, *Trust But Verify? Voluntary Regulation Programs in the Nonprofit Sector*, 4 *REGULATION & GOVERNANCE* 22 (2010) (discussing voluntary regulation programs as an alternative way to resolve agency problems in nonprofits).

64. See, e.g., Kathleen M. Boozang, *Does an Independent Board Improve Nonprofit Governance?*, 75 *TENN. L. REV.* 83, 136 (2007) (arguing that the "ongoing move toward board and director independence in the nonprofit sector appears to be a movement without a clear goal, supported by little evidence that independence has accomplished improvements in the business sector").

65. See, e.g., Ellen W. McVeigh & Eve R. Borenstein, *The Changing Accountability Climate and Resulting Demands for Improved "Fiduciary Capacity" Affecting the World of Public Charities*, 31 *WM. MITCHELL L. REV.* 1 (2004) (noting increased board duties).

Sarbanes-Oxley type requirements to nonprofits, there was some movement in the states. For example, under California's Nonprofit Integrity Act of 2004,<sup>66</sup> charitable nonprofits that bring in an annual revenue of more than \$2 million must be audited, the results of which are publicly available and must have an audit committee whose composition is publicly available and does not overlap more than fifty percent with the finance committee.<sup>67</sup>

As more fully discussed below, the tools and remedies for monitoring nonprofits are limited.<sup>68</sup> Even with limited remedies, a benefit of articulating high standards for nonprofit directors is the hope that most nonprofit directors will adhere to the articulated standards.<sup>69</sup> It may seem a bit too much like Pollyanna to suggest that directors will follow the higher standards even without heightened remedies. However, being a nonprofit director is a thankless job and many such directors are likely to see board service as part of their philanthropy. As such, their commitment to the cause and sense of doing what is right certainly will have some salutary effect even if it is not sufficient in itself.

Following the pattern of business corporation law, the basic formation and governance rules for nonprofit corporations are governed by state law.<sup>70</sup> Although there may be nuanced differences in state nonprofit corporation acts,<sup>71</sup> they share much common ground. The most significant recent reforms in the nonprofit area have come in through the tax laws rather than state corporate law. This represents a piecemeal approach to the problem.<sup>72</sup> There have been suggestions that the states' nonprofit corporate laws<sup>73</sup> should take more of a role or that there should be a more holistic

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66. SB 1262 (Sept. 29, 2004), 2004 CAL. STAT. 919 (2011); *see also, e.g.*, 2005 Conn. Acts 101 (Reg. Sess.) (regulating the solicitation of charitable funds); N.H. REV. STAT. ANN. § 7:28 (2004).

67. CAL. GOVT. CODE § 12586 (2011). In addition, all nonprofits regardless of size must make their audited financial statements available to the public and, consistent with IRS Forms 990, must disclose the compensation of President, CEO, Treasurer and CFO approved by the board. *Id.*

68. *See infra* Part XII.

69. James Fishman, *Standards of Conduct for Directors of Nonprofit Corporations*, 7 PACE L. REV. 389 (1986).

70. JAMES D. COX & THOMAS LEE HAZEN, TREATISE ON THE LAW OF CORPORATIONS § 2:4 (3d ed. 2010) (hereinafter "COX & HAZEN").

71. *See, e.g.*, Thomas Lee Hazen & Lisa Love Hazen, *Duties of Nonprofit Corporate Directors—Emphasizing Oversight Responsibilities*, 90 N.C. L. REV. (forthcoming 2012).

72. *See* Roger Colinviaux, *Charity in The 21st Century: Trending Toward Decay*, 11 Fla. Tax L. Rev. 1 (2011) (noting the piecemeal reform in defining "charitable" for tax purposes and suggesting it is time to take a longer view of the problem rather than simply react to each scandal or controversy as it occurs).

73. *Cf.* Lloyd Hitoshi Mayer & Brendan M. Wilson, *Regulating Charities in the Twenty-First Century: An Institutional Choice Analysis*, 85 CHI.-KENT L. REV. 479 (2010) (arguing that state-based regulation is more appropriate than relying on IRS rules).



approach to federal regulation.<sup>74</sup> While such fundamental changes in regulatory structure might be warranted, that is not the focus of this article. This article explores the more basic question of whether existing law respecting nonprofit directors is adequate. Thus, this article explores the current law by examining how current state nonprofit law and the IRS rules currently operate and what existing standards in fact do apply to nonprofit directors.

Legal scholarship on nonprofit charitable organizations has focused on a number of discrete issues. For example, there is a debate as to whether heightened scrutiny of nonprofit director fiduciary duties is appropriate.<sup>75</sup> There is analysis of the 2008 IRS enhanced disclosure requirements<sup>76</sup> and discussion as to whether they are beneficial.<sup>77</sup> Commentators have debated the wisdom of applying Sarbanes-Oxley enhanced governance requirements to nonprofits either by statutory mandate or voluntarily as a matter of identifying best practices.<sup>78</sup> The scholarly literature tends to be fragmented, generally treating tax and state law issues separately. Current literature thus lacks a unified analysis of nonprofit directors' obligations considering state law governance standards as they are impacted by the IRS requirements. This article fills that gap. Even without considering additional reforms, there is much groundwork in existing law for addressing the shortfall in nonprofit directors' accountability.

Much wrongdoing in the area of nonprofit corporations can be traced to the absence of good governance procedures and to the lack of transparency.<sup>79</sup> At a minimum, nonprofit boards should be committed to

74. See, e.g., HOWARD L. OLECK, NON-PROFIT CORPORATIONS, ORGANIZATIONS, AND ASSOCIATIONS 457, 575 (2d ed. 1965) (calling for a centralized agency modeled on the SEC supervisory agency for nonprofits on the federal level rather than a branch of the IRS); Terri Lynn Helge, *Policing the Good Guys: Regulation of The Charitable Sector Through a Federal Charity Oversight Board*, 19 CORNELL J.L. & PUB. POL'Y 1 (2009) (arguing for a federal regulator other than the IRS); Kenneth L. Karst, *The Efficiency of the Charitable Dollar: an Unfulfilled State Responsibility*, 73 HARV. L. REV. 433, 476 (1960) (suggesting a centralized state board supervise private charities rather than the attorney general).

75. See *infra* note 129 (pertaining to what level of scrutiny is appropriate in assessing the fiduciary duties of nonprofit directors).

76. In 2008, effective 2009, the IRS increased the disclosures required on Form 990 that must be filed annually. See *infra* Part V.

77. See *id.*

78. See *id.*

79. See, e.g., JAMES J. FISHMAN & STEPHEN SCHWARZ, NONPROFIT ORGANIZATIONS CASES AND MATERIALS 124 (4th ed. 2010) (noting the many “[e]xamples of poor judgment, ethical lapses and outright fraud . . . throughout these materials” and asserting that “[n]othing so tarnishes the nonprofit sector’s halo than wrongdoing by charities. More often than not, these actions indicate inadequate corporate governance procedures and a lack of transparency of the organization’s activities. Good governance is the implementation of

effective oversight of the organizations' operations and also to assuring transparency. The principal functions of a nonprofit can be distilled into six categories:

(1) to select, encourage, advise, evaluate and, if need be, replace the chief executive officer; (2) to review and adopt long-term strategic directions and to approve specific objectives, financial and other, such as reviewing the basic mission of the organization in light of changed circumstances; (3) to ensure to the extent possible that the necessary resources, including human resources, will be available to pursue the strategies and achieve the organization's objectives; (4) to monitor the performance of management; (5) to ensure that the organization operates responsibly as well as effectively; and (6) to nominate suitable candidates for election to the board, and to establish and carry out an effective system of governance at the board level, including evaluation of board performance.<sup>80</sup>

#### IV. THE NONPROFIT GOVERNANCE CONUNDRUM

Consideration of nonprofit directors' duties presents a conundrum. The conundrum is that while the law imposes high standards of responsibility on nonprofit directors, it incongruously includes significant limitations on board accountability for wrongdoing or lack of oversight. On the one hand, as is the case with for-profit corporations, the trustee-like obligations of overseeing a nonprofit corporation's assets and operations result in directors being held to duties of care and loyalty.<sup>81</sup> These duties in nonprofits are highlighted by the public trust that results from the states' and Internal Revenue Service's<sup>82</sup> grant of nonprofit and preferential non-tax

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certain principles and policies that should protect the organization from misconduct.")

80. *Id.* at 127; see also Peggy Sasso, Comment, *Searching for Trust in the Not-for-Profit Boardroom: Looking Beyond The Duty of Obedience to Ensure Accountability*, 50 UCLA L. REV. 1485, 1501 (2003) (providing a ten-factor list of nonprofit board responsibilities), citing Michael W. Peregrine & James R. Schwartz, *The Business Judgment Rule and Other Protections for the Conduct of Not-for-Profit Directors*, 33 J. HEALTH L. 455, 458 (2000) (describing protective measures in place for directors of non-profit organizations); RICHARD T. INGRAM, *What are the basic responsibilities of nonprofit boards?* in TEN BASIC RESPONSIBILITIES OF NONPROFIT BOARDS (2d ed. 2009) (describing such basic responsibilities as determining the organization's mission and purpose, selecting the chief executive, supporting and evaluating the chief executive, ensuring effective planning, monitoring and strengthening programs and services, protecting assets and providing financial oversight, building a competent board, ensuring legal and ethical integrity, and enhancing the organizations' public standing).

81. See *infra* Part VI.

82. Cf. Karen Donnelly, Note, *Good Governance: Has the IRS Usurped the Business Judgment of Tax-Exempt Organizations in the Name of Transparency and Accountability?*,

status.<sup>83</sup> Effective in 2008, the IRS imposed enhanced disclosure requirements on the Form 990 that must be filed by nonprofits with tax-exempt status.<sup>84</sup> The conundrum is further complicated because, unlike publicly held for-profit corporations, nonprofit directors usually are not compensated and thus serve as volunteers.<sup>85</sup>

#### V. FEDERAL TAX LAW IMPACT ON NONPROFIT CORPORATE GOVERNANCE AND DIRECTORS' DUTIES

Since Congress has long viewed charities as providing a public good, it provides a government subsidy<sup>86</sup> in the form of tax exempt status. Some observers have criticized the wisdom of a government subsidy,<sup>87</sup> especially when the nonprofit is engaging in business operations.<sup>88</sup> We view the tax-exempt subsidy as an appropriate way to encourage charitable endeavors. However, when nonprofit organization operations stretch the limits of bona

79 U.M.K.C. L. REV. 163 (2010) (criticizing the IRS's expansion of Form 990 as an unfortunate intrusion on corporate governance and the business judgment rule).

83. See, e.g., Linda Sugin, *Resisting the Corporatization of Nonprofit Governance: Transforming Obedience into Fidelity*, 76 FORDHAM L. REV. 893 (2007) (cautioning against the corporatization of nonprofit board governance lest the charitable goals be obscured).

84. For a general history of Form 990, see *Chronological History: Redesign of the 2008 Form 990 and Corresponding Instructions*, IRS, <http://www.irs.gov/charities/charitable/article/0,,id=185892,00.html> (last updated July 1, 2011).

85. See *infra* Part X (discussing compensated versus volunteer directors) and *infra* Part XII.E (discussing the liability shield available to volunteer nonprofit directors).

86. E.g., Fleischer, *Equality of Opportunity*, *supra* note 23 (discussing the charitable tax exemption as a subsidy); Daniel I. Halperin, *Is Income Tax Exemption for Charities a Subsidy?*, 64 TAX. L. REV. 283 (2011) (discussing the various tax exemptions for charities and their impact as a subsidy).

87. Kelly Phillips Erb, *Taxing Non-Profits: Is It the Modern Day Solution to Balancing Budgets?*, FORBES (May 11, 2011), <http://www.forbes.com/sites/kellyphillipserb/2011/05/11/taxing-non-profits-is-it-the-modern-day-solution-to-balancing-budgets/>; Stephanie Strom, *States Move to Revoke Charities' Tax Exemptions*, N.Y. TIMES, Feb. 27, 2010, at A21. But see, e.g., BRUCE R. HOPKINS, *Why Are Nonprofits Tax-exempt?*, in LEGAL RESPONSIBILITIES OF NONPROFIT BOARDS (1st ed. 2003). The government, in fact, provides an indirect subsidy to nonprofits and receives a direct benefit in return. Nonprofits also benefit the society as a whole when they provide valuable services." *Id.*

88. See, e.g., Nina J. Crim, *An Explanation of the Federal Income Tax Exemption for Charitable Organizations: A Theory of Risk Compensation*, 50 FLA. L. REV. 419, 461 (1998) (discussing the rationales underlying the exemption and then noting that "an organization uses resources to engage in some noncharitable activities—that is, activities that are unrelated to its purpose constraint."); Tommy F. Thompson, *The Unadministrability of the Federal Charitable Tax Exemption: Causes, Effects, and Remedies*, 5 VA. TAX REV. 1 (1985) (discussing the difficulties in identifying which organizations are worthy of the federal tax exemption).

fide charitable activities, governing board accountability is essential to avoiding abuse of the nonprofit entity. A nonprofit organization bears the burden of establishing the qualification for any applicable tax exemption.<sup>89</sup>

Section 501 of the Internal Revenue Code grants tax-exempt status for qualifying nonprofit organizations.<sup>90</sup> The federal tax exemption for charitable organizations dates back to 1894.<sup>91</sup> The current federal tax code lists twenty-eight categories of qualifying nonprofits. Most charitable nonprofits fall under section 501(c)(3), which provides exemptions for organizations that serve religious, charitable, literary, or scientific purposes, and for educational organizations and organizations that test for public safety.<sup>92</sup> The long-lived justification for exemption from federal tax

89. *Provena Covenant Med. Ctr. v. Dep't of Revenue*, 925 N.E.2d 1131, 1144 (Ill. 2010) (denying state property tax exemption to hospital that was not providing the charitable care necessary to retain nonprofit status, finding that it had not met its burden in establishing entitlement to the exemption).

90. I.R.C. § 501(c) (2011); *see, e.g.*, *Bob Jones Univ. v. United States*, 461 U.S. 574, 589 (1983) (“What little floor debate occurred on the charitable exemption provision of the 1894 Act and similar sections of later statutes leaves no doubt that Congress deemed the specified organizations entitled to tax benefits because they served desirable public purposes.”); BORIS I. BITKER & LAWRENCE LOKKEN, *FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS* ¶ 100.1 (2011) (

[T]he Internal Revenue Code . . . exempts . . . charitable institutions, schools, colleges, churches, and the like . . . [as well as] chambers of commerce, labor unions, and consumer cooperative societies [that] are operated primarily for the economic benefit of their members, and they are nonprofit groups only in the limited sense that they do not engage in business with the general public for the benefit of investors.

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91. Act of Aug. 27, 1894, Chapter 349, § 32, 28 Stat. 556 (“nothing herein contained shall apply to . . . corporations, companies, or associations organized and conducted solely for charitable, religious, or educational purposes”). For further history see BITKER & LOKKEN, *supra* note 90; JAMES J. FISHMAN & STEPHEN SCHWARZ, *NONPROFIT ORGANIZATIONS CASES AND MATERIALS* 294–314 (4th ed. 2010) (discussing the history of and rationales for the tax exemption); JOHN D. COLUMBO & MARK A. HALL, *THE CHARITABLE TAX EXEMPTION* (1995) (discussing the justification for the charitable exemption); Chauncey Belknap, *The Federal Income Tax Exemption of Charitable Organizations: Its History and Underlying Policy*, in 4 *COMM'N ON PRIVATE PHILANTHROPY AND PUB. NEEDS, RESEARCH PAPERS* 2035–36 (1977) (describing the history and justifications for the tax exemption); Charles A. Borek, *Decoupling Tax Exemption for Charitable Organization*, 31 *WM. MITCHELL L. REV.* 183, 188–201 (2004) (discussing the evolution of the tax exemption).

92. I.R.C. § 501(c)(3). As explained by the IRS:

To be tax-exempt under section 501(c)(3) of the Internal Revenue Code, an organization must be organized and operated exclusively for exempt purposes set forth in section 501(c)(3), and none of its earnings may inure to any private shareholder or individual. In addition, it may not be an *action organization, i.e.*,

for charitable organizations is that qualifying charities provide a public good. As explained by the Supreme Court:

When the Government grants exemptions or allows deductions all taxpayers are affected; the very fact of the exemption or deduction for the donor means that other taxpayers can be said to be indirect and vicarious “donors.” Charitable exemptions are justified on the basis that the exempt entity confers a public benefit—a benefit which the society or the community may not itself choose or be able to provide, or which supplements and advances the work of public institutions already supported by tax revenues.<sup>93</sup>

It has been suggested that one reason for the government subsidy that results from the tax exemption is that charitable organizations perform functions that otherwise would fall on the government.<sup>94</sup>

Nonprofits that qualify for IRC section 501(c) tax-exempt status must adhere to the federal tax code and IRS requirements for continued eligibility. The ultimate penalty for noncompliance is the loss of tax-exempt status.<sup>95</sup> The IRS enhancements to Form 990 that are discussed below were designed to shed more light on nonprofit operations with a view to determining continued eligibility for tax exempt status.

The enhanced disclosure requirements in IRS Form 990 for tax years starting in 2008 were aimed at corporate governance.<sup>96</sup> These changes are

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it may not attempt to influence legislation as a substantial part of its activities and it may not participate in any campaign activity for or against political candidates.

*Exemption Requirements—Section 501(c)(3) Organizations*, IRS (Nov. 15, 2010), <http://www.irs.gov/charities/charitable/article/0,,id=96099,00.html>.

93. *Bob Jones Univ.*, 461 U.S. at 591.

94. See, e.g., *Provena Covenant Med. Ctr.*, 925 N.E.2d at 1148. (“Conditioning charitable status on whether an activity helps relieve the burdens on government is appropriate.”); see also HOPKINS, *supra* note 87 (stating that “[t]ax-exemption . . . relieves some burden that would otherwise fall to federal, state, or local government”).

95. Some of these failures are reported in the popular press. See, e.g., Isabel Vincent & Melissa Klein, ‘All My Children’ Actor Doesn’t Know What Happened to Money Raised for 9/11 Victims, NEW YORK POST (July 3, 2011, 9:22 AM), [http://www.nypost.com/p/news/local/soap\\_star\\_in\\_vani\\_act\\_Io82alf3cGwlnHwt5NOaIL](http://www.nypost.com/p/news/local/soap_star_in_vani_act_Io82alf3cGwlnHwt5NOaIL) (noting that a charity to benefit 9/11 victims that was not properly organized but nevertheless raised money lost its tax exempt status).

96. Grace Allison, *The New Form 990 for Tax Exempt Organizations: Revolution in Progress*, 37 ESTATE PLANNING 14 (Mar. 2010) (discussing the new Form 990 requirements); James J. Fishman, *Stealth Preemption: The IRS’s Nonprofit Governance Initiative*, 29 VA. TAX L. REV. 545 (2010) (same); James R. King, Travis F. Jackson, Gerald M. Griffith & Daniel J. Bacastow, *Form 990 Disclosure Requirements Challenge Hospitals, Provide Opportunities*, 21 THE HEALTH LAWYER, Feb. 2009, at 1 (same). Cf. Rummana

consistent with more general increased concern over high executive compensation<sup>97</sup> and other wasteful nonprofit expenditures.<sup>98</sup> In particular, the Form 990 disclosures relating to board involvement in nonprofit governance were designed to increase transparency and accountability of nonprofit boards.<sup>99</sup> The Form 990 filing was amended to add a category of all “key employees” whose names and compensation must be disclosed.<sup>100</sup> Most importantly, the 2008 enhancements to Form 990 require the nonprofit to answer a number of questions. The Form 990 must indicate whether the organization provided a copy of the 990 (including all required schedules) to each voting member of the governing body prior to filing with the IRS.<sup>101</sup> The Form 990 must also describe the process by which the officers, directors, trustees, or management reviewed the form, whether the form was reviewed before it was filed with the IRS, who conducted the review, when it was conducted, and the extent of the review.<sup>102</sup>

A number of the questions in Form 990 are designed to address governance practices in setting executive compensation. In particular the

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Alam, Note, *Not What the Doctors Ordered: Nonprofit Hospitals and the New Corporate Governance Requirements of the Form 990*, 2011 U. ILL. L. REV. 229 (2011) (arguing that the IRS reforms are too burdensome); Karen Donnelly, Note, *Good Governance: Has the IRS Usurped the Business Judgment of Tax-Exempt Organizations in the Name of Transparency and Accountability?*, 79 U.M.K.C. L. REV. 163 (2010) (criticizing the IRS expansion of Form 990 as an unfortunate intrusion on corporate governance and the business judgment rule).

97. See, e.g., *Spitzer v. Grasso*, 816 N.Y.S.2d 863, 877 (N.Y. Sup. Ct. 2006) (denying defendant nonprofit CEO’s motion to dismiss challenges to executive compensation as excessive), *rev’d*, 893 N.E.2d 105 (N.Y. 2008); *Vacco v. Diamandopoulos*, 715 N.Y.S.2d 269, 273 (N.Y. Sup. Ct. 1998) (upholding attorney general’s complaint seeking to hold directors accountable for excessive compensation and mismanagement of university’s assets); Milton Cerny, Michelle A. W. McKinnon, Jeffrey R. Capwell & Kelly L. Hellmuth, *New Scrutiny Of College and University Executive Compensation and Unrelated Business Activity*, 37 J.C. & U.L. 93 (2010) (discussing increased IRS scrutiny of compensation).

98. See, e.g., Melanie B. Leslie, *The Wisdom of Crowds? Groupthink and Nonprofit Governance*, 62 FLA. L. REV. 1179 (2010) (calling for reinforced fiduciary duties and enhanced limitations on self-dealing and conflicts of interest); Evelyn A. Lewis, *Charitable Waste: Consideration of a “Waste Not, Want Not” Tax*, 30 VA. TAX REV. 39 (2010) (calling for tax on excess payments rather than a prohibition on such payments). Cf. John F. Coverdale, *Legislating in the Dark: How Congress Regulates Tax-Exempt Organizations in Ignorance*, 44 U. RICH. L. REV. 809 (2010) (criticizing 2006 reforms aimed at donor-advised funds).

99. The new Form 990 was implemented by Treasury Department release T.D. 9423, published in the Federal Register at 73 Fed. Reg. 52527 (2008) and embodied in the Treasury Regs. 26 C.F.R. 1.6033-2T.

100. “Key Employees” are defined in T.D. 9423 and on Form 990 as those making over \$150,000.

101. IRS Form 990 Part VI, Section B, Question 11(a) and (b); Instructions for Form 990.

102. *Id.*

Form 990 must disclose the number and list *independent* voting members on the governing body.<sup>103</sup> The Form 990 must state whether the nonprofit has a written conflict-of-interest policy.<sup>104</sup> The Form 990 must also disclose whether the nonprofit's officers, directors/trustees, and key employees are required to disclose annually interests that could give rise to conflicts.<sup>105</sup> The Form 990 must indicate whether the nonprofit contemporaneously documents meetings of the board and its committees.<sup>106</sup> The Form 990 must also indicate whether the process for determining the compensation for the CEO, key officers and key employees included a review and approval by independent persons, consideration of compensation data for comparable positions at similar organizations, and contemporaneous documentation of deliberations and decisions regarding compensation.<sup>107</sup>

The ultimate Internal Revenue Code sanction for excessive compensation or self-dealing can be loss of tax-exempt status.<sup>108</sup> Treasury

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103. A board member is deemed "independent" if three specific conditions are satisfied throughout the organization's tax year: 1. The board member was not a compensated employee of the organization or of a related organization; 2. The board member did not receive total annual compensation or other payments in excess of \$10,000 as an independent contractor (other than reimbursement of expenses under an expense reimbursement procedure) or reasonable compensation for services provided as a member of the board; and 3. Neither the board member, nor any family member of the board member, was involved in an "interested persons" transaction reportable on Schedule L. IRS Form 990 Part IV, Question 25a. "Interested Persons" include current and former officers, directors/trustees, key employees and the five highest compensated employees). Reportable transactions with interested persons now include excess benefit transactions; loans, grants or assistance; and business transactions that exceed specified thresholds. IRS Form 990; *see also, e.g.*, Kathleen M. Boozang, *Does an Independent Board Improve Nonprofit Governance?*, 75 TENN. L. REV. 83 (2007) (arguing that the "ongoing move toward board and director independence in the nonprofit sector appears to be a movement without a clear goal, supported by little evidence that independence has accomplished improvements in the business sector"); Dana Brakman Reiser, *Director Independence in the Independent Sector*, 76 FORDHAM L. REV. 795 (2007) (discussing independent directors in the context of nonprofit organizations).

104. IRS Form 990 Part VI, Section B, Question 12a.

105. *Id.* at Question 12b.

106. *Id.* at Question 8(a) and (b).

107. *Id.* at Question 15(a) and (b). Affirmative responses will allow the nonprofit to qualify for the rebuttable presumption that the compensation is reasonable. Treas. Reg. § 53.4958-6 (2002).

108. Under I.R.C. § 4958 (2011), a violation of section 501(c)(3)'s language against private inurement can result either in an excess-benefit tax or in revocation of tax-exempt status. Prior to 1996, violation of the private inurement clause was limited to revocation of tax-exempt status. With the enactment of section 4958 in 1996, a new middle ground was created where "intermediate sanctions" could be applied solely to persons involved in the excess benefit transaction rather than full revocation of exempt status. I.R.C. § 4958 (2011).

Regulation section 1.501(c)(3)-1(F)(2)(ii) sets forth factors to be considered in deciding the appropriate remedy for abuse of charitable tax-exempt status.<sup>109</sup> Mitigating factors include safeguards or oversight procedures instituted by the nonprofit to protect against excessive compensation or self-dealing.<sup>110</sup>

The absence of appropriate internal controls can thus have dire consequences for the organization. For example, the IRS has cited the lack of internal controls, the board's failure to question the organization's use of funds, and the lack of internal safeguards against excess benefit transactions as contrary to Treasury Regulation 1.501(c)(3)-1(F)'s guidelines and thus grounds for revoking tax-exempt status.<sup>111</sup> In this instance, as pointed out by the IRS, the board's failure to notice or inquire about a manager's self-dealing was problematic.<sup>112</sup> Also of concern was the failure to have documentation for loans made to the organization's manager.<sup>113</sup> In revoking exemption, the government referred to Treas. Reg. § 1.501(c)(3)-1(F)'s "safeguards" and "correction measures" as the "killer" factors in determining the appropriateness of revocation.<sup>114</sup> The ruling also noted that internal controls and safeguards weigh most heavily against revocation only when preliminary steps for correction have begun before the IRS becomes aware of the situation. Thus, it appears that safeguards and internal controls are an important preventative measure for nonprofit

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109. Enacted in 2008, Treas. Reg. 1.501(c)(3)-1-(F)(2)(ii) provides guidelines for deciding the appropriate penalty. Briefly, those guidelines look to size, scope, frequency, prevention measures, and correction measures taken with respect to the transaction. The prevention measures are outlined in paragraph D. *Id.*

110. *Id.* See also I.R.S. Priv. Ltr. Rul. 201113041 (Jan. 7, 2011), at 13.32 ("[s]ufficient safeguards have not been put in place to prevent future violations . . .").

111. I.R.S. Priv. Ltr. Rul. 201029035 (Apr. 2, 2010), at 14.

112. The manager had used the organization's funds for a multitude of personal expenses and was never questioned by her board, which was described as composed of "'yes' people." *Id.*

113. *Id.*; see also I.R.S. Priv. Ltr. Rul. 2010150145 (Jan. 8, 2010), at 8 (revoking exemption because the organization gave money to its director, who labeled it a "loan"). The ruling spent a good deal of time discussing the failures in oversight that help make this transaction illegitimate:

Moreover, there is no credible evidence that the terms of the "loans" to FN were considered by the entire board of directors . . . or that the purported loans were reviewed by anyone acting in the interests of charity. Although FN have provided the Internal Revenue Service with a statement . . . stating the Board approved the loans when the Foundation was formed, this approval is not documented in any minutes of the Board. There is also no evidence that the Foundation made any attempts at collection when FN failed to repay the "loans" according to their purported terms.

*Id.*

114. I.R.S. Priv. Ltr. Rul. 201029035, 2010 PLR LEXIS 809, at 25 (Apr. 2, 2010).



boards. In addition, in a close case, documentation of board involvement is an important factor in determining whether benefits were excessive.<sup>115</sup>

The excessive benefits need not be the result of intentional wrongdoing since it is the size of the benefit that counts.<sup>116</sup> The IRS has indicated the type of remedial steps that could help restore tax-exempt status for an organization that had excessive private inurements. A key preventative measure in this regard is an unbiased independent board<sup>117</sup> having proper procedures in place.<sup>118</sup>

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115. See, e.g., *Founding Church of Scientology v. United States*, 412 F.2d 1197, 1202 (Ct. Cl. 1969), *cert. denied*, 397 U.S. 1009 (1970) (noting that the organization could not produce any documents evidencing the indebtedness and concluding that the church had failed to meet its burden of proof that a part of the corporate earnings was not a source of benefit to private individuals); *Ramses Sch. v. Comm’r*, 93 T.C.M. 1092, \*31–32 (2007) (holding that the lack of documented minutes for board discussions regarding a questionable lease naturally failed to satisfy the burden); Rev. Rul. 59-95, 1959-1 C.B. 627 (observing that failure to document transactions resulted in revocation); I.R.S. Priv. Ltr. Rul. 201029035, *supra* note 111 (noting that lack of documentation weighed in favor of revocation of tax exempt status).

116. For example, ordinarily compensation that is based on the organization’s profits or revenue is improper. Except for profit-sharing arrangements meeting the requirements in I.R.C. § 401, the general rule is that compensation for an individual cannot be based on the corporation’s earnings without some kind of cap or restraint. To do so would be to inure earnings to private benefit. In the most obvious case, an executive sets his compensation to simply match a percentage of the corporation’s net profits for that year. *Gemological Inst. of Am., Inc. v. Riddell*, 149 F. Supp. 128, 130 (S.D. Cal. 1957) (refusing to accept the argument that a particular compensation is not part of net earnings simply because it is merely *measured by* the amount of those earnings). The court in *Riddell* echoed the proposition in *People of God Cmty. v. Comm’r of Internal Revenue*, 75 T.C. 127, 132 (1980), that no matter what a person’s services are worth, they are not directly related to the organization’s gross receipts that include charitable contributions. Cf. *Birmingham Bus. Coll., Inc. v. Comm’r*, 276 F.2d 476, 480 (5th Cir. 1960) (refraining from distributing profits during lean years does not counteract such actions taken during better times).

117. See, e.g., I.R.S. Priv. Ltr. Rul. 201113041, *supra* note 110 (noting the importance of an independent board). The IRS has indicated that “how” the organization is governed is a factor in determining if the organization is primarily conducting exempt activities. I.R.S. Priv. Ltr. Rul. 200851024 (Aug. 5, 2008) (“Therefore, we find that the governance of ORG, in composition and in their (lack of) actions, is a factor highly in favor of ORG not operating primarily to further education within the meaning of 501(c)(3).”).

118. The type of controls that the IRS is looking for is illustrated by the following statement of what could be done to reinstate tax exempt status for an organization that had it revoked:

Once the President has employed his best efforts to populate the Board with additional members unrelated to him; has resigned from the Board after doing so; has found competent financial help; has adopted a conflict of interest policy; and has attended educational symposia to improve his management skills . . . the new organization could then reapply for exemption.

I.R.S. Priv. Ltr. Rul. 201113041, *supra* note 110, at 13.

In addition to having an impact on IRS sanctions in the case of excessive benefits, proper procedures and board oversight can be important in avoiding a finding of excess benefits in close cases. Code section 4958 and its accompanying Regulation 53.4958-6 provide that payments under a compensation arrangement are entitled to a rebuttable presumption of reasonableness (meaning they are not excess benefit transactions and do not violate private inurement) when the following three elements are met: (1) a disinterested body of the organization, (2) relies on comparable data and (3) properly documents the basis for the decision.<sup>119</sup> Thus, obtaining such a presumption for an individual's compensation would require proper oversight actions by other members of the organization.<sup>120</sup> The lack of proper oversight procedures may even raise an inference that the board at least tacitly approved of the improper benefits.<sup>121</sup> For example, lack of conflict of interest protections in approving expense reimbursements has led to imposition of IRS sanctions.<sup>122</sup>

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119. I.R.C. § 4958 (2011); Treas. Reg. § 53.4958-6 (2002).

120. Treas. Reg. § 53.4958-6 provides that an authorized body has appropriate data as to comparability if, given the knowledge and expertise of its members, it has information sufficient to determine whether the property transfer or compensation is at fair market value. Where there was no evidence that the personnel committee had any particular knowledge or expertise in determining whether compensation paid to the chief executive officer of a large hospital system was reasonable, the government cites the lack of consideration of any compensation analysis, and states that the five-year-old analysis that was available would have been inadequate even if considered. I.R.S. Priv. Ltr. Rul. 200244028 (June 21, 2002). The government listed several alternative comparisons that would have satisfied the comparability prong, such as "compensation levels paid by similarly situated organizations, the availability of similar services in M's geographic area, compensation surveys compiled by independent firms or actual written offers from similar institutions competing for A or B's services." *Id.* at 15.

121. The board's poor oversight abilities can suggest that the organization has been operated primarily for non-exempt purposes. I.R.S. Priv. Ltr. Rul. 201113041, *supra* note 110. One person ran the organization with a governing board consisting of that person, his wife, and his father. The IRS found that the board did not constitute an independent body, and that this created an inherent conflict of interest when the board was placed in a position to approve financial transactions involving other family members. The IRS concluded that:

[t]he organization does not have a conflict of interest policy. The records of the organization evidenced the fact that operating under the control of one person or a small, related group suggests that an organization operates primarily for non-exempt private purposes, rather than exclusively for public purposes, which is the basis for exemption of any 501(c)(3) organization.

*Id.* at 11.

122. For example, in one private letter ruling the IRS stated "Due to a lack of oversight in your organizational structure, incidents of conflict of interest are not addressed . . . you have not proved that your net earnings would not inure to the benefit of private individuals, your board member and officer." I.R.S. Priv. Ltr. Rul. 201108042 (Dec. 2, 2010), at 1442.

The absence of a good governance structure has in some cases led the IRS to conclude that the organization was not primarily pursuing charitable goals.<sup>123</sup> It is noteworthy that the organization has the burden of establishing that it is operating for a proper charitable purpose.<sup>124</sup> It is important to recognize that although it is part of a new enforcement initiative, the enhanced Form 990 did not create new law. Even prior to enactment of the enhanced disclosure obligations, the IRS looked to the organization's ability to provide documentation for transactions that it considered compensation in comparable organizations.<sup>125</sup>

Notwithstanding the criticism in some circles that the enhanced Form 990 is an unwarranted intrusion into charitable operations,<sup>126</sup> the burdens imposed by the IRS are not excessive. In the first instance, the Form 990 is merely providing enhanced disclosure to enable the IRS to enforce its preexisting rules for charitable organizations. Disclosure has further ameliorative effects by shedding light on practices that may violate the home state's governance rules and providing a basis for enforcement by the attorney general. As Louis Brandeis astutely observed nearly a century ago, sunlight is the best disinfectant.<sup>127</sup> Disclosure thus has a significant impact on conduct.<sup>128</sup>

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123. See, e.g., I.R.S. Priv. Ltr. Rul. 200830028 (Apr. 28, 2008), at 6, wherein it was noted that:

You have not adopted bylaws or provided specific information about the governance of your organization, nor have you adopted a conflict of interest policy. In addition, you do not have any members outside of A's family and no other organization exercises significant influence over you.

The structure of your organization indicates that it can be used to benefit private individuals, such as A and his family, and you lack safeguards that would help to prevent such use. In addition, you have provided no evidence that the organization will not be used for the benefit of private individuals. Therefore, you have not met your burden to prove that you will be operated for public rather than private purposes.

124. *Id.*

125. See, e.g., *John Marshall Law Sch. v. United States*, 228 Ct. Cl. 902, 35, 81–2 U.S. Tax Cas. (CCH) ¶ 9514 (1981) (upholding denial of tax-exempt status for past tax years and noting that “[p]erhaps the most significant factor in passing upon the reasonableness of compensation in a tax case is a comparison between the compensation that is under consideration and the prevailing rates of compensation paid to the holders of comparable positions by comparable companies within the same industry.”) (quoting *Jones Bros. Bakery, Inc. v. United States*, 411 F.2d 1282, 1291 (1969)) (internal quotation marks omitted).

126. See, e.g., Karen Donnelly, Note, *Good Governance: Has the IRS Usurped the Business Judgment of Tax-Exempt Organizations in the Name of Transparency and Accountability?*, 79 U.M.K.C.L. REV. 163 (2010) (criticizing the IRS policy).

127. See LOUIS D. BRANDEIS, *OTHER PEOPLE'S MONEY AND HOW THE BANKERS USE IT* 62

Apart from compensation issues, tax-exempt status can be compromised by partnering with for-profit operations.<sup>129</sup> For example, in the context of a joint venture with an organization, it is crucial that the nonprofit have control over the enterprise.<sup>130</sup> Nonprofit parent-subsidiary relationships also raise questions about establishing proper governance structures for the affiliated corporations.<sup>131</sup> Corporate governance can be an important factor in determining whether to treat separate entities as a single entity for the purpose of determining tax-exempt status.<sup>132</sup> For

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(Richard M. Abrams ed., 1914) (“[S]unlight is said to be the best of disinfectants; electric light the most efficient policeman.”).

128. See, e.g., Cynthia A. Williams, *The Securities and Exchange Commission and Corporate Social Transparency*, 112 HARV. L. REV. 1197, 1222 (1999) (noting that Felix Frankfurter agreed and, for example, “wrote an article in *Fortune* magazine about the anticipated social and financial effects of the [Securities] Act. Frankfurter was quite explicit that the purpose of disclosure was to affect the behavior of corporate managers, bankers, and accountants.”). For discussion of the federal securities laws’ focus on disclosure as effecting conduct, see THOMAS LEE HAZEN, TREATISE ON THE LAW OF SECURITIES REGULATION § 1.2 (6th ed. 2009) (discussing the history, scope and coverage of state and federal securities laws).

129. See, e.g., Linda M. Lampkin, *IRS Increases Enforcement Focus on Nonprofit Executive Compensation*, GUIDESTAR.COM, <http://www2.guidestar.org/rxa/news/articles/2007/irs-increases-enforcement-focus-on-nonprofit-executive-compensation.aspx?articleId=1111> (Feb. 2007) (noting how IRS identifies non-profits for increased scrutiny of executive compensation and how non-profits can avoid problems arising out of executive compensation).

130. See, e.g., Rev. Rul. 98-15, 1998-1 C.B. 718. (listing several incriminating oversight failures, including the following: that the exempt organization does not have a majority voice on the board of the joint venture; that the management company and the officers are related to the for-profit partner; and that the management company has discretion to enter into all but “unusually large” contracts without board approval, including extension of their management contract).

131. Proper governance of subsidiaries by parent non-profits is important to a subsidiary’s tax-exempt status. See, e.g., I.R.S. Priv. Ltr. Rul. 200204040 (Oct. 30, 2001) (“X’s [subsidiary’s] making of grants to organizations other than Y [parent] does not violate the 509(a)(3) [private foundation] operational test where, as here, Y’s board may disapprove any such grant—such procedure is substantially similar to the making of grants to Y.”). Also, in determining whether the parent in fact controls the subsidiary, the IRS looks to the parent’s “manner of exercising voting rights with respect to stocks in which members of its governing body also have some interest.” *Id.* at 6.

132. For example, IRS Regulation 1.170A-9(e)(11) provides rules for determining whether a trust or funds may be treated as component parts of a community trust, to meet the requirements for classification as a “publicly supported” organization under section 170(b)(1)(A)(vi) of the Code. If the requirements of section 1.170A-9(e)(11) are met, the community trust will be treated as a single entity, and its separate funds as component parts of that entity for purposes of sections 170, 501, 507, 508, 509 and chapter 42 of the Code. The relevant requirements include:

The organization must have a common governing body that either directs, or in the case of a fund designated for specific beneficiaries, monitors the distribution of all funds exclusively for charitable purposes. (section 1.170A-9(e)(11)(v)).

example, corporate governance has been an important factor in examining the relationship between a foundation and the entity or entities that it supports.<sup>133</sup>

It is clear that inadequate board oversight of a nonprofit's grant-making decisions can also be a contributing factor in loss of tax exempt status.<sup>134</sup> Thus, it is critical for non-profit corporate boards and

The governing body must have the following powers: (section 1.170A-9(e)(11)(v)(B))

...

The governing body must commit itself to obtain information and take appropriate steps to ensure that each trustee administers the trusts or funds under its control according to each individual governing instrument and accepted standards of fiduciary conduct to produce a reasonable return of net income. The governing body's responsibility extends both to individual trusts or funds, and the aggregate of trusts or funds, held by each trustee. (section 1.170A-9(e)(11)(v)(F)).

The organization must prepare periodic financial reports treating all the funds it holds, either directly or as component parts, as its funds. (section 1.170A-9(e)(11)(vi)).

I.R.S. Priv. Ltr. Rul. 200114039, 2001 PLR LEXIS 22, at 7-9 (Jan. 5, 2001). The IRS goes on to require that the Board of Directors shall monitor all activities of the corporation, and that the corporation must prepare periodic financial reports regarding all the funds which will be held by the Corporation as funds of the organization. *Id.* at 13.

133. Section 509(a)(3) sets forth a relationship test between the supporting and the supported organization which requires, as set forth in Regulation 1.509(a)-4(f)(2), one of three permissible relationships: (i) operated, supervised, or controlled by; (ii) supervised or controlled in connection with; and (iii) operated in connection with one or more publicly supported organizations. Addressing the first type of relationship above, the IRS noted that such relationship is satisfied where "a majority of the officers, directors, or trustees of the supporting organization are appointed or elected by the governing body . . . of the publicly supported organization." I.R.S. Priv. Ltr. Rul. 200946065 (Aug. 17, 2009), at 16. Regarding the second type of relationship mentioned above, such relationship exists where "there is common supervision or control by the persons supervising or controlling both the supporting and the publicly supported organizations, i.e., that control or management of the supporting organization is vested in the same persons . . ." *Id.* Essentially, the board of the supported organization must either appoint or supervise/control the board of the supporting organization in order for it to be considered a supporting organization. For a discussion of the third type of relationship mentioned above, see I.R.S. Priv. Ltr. Rul. 201019034 (May 14, 2009), which requires that the board member appointed by the supported organization have a significant voice in the operations of the supporting organization.

134. For example, in I.R.S. Priv. Ltr. Rul. 201113036 (Jan. 7, 2011), the IRS noted that "[t]here is no evidence of any discussion relating to applications filed by potential grantees; no discussion of how grantees are going to use the funds; and no evidence that Company conducted investigations of potential grantees." The letter then concludes that the level of control exercised over the grant-making program was not "appropriate," and that absent such appropriate control "[a]pplicant's grant-making program operates as a conduit to direct charitable donations to non-501(c)(3) organizations . . . [and,] [t]herefore, Applicant is not

management to exercise good oversight of their charitable donation (or grant-making) arms, lest they help the wrong people and lose their exemptions.<sup>135</sup>

Following the pattern of for-profit corporations,<sup>136</sup> the law relating to nonprofit corporation formation and organization is determined by the state of incorporation.<sup>137</sup> As is the case with for-profit corporations, the most prominently referenced duties of nonprofit directors are the duties of care, good faith, and loyalty. The discussion that follows addresses the duties of care (including good faith), loyalty, and obedience.

## VI. DUTY OF CARE

The duty care for business corporation directors developed as a matter of case law<sup>138</sup> and has since been codified in most business corporation acts.<sup>139</sup> The duty of care includes obligations of keeping informed, remaining attentive, and acting in a manner that the director *reasonably* believes is in the best interest of the corporation.<sup>140</sup> Previously, the law phrased the obligation more in terms of a reasonable person standard so as to judge care according to a reasonable director under like circumstances.<sup>141</sup> Today most statutes speak in terms of a reasonable belief that the director is acting in the best interests of the corporation.<sup>142</sup> This change in language may be more semantic than substantive since both are objective tests based on *reasonableness* and are not limited to the director's subjective good faith belief. The Model Nonprofit Corporation Act retained the prudent person standard until 2008 when it was redrafted to speak in terms of the director's good faith belief of acting in the corporation's best interest.<sup>143</sup>

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operated for tax-exempt purposes . . . ." *Id.* at 10.

135. *Id.*

136. See, e.g., Thomas Lee Hazen, *Corporate Directors' Accountability: The Race to the Bottom—The Second Lap*, 66 N.C. L. REV. 171 (1987) (noting that choice of law is determined by the state of incorporation).

137. See, e.g., Garry W. Jenkins, *Incorporation Choice, Uniformity, and Reform of Nonprofit State Law*, 41 GA. L. REV. 1113 (2007) (discussing incorporation of nonprofit organizations).

138. See, e.g., *Bates v. Dresser*, 251 U.S. 524 (1920) (noting that directors oversee the operations but are not held directly accountable for day to day management); *Hun v. Cary*, 82 N.Y. 65 (1880) (holding that a corporate director must act in the same manner as a reasonable person in managing his or her own affairs).

139. See, e.g., MODEL BUS. CORP. ACT § 8.30 (2011) (discussing directors' standard of conduct).

140. COX & HAZEN, *supra* note 70, §§ 10:1, 10:3.

141. *Id.* § 10:3.

142. *Id.*

143. The comments to the 2008 version of the Model Nonprofit Act explain the change as follows:

Many state statutes retain the reasonable person standard.<sup>144</sup> In addition, the American Law Institute's draft Principles of Nonprofit Law retains the reasonable person language that sounds more like a traditional negligence standard.<sup>145</sup>

Business corporation directors' duty of care is eased to some extent as it is qualified by the business judgment rule that was developed in case law.<sup>146</sup> The business judgment rule in essence allows the directors to make what turn out to be bad decisions since courts do not view their role as second-guessing the business community with respect to business

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In the prior version of the act the duty of care element was included in subsection (a), with text reading: "[a] director shall discharge his duties . . . with the care an ordinarily prudent person in a like position would exercise under similar circumstances." The use of the phrase "ordinarily prudent person" in a basic guideline for director conduct, suggesting caution or circumspection vis-à-vis danger or risk, has long been problematic given the fact that risk-taking decisions are central to the directors' role. When coupled with the exercise of "care," the prior text had a familiar resonance long associated with the field of tort law. See the Official Comment to Section 8.31. The further coupling with the verb "shall discharge" added to the inference that former Section 8.30(a)'s standard of conduct involved a negligence standard, with resultant confusion. In order to facilitate its understanding, and analysis, independent of the other general standards of conduct for directors, the duty of care element has been set forth as a separate standard of conduct in subsection (b).

MODEL NONPROFIT CORP. ACT—Official Text with Official Comments and Statutory Cross-References § 8.30 (3d ed. 2008).

144. See, e.g., CAL. CORP. CODE § 5231(a)(2011) ("A director shall perform the duties of a director . . . in a manner that director believes to be in the best interests of the corporation and with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances."); MINN. STAT. § 317A.251 (2011) ("A director shall discharge the duties of the position of director in good faith, in a manner the director reasonably believes to be in the best interests of the corporation, and with the care an ordinarily prudent person in a like position would exercise under similar circumstances."); N.C. GEN. STAT. § 55A-8-30 (1994) (a director must act "(1) In good faith; (2) With the care an ordinarily prudent person in a like position would exercise under similar circumstances; and (3) In a manner he reasonably believes to be in the best interests of the corporation.").

145. With respect to nonprofit directors, the American Law Institute's draft Principles of Nonprofit Law provides:

The duty of care requires each governing-board member—

- (a) to become appropriately informed about issues requiring consideration, and to devote appropriate attention to oversight; and
- (b) to act with the care that an ordinarily prudent person would reasonably exercise in a like position and under similar circumstances.

ALI NONPROFIT PRINCIPLES, *supra* note 37, § 315.

146. COX & HAZEN, *supra* note 70, § 10:2.

decisions.<sup>147</sup> The business judgment rule is conditioned on the directors' informing themselves and uninformed directors will not get the rule's protection.<sup>148</sup>

The American Law Institute's draft Principles of the Law of Nonprofit Organizations reflects the general understanding that the duty of care consists of a combination of a duty to be informed and then act in a manner consistent with a reasonably prudent director under like circumstances.<sup>149</sup>

As discussed below, there are limitations on liability for due care violations. However, even in the absence of clear liability, nonprofit directors should be motivated to live up to their statutory responsibilities. For example, there is some evidence that when a nonprofit board is populated with large donors, there is greater efficiency in monitoring management's activities.<sup>150</sup> There is some evidence that this can result in

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147. See, e.g., *Shlensky v. Wrigley*, 237 N.E.2d 776, 780–81 (1968) (refusing to second-guess the directors' judgment not to install lights in Wrigley Field even though every other major league baseball team played night games and revenues for weekday night games were higher than day games).

148. See, e.g., *Smith v. Van Gorkom*, 488 A.2d 858 (1985) (holding that directors of for-profit corporation could be held accountable for approving sale of company without using due diligence); see also *Armenian Assembly of Am., Inc. v. Cafesjian*, 772 F. Supp. 2d 20, 103–04 (D.D.C. 2011) (acknowledging the application of the business judgment rule to nonprofit directors but not where the directors have an actual or potential conflict of interest).

149. ALI NONPROFIT PRINCIPLES, *supra* note 37, § 315.

150. See, e.g., Jeffrey L. Callen, April Klein & Daniel Tinkelman, *Board Composition, Committees, and Organizational Efficiency: The Case of Nonprofits*, 32 NONPROFIT & VOLUNTARY SECTOR Q. 493 (2003) (finding a significant statistical association between the presence of major donors on the board and indicators of organizational efficiency. Although causation was not demonstrated conclusively, the findings are consistent with the suggestion that that major donors are likely to monitor nonprofit organizations at least in part through their board membership); see also Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, 301–02 (1983) (contending “that separation of decision and risk-bearing functions survives in these organizations in part because of the benefits of specialization of management and risk bearing but also because of an effective common approach to controlling the agency problems caused by separation of decision and risk-bearing functions”). The Callen, Klein & Tinkelman article's analysis indicates that the ratio of total expenses to program expenses is significantly and negatively associated with higher donor representation. For example, the number of major donors on the finance committee that oversees budgets and administrative expenses correlates inversely with the nonprofit's administrative expenses. Callen, Klein & Tinkelman, *supra* note 150. However, having major donors on other committees does not show a statistically significant correlation with nonprofit efficiency. *Id.*; see also Eddy Cardinaels, *Governance in Not-for-profit Hospitals: Effects of Board Members' Remuneration and Expertise on CEO Compensation*, 93 HEALTH POL'Y, 64–75 (Nov. 2009) (“The findings suggest that supervisory boards are more effective in controlling agency problems (i.e., aligning CEO pay to economic conditions) when their members have more expertise, but at the same time that the monitoring function is hampered when supervisory board members receive a large (excessive) remuneration.”).



positive outcomes when balanced by management representation on the board.<sup>151</sup> Although having management on nonprofit boards can have positive benefits, the presence of management does not eliminate the need and, if anything, increases the need for independent oversight.<sup>152</sup>

A separate topic in itself, and thus one not addressed by this article, is a director's or trustee's obligations with respect to investment and management of a charity's assets.<sup>153</sup> Investment decisions and the like are governed by prudent investment requirements.<sup>154</sup>

While it is true that the volunteer nature of most nonprofit directors may be a factor in considering liability for mismanagement, it is not a complete bar.<sup>155</sup> Thus, for example, where directors allowed foundation funds to sit in non-interest bearing accounts, the court found this to be a breach of duty.<sup>156</sup> Directors also may be held accountable for allowing mismanagement of assets.<sup>157</sup> It is generally accepted that mere negligence is not sufficient to hold a nonprofit director or officer accountable.<sup>158</sup>

151. Edward A. Dyl, Howard L. Frant & Craig A. Stephenson, *Governance and Funds Allocation in United States Medical Research Charities*, 16 FIN. ACCOUNTABILITY & MGMT. 4 (Nov. 2000).

152. See generally Eric W. Hayden, *Governance Failures Also Occur in the Non-Profit World*, 2 INT'L J. OF BUS. GOVERNANCE & ETHICS 116 (2006) (stating that "governance suffers when boards are dominated by affiliated outsiders or when the allegiance of the board is not fully committed to the organisation's mission and ongoing financial viability").

153. See, e.g., William Meade Fletcher, 6 FLETCHER CYC. CORP. § 2603 (current through 2011) (noting "[g]enerally, charitable corporations . . . can hold property in trusts that are within the objects of their creation, and . . . may act as substitute trustee for another such corporation") (internal citations omitted).

154. See, e.g., NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS, UNIFORM PRUDENT MANAGEMENT OF INSTITUTIONAL FUNDS ACT (2006) (outlining obligations of directors of institutional funds); see also Susan N. Gary, *Is it Prudent to be Responsible? The Legal Rules for Charities that Engage in Socially Responsible Investing and Mission Investing*, 6 NW. J.L. & SOC. POL'Y 106 (2011) (discussing limits on prudent investing); Steven J. Riekes, *Is the Law Causing Charities to Drown Because Their Endowment Funds Are Now Under Water?*, 43 CREIGHTON L. REV. 529 (2010) (discussing the ability to dip into the endowment during tough economic times); Peter Conti-Brown, Note, *Scarcity Amidst Wealth: The Law, Finance, and Culture of Elite University Endowments in Financial Crisis*, 63 STAN. L. REV. 699 (2011) (discussing restrictions on spending); Rachel M. Williams, Note, *Transitioning from UMIFA to UPMIFA: How The Promulgation of the Uniform Prudent Management of Institutional Funds Act Will Affect Donor-Initiated Lawsuits Brought Against Colleges and Universities*, 37 J.C. & U.L. 201 (2010) (discussing impact of prudent funds management law on donors' suits).

155. See discussion of qualified immunity for volunteers in the text accompanying notes 327–43 *infra*.

156. *Lynch v. John M. Redfield Found.*, 88 Cal. Rptr. 86 (Cal. Ct. App. 1970).

157. *Vacco v. Diamandopoulos*, 715 N.Y.S.2d 269, 270 (N.Y. Sup. Ct. 1998).

158. See, e.g., *La. World Exposition v. Fed. Ins. Co.*, 864 F.2d 1147 (5th Cir. 1989)

Another area that falls within directors' oversight is the manner in which nonprofits solicit funds. Charitable solicitations are often governed by consumer (or donor) protection statutes.<sup>159</sup> Discussion of those consumer protection issues go beyond the scope of this article.

On occasion nonprofit hospitals convert into or are acquired by for-profit entities. In such a situation, the board is forsaking the nonprofit mission. Acquisitions of nonprofit hospitals by for-profit companies have been challenged on the grounds that the sale was for less than fair value.<sup>160</sup>

#### A. *Business Judgment Rule*

Although nonprofit corporations are not focused on business decisions, the business judgment rule is recognized in the nonprofit context. For example, the ALI's Principles of Nonprofit Law provides:

A governing-board member who makes a business judgment in good faith satisfies § 315 (Duty of Care) if he or she:

- (a) is not interested, directly or indirectly, in the subject of the business judgment and is otherwise able to exercise independent judgment;
- (b) is informed with respect to the subject of the business judgment to the extent he or she reasonably believes to be appropriate under the circumstances; and
- (c) reasonably believes that the business judgment is in the best interests of the charity, in light of its stated purposes.<sup>161</sup>

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(holding that simple negligence alone by an officer or director of a non-profit corporation is insufficient for a finding of personal liability for that officer or director).

159. See, e.g., 10 PA. STAT. ANN. §§ 162.5–162.17 (West 2011) (stating the consumer protection statute for Pennsylvania); see also Jamie Usry, *Charitable Solicitation Regulation for the Nonprofit Sector: Paving the Regulatory Landscape for Future Success*, CENTER FOR PUBLIC POLICY & ADMINISTRATION, Policy Perspectives (July 30, 2008), [http://www.imakenews.com/cppa/e\\_article001162331.cfm](http://www.imakenews.com/cppa/e_article001162331.cfm) (summarizing charitable solicitation laws).

160. See, e.g., *Mary v. Lupin Found.*, 609 So.2d 184 (La. 1992) (allowing suit by member and director of nonprofit challenging sale of nonprofit hospital to a for-profit company); see also Letter on behalf of Service Employees International Union to Michigan Attorney General Mike Cox (Sept. 27 2010), [http://www.michigan.gov/documents/ag/SEIU\\_DMC\\_Letter\\_333733\\_7.pdf](http://www.michigan.gov/documents/ag/SEIU_DMC_Letter_333733_7.pdf) (urging state attorney general to challenge sale of nonprofit hospital to a for-profit corporation). The challenged transaction was approved by the attorney general. Press Release, Attorney General Bill Schuette, Cox Announces Approval for Sale of Detroit Medical Center to Vanguard (Nov. 13, 2011), <http://www.michigan.gov/ag/0,1607,7-164--247096--,00.html>. Cf. *German Corp. of Negaunee v. Negaunee German Aid Soc'y*, 138 N.W. 343 (Mich. 1912) (holding that a sale of nonprofit's assets was for less than fair value).

161. ALI NONPROFIT PRINCIPLES, *supra* note 37, § 365 (Tent. Draft No. 1, 2007).

Although not all observers agree that it is appropriate,<sup>162</sup> the business judgment rule is a factor in assessing conduct of nonprofit directors. A key point in this regard is the directors' duty to be informed in making decisions.

## VII. DUTY OF LOYALTY

The duty of loyalty is an important concept in both corporate law and the law of trusts.<sup>163</sup> Among other things, the duty of loyalty addresses situations in which a director has a direct or indirect conflict of interest.<sup>164</sup> In its early stages, the rules relating to directors' obligations of loyalty borrowed heavily from the strict rules governing trustees and agents.<sup>165</sup> The cases often classified corporate directors as trustees and subjected them to strict rules of disqualification of agents contracting with their principal.<sup>166</sup> References to directors as trustees continue in current case law.<sup>167</sup> Whereas the duty of care is often viewed as a matter of process, the

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162. See, e.g., Denise Ping Lee, Note, *The Business Judgment Rule: Should it Protect Nonprofit Directors?*, 103 COLUM. L. REV. 925 (2003) (arguing that the current standard for nonprofit directors is too low and urging that courts should not apply the business judgment rule that developed to deal with for-profit corporations to insulate directors from liability for lack of due diligence).

163. See, e.g., Melanie B. Leslie, *Making Nonprofits Police Themselves: What Trust Law Can Teach Us About Conflicts of Interest*, 85 CHI-KENT L. REV. 551 (2010) (discussing the different standards of fiduciary duties in trust law and corporate law).

164. COX & HAZEN, *supra* note 70, §§ 10:11–10:19.

165. *Id.* § 10:11 (discussing the origins and development of the duty of loyalty).

166. See, e.g., *Stack v. Welder*, 31 P.2d 436 (Cal. Ct. App. 1934) (discussing the narrow conditions in which a director of a corporation may deal directly with that corporation); *N. Confidence Mining & Dev. Co. v. Fitch*, 208 P. 328 (Cal. Ct. App. 1922) (holding that a director with an adverse interest in the settlement of a claim could not vote on a resolution of the settlement); *Gates v. Plainfield Trust Co.*, 191 A. 304, 318 (N.J. Ch. 1937) (detailing, among other things, the duties a trustee has to his beneficiaries), *aff'd*, 194 A. 65 (N.J. 1937); see also RESTATEMENT (SECOND) OF AGENCY §§ 389–393 (1958) (stating the law of agency on the issues of adverse parties and conflicts of interest).

167. On the general topic of determining the roots for corporate fiduciary obligations, see Victor Brudey, *Contract and Fiduciary Duty in Corporate Law*, 38 B.C. L. REV. 595 (1997) (proposing a modified contract-based account of a director's fiduciary duty); Deborah A. DeMott, *Breach Of Fiduciary Duty: On Justifiable Expectations Of Loyalty And Their Consequences*, 48 ARIZ. L. REV. 925 (2006) (noting that duty arises from shareholders' justifiable expectations of loyal conduct); Lyman P.Q. Johnson & David Millon, *Recalling Why Corporate Officers Are Fiduciaries*, 46 WM. & MARY L. REV. 1597 (2005) (outlining the history and duties of corporate officers); Park McGinty, *The Twilight of Fiduciary Duties: On the Need for Shareholder Self-Help in an Age of Formalistic Proceduralism*, 46 EMORY L.J. 163 (1997) (arguing that shareholder protections from director self-interest are inadequate, and proposing various means that a stockholder can take to counter-balance director interests); Edward Rock & Michael Wachter, *Dangerous*

duty of loyalty is more about substance, focusing on the director's or officer's motives, purposes, and goals.<sup>168</sup>

The duty of loyalty, among other things, forbids many self-dealing contracts and transactions, which more generally are referred to as conflict-of-interest transactions. A director will not receive the benefit of the business judgment rule if acting out of self-interest and thus not serving the organization's interests.<sup>169</sup> An even more blatant form of loyalty breach arises when the officer or director has usurped a corporate opportunity.<sup>170</sup> Interestingly, in special instances, loyalty violations can even arise when the directors or officers are acting in their good faith belief that they are advancing the corporation's interest.<sup>171</sup> Duty of loyalty and potential conflict of interest situations place directors under a heightened duty of disclosure.<sup>172</sup> For example, a director's duty of loyalty arises when the director, even though financially disinterested, knowingly fails to warn other directors of material facts relevant to a transaction before the board.<sup>173</sup>

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*Liasons: Corporate Law, Trust Law, And Interdoctrinal Legal Transplants*, 96 NW. U. L. REV. 651 (2002) (arguing that loyalty standards within corporate law are more nuanced than in the context of trusts reflecting their differing institutional settings); D. Gordon Smith, *The Critical Resource Theory of Fiduciary Duty*, 55 VAND. L. REV. 1399 (2002) (crafting a unified theory of fiduciary duty as a "critical resource theory"); Lynn A. Stout, *On The Proper Motives Of Corporate Directors (Or, Why You Don't Want To Invite Homo Economicus To Join Your Board)*, 28 DEL. J. CORP. L. 1 (2003) (discussing the importance of altruistic behavior by board members). For an early consideration of the same topic see E. Merrick Dodd, Jr., *Is Effective Enforcement of Fiduciary Duties of Corporate Managers Practicable?*, 2 U. CHI. L. REV. 194 (1935).

168. COX & HAZEN, *supra* note 70, § 10:11.

169. *Id.* § 10:02.

170. *Id.* § 11:8.

171. *Blasius Indus. v. Atlas Corp.*, 564 A.2d 651, 663 (Del. Ch. 1988) (holding that even though acting in the good faith belief they are serving the corporation's interest, management must demonstrate a compelling justification for action taken for purpose of thwarting the on-going efforts of a stockholder to exercise its rights of corporate suffrage).

172. *See, e.g., Globe Woolen Co. v. Utica Gas & Elec. Co.*, 121 N.E. 378 (N.Y. 1918) (discussing the duty of loyalty generally and, in particular, the need for full disclosure in conflict of interest transactions).

173. *See, e.g., Berkman v. Rust Craft Greeting Cards, Inc.*, 454 F. Supp. 787 (S.D.N.Y. 1978) (noting that some of the directors failed to disclose to their fellow directors their knowledge that the investment banker whose fairness opinion the board would rely upon had a material financial interest in the outcome of the transaction); *Ryan v. Gifford*, 935 A.2d 258 (Del. Ch. 2007) (discussing failure of director to report to fellow directors knowledge that company had been defrauded). In an early decision, a court asserted:

The trustee is free to stand aloof, while others act, if all is equitable and fair. He cannot rid himself of the duty to warn and to denounce, if there is improvidence or oppression, either apparent on the surface, or lurking beneath the surface, but visible to his practised [sic] eye . . . There slumbered within these contracts a potency of profit which the plaintiff neither ignored in their making nor forgot in their enforcement. . . . [T]he refusal to vote does not nullify as of course an

Similarly, the duty of loyalty is implicated when a director actively assists another in misconduct harmful to the corporation.<sup>174</sup>

Some very early American decisions adopted the inflexible English rule of disqualification whereby directors were forbidden to enter into contracts in which they have a personal interest that conflicts with their fiduciary duty of loyalty to the corporation.<sup>175</sup> The strict rule proved impracticable and the former rule gave way to the belief that there are commercial advantages to such transactions and that regulation, rather than strict prohibition, is the approach with the greatest social welfare.<sup>176</sup> Case law often held that interested directors may not be counted toward the quorum necessary for the board to take action on the transaction in which the directors have an interest.<sup>177</sup> However, director conflict of interest statutes generally provide that if a majority of disinterested directors approve the transaction, the approval is not conditioned on the disinterested directors satisfying the quorum requirement without counting the interested directors.<sup>178</sup> Most states provide that a corporation's contract with its director is not voidable if approved by a disinterested body of directors or stockholders, or if the contracting director or officer successfully bears the burden of showing the fairness of the transaction.<sup>179</sup> As discussed below,

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influence and predominance exerted without a vote.

Globe Woolen Co. v. Utica Gas & Electric. Co., 121 N.E. at 380–81.

174. See, e.g., *In re Am. Int'l Grp., Inc.*, 965 A.2d 763 (Del. Ch. 2009) (illustrating an example of such misconduct in which it was alleged that a vice-chairman assisted in concealment of fraudulent transactions designed to inflate corporation's revenues).

175. COX & HAZEN, *supra* note 70, § 10:12. Portions of the discussion that follows are adapted from COX & HAZEN.

176. 3 FLETCHER, *supra* note 153, § 931 (declining to follow the strict rule); 12 SAMUEL WILLISTON, CONTRACTS § 1533 (3d ed. 1970); Harold Marsh, Jr., *Are Directors Trustees?*, 22 BUS. LAW. 35 (1966) (noting shift over time towards regulation and away from strict rule).

177. See, e.g., *Karris v. Water Tower Trust & Sav. Bank*, 389 N.E.2d 1359 (Ill. App. Ct. 1979) (holding interested directors cannot be included in quorum); *Am. Disc. Corp. v. Kaitz*, 206 N.E.2d 156 (Mass. 1965) (same); *Davis v. Heath Dev. Co.*, 558 P.2d 594 (Utah 1976) (same); *Rocket Mining Corp. v. Gill*, 483 P.2d 897 (Utah 1971) (same).

178. See, e.g., DEL. CODE ANN. tit. 8, § 144(a)(1) (West 2011) (majority of disinterested directors is sufficient even if less than a quorum); MODEL BUS. CORP. ACT § 8.62(c) (2008) (“A majority (but no fewer than two) of all the qualified [disinterested] directors on the board of directors or on the committee, constitutes a quorum for purposes of action that complies with this section”).

179. *Pepper v. Litton*, 308 U.S. 295 (1939) (requiring director to show good faith and inherent fairness of transaction); *Norlin Corp. v. Rooney, Pace, Inc.*, 744 F.2d 255 (2d Cir. 1984) (recognizing that after prima facie showing that director has self-interest in a transaction, the burden shifts to director to demonstrate fairness of transaction); see also *Gearhart Indus. v. Smith Int'l*, 741 F.2d 707, 720 (5th Cir. 1984); *Drobbin v. Nicolet Instrument Corp.*, 631 F. Supp. 860, 880 (S.D.N.Y. 1986); *Bellis v. Thal*, 373 F. Supp. 120

this rule is now included in most corporation statutes.<sup>180</sup> At least one commentator has suggested that a strict prohibition on self-dealing would be appropriate for nonprofit directors.<sup>181</sup>

Nonprofit corporation law follows the same pattern as the business corporation law discussed above.<sup>182</sup> Similarly, the conflict of interest rules for nonprofit corporations follow the pattern of business corporation acts.<sup>183</sup> Thus, a conflict of interest transaction is not voidable due to the relationship creating the conflict if the transaction is approved by a disinterested governing body or if it is proven to be fair to the corporation.<sup>184</sup> In these situations, the burden of proving fairness clearly lies with the person trying to validate the conflict of interest transaction.

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(E.D. Pa. 1974), *aff'd*, 510 F.2d 969 (3d Cir. 1975); *Am. Timber & Trading Co. v. Niedermeyer*, 558 P.2d 1211 (Or. 1976); *Sammis v. Stafford*, 56 Cal. Rptr. 2d 589, 594 (Cal. App. 4th Dist. 1996) (holding that the defendant met the burden of establishing that the challenged transaction was “just and reasonable”).

180. *See, e.g.*, DEL. CODE ANN. tit. 8, § 144 (West 2011) (describing process for avoiding voidability of conflict of interest transactions); MODEL BUS. CORP. ACT §§ 8.60–8.63 (2008) (same).

181. Leslie, *supra* note 52, at 1226:

The law should be restructured to support desirable social norms. Restructuring the state law fiduciary duty of loyalty as a set of clear rules would best accomplish this goal. A flat prohibition on self-dealing and conflict of interest transactions would be the most effective way to ensure that fiduciaries place the best interests of the nonprofit ahead of self-interest. The rule would be unlikely to hurt nonprofits because board members who wish to help can structure transactions to avoid conflict. Short of that, clear rules that require investigation of alternatives, deliberation, and proof that inside transactions are clearly below market would do much to counter the damaging impact of groupthink.

182. PRINCIPLES OF THE LAW OF NONPROFIT ORGS. § 330 (Tentative Draft No. 1, 2007); *see also* Leslie, *supra* note 52 (calling for heightened rules on nonprofit conflict of interest transactions).

183. *See* MODEL NONPROFIT CORP. ACT § 8.60 (2008) (stating that for nonprofit corporations a transaction or contract in which a director is an interested party is not thereby void or voidable).

184. PRINCIPLES OF THE LAW OF NONPROFIT ORGS. § 330 (Tentative Draft No. 1, 2007). The draft Principles, which reflect current law, provide:

The governing board may approve a transaction between the charity and a fiduciary, waive the charity’s interest in a transaction between another person and a fiduciary, or approve or waive any other conflict of interest of the fiduciary described in § 310(b) if in good faith the board reasonably determines that the transaction with the charity is both fair to and in the best interests of the charity, or that the approval or waiver of the charity’s interest in any other conduct is in the best interests of the charity.

*Id.* § 330(a). In addition, approval by a disinterested governing board or committee is conditioned upon the fiduciary having “made a good-faith disclosure to the decisionmaking body of all relevant material facts, and refrained from seeking to influence the decisionmaking process.” *Id.* § 330(b)(1).

This rule is reflected in nonprofit corporation statutes.<sup>185</sup> Strict prohibition is likely to prove as impracticable for nonprofit organizations as it has with for business corporations.

Although not necessarily limited to self-dealing transactions, nonprofits must be mindful about not operating too much like a business entity that focuses on profits to its shareholders. As noted earlier, the IRS polices nonprofits that abuse their charitable status by providing private rather than public benefits.<sup>186</sup> The nonprofit corporation also can also be used to curtail abuses. Blatant self-dealing will provide a basis for dissolution of a nonprofit corporation.<sup>187</sup> Converting a public benefit nonprofit into a corporation focused on private benefits amounts to a

185. *See, e.g.*, MODEL NONPROFIT CORP. ACT § 8.60 (2008):

(a) A contract or transaction between a nonprofit corporation and one or more of its members, directors, members of a designated body, or officers or between a nonprofit corporation and any other entity in which one or more of its directors, members of a designated body, or officers are directors or officers, hold a similar position, or have a financial interest, is not void or voidable solely for that reason, or solely because the member, director, member of a designated body, or officer is present at or participates in the meeting of the board of directors that authorizes the contract or transaction, or solely because his or their votes are counted for that purpose, if:

(1) the material facts as to the relationship or interest and as to the contract or transaction are disclosed or are known to the board of directors and the board in good faith authorizes the contract or transaction by the affirmative votes of a majority of the disinterested directors even though the disinterested directors are less than a quorum;

(2) the material facts as to the relationship or interest of the member, director, or officer and as to the contract or transaction are disclosed or are known to the members entitled to vote thereon, if any, and the contract or transaction is specifically approved in good faith by vote of those members; or

(3) the contract or transaction is fair as to the corporation as of the time it is authorized, approved, or ratified by the board of directors or the members

(b) Common or interested directors may be counted in determining the presence of a quorum at a meeting of the board that authorizes a contract or transaction specified in subsection (a).

(c) This section is applicable except as otherwise restricted in the articles of incorporation or bylaws.

*See also* CAL. CORP. CODE § 5233 (West 2011) (describing approval process for self-dealing transactions with nonprofit corporations); N.C. GEN. STAT. ANN. § 55A-8-31 (West 2010) (containing provisions dealing with directors' conflict of interest).

186. I.R.C. § 501 (2011).

187. *See Summers v. Cherokee Children & Family Serv., Inc.*, 112 S.W.3d 486 (Tenn. Ct. App. 2002).

breach of fiduciary duty.<sup>188</sup> Payments by a nonprofit to its officers that purport to be compensation implicate the board as these payments must be approved by the board.<sup>189</sup> In addition to dissolution, the principals who take assets from a nonprofit may be held accountable and held liable in damages.<sup>190</sup>

The corporate opportunity doctrine holds that a corporate fiduciary cannot take for his or her personal benefit an opportunity that should be offered to the corporation.<sup>191</sup> The corporate opportunity doctrine applies to nonprofit corporation directors and managers.<sup>192</sup>

#### VIII. GOOD FAITH (AN INDEPENDENT DUTY?)

There are frequent references in both cases and scholarship to a director's duty of good faith as a third fiduciary duty<sup>193</sup> in addition to the duties of care and loyalty. Even if not viewed as a stand-alone duty, the obligation of good faith is subsumed in the duties of care and loyalty. This is the better view.<sup>194</sup> For example, the Delaware Supreme Court clarified

188. *Id.* at 504 (“[A] director’s duty of loyalty lies in pursuing or ensuring pursuit of the charitable purpose or public benefit which is the mission of the corporation.”).

189. *Vacco v. Diamandopoulos*, 715 N.Y.S.2d 269 (N.Y. Sup. Ct. 1998); *State ex rel. Little People’s Child Dev. Ctr., Inc. v. Little People’s Child Dev. Ctr., Inc.*, No. M2007-00345-COA-R3-CV, 2009 WL 103509, at \*8 (Tenn. Ct. App. Jan. 9, 2009); *see also* *People ex rel. Spitzer v. Grasso*, 816 N.Y.S.2d 863 (N.Y. Sup. Ct. 2006) (denying defendant nonprofit CEO’s motion to dismiss challenges to executive compensation as excessive). However, on appeal, the New York Court of Appeals found no violation of the New York Nonprofit Corporation Act. *People v. Grasso*, 893 N.E.2d 105 (2008) (dismissing claims).

190. *Little People’s Child Dev. Ctr., Inc.*, 2009 WL 103509; *see also* *Mid-List Press v. Nora*, 275 F. Supp. 2d 997 (D. Minn. 2003) (holding director and officer of nonprofit press violated fiduciary duty by misappropriating to himself trade name and ISBN numbers belonging to the nonprofit corporation).

191. *COX & HAZEN*, *supra* note 70, §§ 11:8–11:10.

192. *See* *Valle v. N. Jersey Auto. Club*, 359 A.2d 504 (N.J. Super. Ct. App. Div. 1976); *see also* MODEL NONPROFIT CORP. ACT § 8.70 (2008).

193. *See, e.g.*, Clark W. Furlow, *Good Faith, Fiduciary Duties, and the Business Judgment Rule in Delaware*, 2009 UTAH L. REV. 1062 (2009) (discussing how good faith relates to directors’ duties under Delaware corporate law); Leo E. Strine, Jr., Lawrence A. Hamermesh, R. Franklin Balotti & Jeffrey M. Gorris, *Loyalty’s Core Demand: The Defining Role of Good Faith in Corporation Law*, 98 GEO. L.J. 629, 673 (2010) (discussing “the rise and demise of an independent duty of good faith”).

194. RUSSELL M. ROBINSON, II, ROBINSON ON NORTH CAROLINA CORPORATION LAW § 14.03 at 14–7 (7th ed. 2010) (

The requirement of good faith is listed separately in the statute and has occasionally been cited as a separate duty apart from the duties of due care and loyalty; but it normally operates more as a component of the other two traditional duties, requiring conscientious effort in discharging the duty of care and constituting the very core of the duty of loyalty.



that the duty of good faith is in essence a component of both the duty of care and the duty of loyalty.<sup>195</sup> Good faith is also an important concept when dealing with statutes that permit limitation of liability for due care violations.<sup>196</sup> The current version of the model nonprofit act permits provisions in the articles of incorporation limiting liability for actions by a disinterested director that are taken in good faith.<sup>197</sup> The exculpation provision is not applicable to charitable organizations since their directors are already protected by a liability shield.<sup>198</sup>

A director's duty of good faith also includes disclosure obligations. It has thus been said that nonprofit directors are subject to a duty of candor.<sup>199</sup> Whether good faith is viewed as a separate obligation is not truly significant in measuring directors' duties. Since good faith is clearly included in the duties of due care and loyalty, directors not acting in good faith should be held accountable.

#### IX. DUTY OF OBEDIENCE

In addition to the duties of care, loyalty, and good faith, courts and observers speak in terms of a director's duty of obedience with respect to both business corporations and nonprofit corporations.<sup>200</sup> The duty of obedience is especially significant in the case of nonprofit corporations. References to a duty of obedience capture the idea that a director is under an obligation to ensure that the corporation acts within its proper purpose

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) (internal citations omitted).

195. *Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006) (

[A]lthough good faith may be described colloquially as part of a "triad" of fiduciary duties that includes the duties of care and loyalty . . . [o]nly the latter two duties, where violated, may directly result in liability . . . .

(internal citation omitted). The draft ALI Principles applicable to nonprofits discuss the history of good faith in Delaware corporate law as a guide to the meaning of good faith in the context of nonprofits. *PRINCIPLES OF THE LAW OF NONPROFIT ORGS.* § 370 Reporter's Note 15 (Tentative Draft No. 1, 2007).

196. *See, e.g.*, MODEL BUS. CORP. ACT § 2.02(b)(4) (1980) (permitting a clause in the articles of incorporation limiting damages for due care violations).

197. MODEL NONPROFIT CORP. ACT § 2.02(c) (2008).

198. *Id.* § 8.31(d).

199. *See Armenian Assembly of Am., Inc. v. Cafesjian*, 772 F. Supp. 2d 20, 113 (D.D.C. 2011). This ruling echoes the well-established rule with respect to for-profit directors that a breach of duty does not result in liability absent proof of damages proximately caused by the breach. *See, e.g., Barnes v. Andrews*, 298 F. 614 (S.D.N.Y. 1924) (providing an illustration of the rule that a lawsuit brought on grounds of a director's negligence must satisfy the element of proximate causation).

200. *See, e.g., Alan R. Palmiter, Duty of Obedience: The Forgotten Duty*, 55 N.Y.L. SCH. L. REV. 457 (2010/2011) (discussing the duty of obedience).

and mission. This obedience can also include honoring a donor's intent in the administration of the organization's assets.

Older corporate law treatises and cases referred to a director's duty of obedience.<sup>201</sup> The directors' duty of obedience receives some mention today<sup>202</sup> but is not universally listed as it once was in corporate scholarship.<sup>203</sup> It has been suggested that the duty of obedience should be revived.<sup>204</sup> There is scattered case law throughout the United States referring to a director's duty of obedience for both for-profit<sup>205</sup> and

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201. See HENRY W. BALLANTINE, BALLANTINE ON CORPORATIONS § 62 (rev. ed. 1946). The successor edition of the Ballantine edition explains that the duty of obedience is, in effect, the application of the *ultra vires* doctrine. COX & HAZEN, *supra* note 70, § 10:1 at 126–27. The duty of obedience is referred to in a number of classic corporate law texts. E.g., I. MAURICE WORMSER, FRANKENSTEIN INCORPORATED 125–30 (1931) (

Directors owe a three-fold duty to the corporation. First, they must be obedient. Second, they must be diligent. Third, they must be loyal.

As to obedience, they of course owe a duty to keep within the powers of the corporation as well as within those of the board of directors

...

With regard to diligence, the directors owe a duty to exercise reasonable care and prudence . . . . In no event is the idea to be tolerated that directors serve merely as brightly gilded ornaments of the corporate institution

....

The third duty owing by directors is that of undivided loyalty.

). See also *Gearhart Indus., Inc. v. Smith Int'l, Inc.*, 741 F.2d 707, 719 (5th Cir. 1984) (recognizing duty of obedience as one of three duties arising from the fiduciary status of corporate directors).

202. COX & HAZEN, *supra* note 70, § 10:1 at 126–27; Rob Atkinson, *Obedience as the Foundation of Fiduciary Duty*, 34 J. CORP. L. 43 (2008) (suggesting that the duty of obedience is the pillar of traditional board duties of care and loyalty). Cf. Megan Wischmeier Shaner, *Restoring the Balance of Power in Corporate Management: Enforcing an Officer's Duty of Obedience*, 68 BUS. LAW. 27 (2010) (suggesting increased focus on officers' fiduciary duties and, in particular, the duty of obedience).

203. Rob Atkinson, *supra* note 202, at 45 (2008) (stating that “both doctrinal and theoretical [commentators] have come to agree that the fiduciary relationship rests on twin pillars, the duty of care and the duty of loyalty” and arguing that “a third duty, obedience, is more basic, the foundation on which the duties of care and loyalty ultimately rest.”); Peggy Sasso, Comment, *Searching for Trust in the Not-for-Profit Boardroom: Looking Beyond The Duty of Obedience to Ensure Accountability*, 50 UCLA L. REV. 1485, 1528–29 (2003) (suggesting that “[t]he duty of obedience is a legacy of trust law that does not square with the [Revised Model Nonprofit Corporation Act's] attempt to line up not-for-profit fiduciary duties with those of its for-profit counterpart.”).

204. Palmiter, *supra* note 200; Jeremy Benjamin, Note, *Reinvigorating Nonprofit Directors' Duty of Obedience*, 30 CARDOZO L. REV. 1677 (2009).

205. For more on for-profit corporation cases referencing the duty of obedience, see *Wooley v. Lucksinger*, 61 So.3d 507, 514 (La. 2011) (stating that “[t]hree broad duties stem from the fiduciary status of corporate officers and directors: namely the duties of obedience, loyalty, and due care”), and *Lundy v. Masson*, 260 S.W.2d 482, 507 (Tex. App.

nonprofit corporations.<sup>206</sup> Regardless of the label, it is significant whether the concepts behind what at least one commentator referred to as a “largely forgotten”<sup>207</sup> duty of obedience are already enshrined as part of the existing law of nonprofit directors’ duties. The duty of obedience is a reflection of the age-old *ultra vires* doctrine that prohibits corporate acts beyond the corporation’s mission and purpose.<sup>208</sup> The same concept applies with nonprofit corporations.<sup>209</sup> From a practical standpoint the duty of obedience can be seen as a substantive rather than process-oriented view of board obligations.<sup>210</sup> Although case references to the duty of obedience

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Houston Dist. 14 2008). *Cf.* Weinstein Enters., Inc. v. Orloff, 870 A.2d 499, 509 (Del. 2005) (holding that when a parent corporation elects a subsidiary’s directors those directors do not owe a duty of obedience to the parent; duties are owed to the subsidiary); Deborah A. DeMott, *The Mechanisms of Control*, 13 CONN. J. INT’L L. 238, 253 (1999) (arguing that a subsidiary’s directors do not have a duty of obedience to the parent company). *But cf.* Cent. Power Co-Op v. Consumers Energy, 741 N.W.2d 822 (table), 2007 WL 2710841 (Iowa App. 2007) (addressing only the duties of good faith and care although the complaint referenced a duty of obedience). Most of the cases retrieved from a Westlaw search (director & corporation & “duty of obedience”) of the fifty state cases dealing with directors’ duty of obedience arose in Texas. The same was true of a similar Westlaw search of federal cases which revealed fifty-seven cases, most of which did not deal with directors’ duties. *See, e.g.*, Gearhart Indus., Inc. v. Smith Int’l., Inc., 741 F.2d 707 (5th Cir. 1984) (referencing a director’s duty of obedience under Texas law); *In re Hollis*, 2011 WL 1168403 (Bankr. E.D. Tex. 2011) (recognizing duty of obedience owed by director under Texas law).

206. *See* Queen of Angels Hosp. v. Younger, 136 Cal. Rptr. 36 (Ct. App. 1977) (holding that a nonprofit’s use of funds for medical clinics instead of operating a hospital breached the duty of obedience); Shorter Coll. v. Baptist Convention of Ga., 614 S.E.2d 37 (Ga. 2005) (discussing nonprofit directors’ duty of obedience); People *ex rel.* Spitzer v. Grasso, 831 N.Y.S.2d 349 (Table), 2006 WL 3016952 (N.Y. Sup. Ct. Oct. 18, 2006) (stating that “[f]iduciary duty actually includes three distinct duties: duty of care, loyalty and obedience” and then discussing the duty of obedience while denying defendant nonprofit CEO’s motion to dismiss challenges to executive compensation as excessive), *aff’d as modified sub nom*, 54 A.D.3d 180 (2008) (dismissing claims); Manhattan Eye, Ear & Throat Hosp. v. Spitzer, 715 N.Y.S.2d 575 (N.Y. Sup. Ct. 1999) (recognizing duty of obedience for directors of nonprofits). *Cf.* Consumers Union of U.S., Inc. v. State, 840 N.E.2d 68 (N.Y. 2005) (discussing duty of obedience but rejecting plaintiff’s challenge to conversion of not-for-profit’s health plan to a for-profit plan).

207. Palmiter *supra* note 200, at 458.

208. COX & HAZEN, *supra* note 70, ch. 4.

209. Carson v. Carson, 88 S.W. 175, 178 (Tenn. 1905) (stating that a “corporation organized for charitable purposes has these purposes and trusts set out in its charter and articles of foundation . . . [b]ut no trusts in such case need be declared, as they are set out in the charter and articles of foundation”).

210. Practitioners have described the duty as substantive. *See, e.g.*, David H. Robbins, *New Risks for Hospital Boards: Good Faith Decisions with Bad Outcomes*, MODERN HEALTHCARE MAGAZINE (July 2006) (“[T]he duty of obedience tests the substantive, as opposed to the procedural, quality of decisions by nonprofit boards.”).

may be relatively rare, practicing lawyers clearly recognize its importance.<sup>211</sup> The duty of obedience is also included in guidebooks for nonprofit directors.<sup>212</sup> State attorneys general who have enforcement responsibilities regarding nonprofit corporations also recognize the significance of the duty of obedience in the nonprofit sector.<sup>213</sup> Many charitable nonprofits have a limited mission statement and, if so, this would bear upon the board's duty of obedience with respect to that mission.<sup>214</sup> Similarly, if there are donor restrictions on use of funds,<sup>215</sup> the board needs

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211. *Id.*; see also, e.g., *Board of Directors: Duty of Care*. BENJAMIN P. FLAVIN ATTORNEY AT LAW (Apr. 14, 2011), <http://benflavinlaw.com/law-blog/board-of-directors-duty-of-care> (“Each member of a board of directors of a corporation is charged with three duties: the Duty of Care, the Duty of Loyalty and the Duty of Obedience.”); James H. Freis and Erin K. Callahan, *Responsibilities of Not for Profit Corporate Board Members*, DRINKER BIDDLE (2002), [http://www.drinkerbiddle.com/files/Publication/6e3918ff-618f-4478-8536-f64c88db8871/Presentation/PublicationAttachment/012807b5-6324-4d54-b7ab-abd075c19990/freis\\_nonprofit.pdf](http://www.drinkerbiddle.com/files/Publication/6e3918ff-618f-4478-8536-f64c88db8871/Presentation/PublicationAttachment/012807b5-6324-4d54-b7ab-abd075c19990/freis_nonprofit.pdf) (including among responsibilities of not for profit corporate board members the duty of obedience); Memorandum from James P. Joseph, *Fiduciary Duties of a Director and Conflicts of Interest*, ARNOLD & PORTER LLP (May 8, 2006) (including duty of obedience as a director duty).

212. See, e.g., Business Law Section of The North Carolina Bar Association & N.C. Center For Nonprofits, *GUIDEBOOK FOR BOARDS OF DIRECTORS OF NORTH CAROLINA NONPROFIT CORPORATIONS* 19, 26, 31 (2d ed. 2003) (referencing the duty of obedience).

213. See, e.g., *Fiduciary Duties of Directors of Charitable Organizations*, OFFICE OF THE [MINN.] ATT'Y GEN. LORI SWANSON, <http://www.ag.state.mn.us/charities/fiduciaryduties.asp> (last visited June 22, 2011) (discussing nonprofit directors' duties of care, loyalty, and obedience); *A Guide to Non-Profits*, NEV. DEPT. OF JUSTICE—OFFICE OF THE ATT'Y GEN., 9 (2011) (including duty of obedience); *Right From the Start—A Handbook for Not-For-Profit Board Members*, N.Y. OFFICE OF THE ATT'Y GEN., 7 (2009) (including the duty of obedience).

214. See, e.g., *Shorter C. v. Baptist Convention of Ga.*, 614 S.E.2d 37, 43 (Ga. 2005) (quoting *Manhattan Eye, Ear & Throat Hosp. v. Spitzer*, 715 N.Y.S.2d 575 (N.Y. Sup. Ct. 1999)) (

It is axiomatic that the board of directors [of a nonprofit] is charged with the duty to ensure that the mission of the charitable corporation is carried out. This duty has been referred to as the “duty of obedience.” It requires the director of a not-for-profit corporation to “be faithful to the purposes and goals of the organization,” since “[u]nlike business corporations, whose ultimate objective is to make money, nonprofit corporations are defined by their specific objectives . . . .”

) (emphasis added). The court held that the transfer of nonprofit college assets to a foundation did not constitute a valid dissolution of the non-profit corporation. *Id.*

215. See, e.g., Susan N. Gary, *The Problems With Donor Intent: Interpretation, Enforcement, and Doing the Right Thing*, 85 CHI.-KENT L. REV. 977 (2010) (discussing problems in identifying donor intent); Carrie M. Lovelace & Jeffrey C. Sun, Commentary, *Analyzing the Continuing Relationship Between Universities and Their Donors' Successors*, 256 ED. L. REP. 513 (2010) (discussing the ability of donors' successors to monitor and challenge use of funds); see also Michael J. Hussey, *Avoiding Misuse of Donor Advised Funds*, 58 CLEV. ST. L. REV. 59 (2010) (discussing donor-advised funds).

to assure proper procedures are in place and that there is sufficient transparency to assure obedience to the donor's restrictions.<sup>216</sup> For example, in one case a group of trustees were allowed to challenge a change in the charity's mission and to attempt to enforce the duty of obedience even though the state attorney general was not concerned since the funds were still being used for the public good.<sup>217</sup> The trustees were thus allowed to try to enforce the duty of obedience even though the state attorney general's charge under the statute is primarily to assure that the funds were being used for the public good.

Charitable organizations that disburse donor funds have special obligations. For example, failure to follow the donors' intent can be problematic and form the basis for challenging the charity's operations.<sup>218</sup> The charitable trust doctrine<sup>219</sup> holds that, with restricted gifts, a donor's

216. Iris J. Goodwin, *Donor Standing to Enforce Charitable Gifts: Civil Society vs. Donor Empowerment*, 58 VAND. L. REV. 1093, 1094 (2005) (discussing the stewardship of donor intent and noting: "[t]he cat is out of the bag: Donors are fast discovering what was once a well-kept secret in the philanthropic sector—that a gift to public charity donated for a specific purpose and restricted to that purpose is often used by the charity for its general operations or applied to other uses not intended by the donor"). Cf. Reid Kress Weisbord, *The Effects of Donor Standing on Philanthropy: Insights from the Psychology of Gift-Giving*, 45 GONZ. L. REV. 225 (2009) (discussing impact of donor control of management of funds and suggesting that giving donors standing to sue will not necessarily promote the public policy of the charity); Lisa Loftin, Note, *Protecting the Charitable Investor: A Rationale for Donor Enforcement of Restricted Gifts*, 8 B.U. PUB. INT. L.J. 361 (1999) (discussing benefits of donor control over use of funds). Just recently, a hospital was required to return a donor's contribution and pay punitive damages for failure to follow the donor's directions. See *Hospital Must Pay Garth Brooks \$1 Million*, USA TODAY, <http://www.usatoday.com/life/people/story/2012-01-24/garth-brooks-hospital-settlement/52783732/1> (Jan. 24, 2012). See also *Ray Charles Foundation wants \$3M Gift back From Ga. University, says arts Center Never Built*, WASH. POST, [http://www.washingtonpost.com/national/ray-charles-foundation-wants-3m-back-from-ga-college-seeks-building-named-after-late-singer/2012/02/14/gIQAf8zEER\\_story.html](http://www.washingtonpost.com/national/ray-charles-foundation-wants-3m-back-from-ga-college-seeks-building-named-after-late-singer/2012/02/14/gIQAf8zEER_story.html) (Feb. 14, 2012) (discussing foundation's attempt to recoup donation due to failure to follow donor's intent).

217. *Holt v. Coll. of Osteopathic Physicians and Surgeons*, 394 P.2d 932 (Cal. 1964). The attorney general was not the exclusive party to bring suit. *Id.* at 937. The court allowed the plaintiff-trustees to bring suit challenging the change in name and mission of the foundation. *Id.* The attorney general had found that the name change was proper since the funds were still going towards the public good even though the plaintiff-trustees disagreed. *Id.* at 936; see also, Dana Brakman Reiser, *Nonprofit Takeovers: Regulating the Market for Mission Control*, 2006 BYU L. REV. 1181 (2006) (discussing attempts to change a charity's mission).

218. See, e.g., John K. Eason, *Motive, Duty, and the Management of Restricted Charitable Gifts*, 45 WAKE FOREST L. REV. 123 (2010) (discussing difficulties that can arise in honoring donors' intent with respect to restricted gifts); Gary, *supra* note 215 (same); see also Hussey, *supra* note 215 (same).

219. See, e.g., Evelyn Brody, *Charity Governance: What's Trust Law Got to Do with It?*,

intent creates trust obligations in managing the trust.<sup>220</sup> The Board's oversight functions can include having a reasonable basis for believing that donor intent is being honored.<sup>221</sup> There has been a debate concerning the extent to which a charity should have to honor the so-called dead hand of a donor's intent.<sup>222</sup> The issues can be quite complex. For example, is the donor's intent no longer consistent with the foundation's goals due to a change in circumstances? Are there other reasons that a board may believe

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80 CHI.-KENT. L. REV. 641, 642 (2005) ("When it comes to enforcing restrictions on gifts—even those made to corporate charities—regulators and courts commonly apply charitable trust doctrines."); *see also* RESTATEMENT (SECOND) OF TRUSTS § 348 (1959) (stating that "[a] charitable trust is a fiduciary relationship with respect to property arising as a result of a manifestation of an intention to create it, and subjecting the person by whom the property is held to equitable duties to deal with the property for a charitable purpose").

220. *See, e.g.*, *Detroit Osteopathic Hosp. v. Johnson*, 287 N.W. 466, 471 (Mich. 1939) (

There is no doubt that he and the other donors intended that the use of the property and the contemplated activity of this corporation should be purely eleemosynary and a contribution to the general welfare of the community, and that it should be carried on in a manner not inconsistent with the articles of association and the original by-laws. . . . [T]he original set-up is so clearly a fundamental element of the plan of the original founders of this trust that it should be protected and preserved by equity. Especially is this true since jurisdiction over the control and execution of trusts is in general vested in the equity courts. . . . A material change in this provision of the by-laws should be and is perpetually enjoined; and also for the reasons hereinbefore noted defendants' attempted amendment of article V of the articles of association which would materially change the control and execution of this trust, should be and is held to be invalid . . . .

); *see also*, *Healy v. Loomis Inst.*, 128 A. 774 (Conn. 1925) (holding trustees required to follow intent of the will); *Hite v. Queen's Hosp.*, 36 Haw. 250 (Haw. 1942) (approving of the charitable trust doctrine); John K. Eason, *Motive, Duty, and the Management of Restricted Charitable Gifts*, 45 WAKE FOREST L. REV. 123 (2010) (discussing donor intent).

221. Nonprofit corporation acts allow the board to rely on management unless there have been red flags that make reliance questionable. MODEL NONPROFIT CORP. ACT § 8.30(f) (2009). It would be good practice for the board or an applicable committee to engage in some independent investigation to reassure themselves of their ability to rely on management.

222. *See, e.g.*, Evelyn Brody, *From the Dead Hand to the Living Dead: The Conundrum of Charitable Donor Standing*, 41 GA. L. REV. 1183 (2007) (referring to the debate over hundreds of years but focusing on the issue of donor standing to enforce donor intent); Evelyn Brody & John Tyler, *Respecting Foundation and Charity Autonomy: How Public is Private Philanthropy?*, 85 CHI.-KENT L. REV. 571 (2010) (noting tensions between donor intent and public interest); John K. Eason, *The Restricted Gift Life Cycle, or What Comes Around Goes Around*, 76 FORD. L. REV. 693, 694 (2007) ("The overriding issue is thus one of honoring donor intent. As time passes after the inception of the gift, the issue is often less favorably characterized as one of enduring and potentially unwise dead-hand control."); Robert A. Katz, *Let Charitable Directors Direct: Why Trust Law Should not Cure Board Discretion over a Charitable Corporation's Mission and Unrestricted Assets*, 80 CHI.-KENT L. REV. 689 (2005) (discussing the possible tension between honoring donor intent and fulfilling the goals and mission of the charity).

that the donor's intent should yield to the public good or the mission of the foundation? On the other hand, adhering to donor intent is in the public interest to the extent it encourages charitable contributions.<sup>223</sup> Even if the board can decide that the donor's intent should yield to the charity's general purpose, the board's oversight obligation is implicated and they should assure transparency in the charity's decisions.

#### X. VOLUNTEER VERSUS COMPENSATED DIRECTORS

Directors of larger for-profit corporations generally are compensated for their board service.<sup>224</sup> Although it is usually assumed that nonprofit directors are volunteers, this is not always the case. For example, nonprofit health plans<sup>225</sup> that in fact operate a business, albeit in a nonprofit form,<sup>226</sup> often compensate their governing board. Even foundations with a truly charitable mission may compensate directors. For example, a recent study

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223. Ilana H. Eisenstein, Comment, *Keeping Charity in Charitable Trust Law: The Barnes Foundation and the Case for Consideration of Public Interest in Administration of Charitable Trusts*, 151 U. PA. L. REV. 1747, 1767 (2003) (

Enforcement of donor provisions furthers the general public welfare insofar as it creates a donor-friendly environment, where donors can be confident their wishes will continue to be enforced. . . . [T]he policy . . . encourage[s] donors to continue to dedicate their fortunes to public purposes. Public enforcement also benefits the donor by ensuring that his particularized vision . . . will endure.

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224. According to a study by a corporate compensation consulting firm, median director compensation in 2009 for the 100 largest companies listed on the New York Stock Exchange was \$214,000. *2010 Director Compensation: NASDAQ 100 v. NYSE 100*, FREDERIC W. COOK & CO., INC. 7 (2010). Another survey of 250 mid-market public companies found that average board member compensation was \$101,432. *The BDO 250*, BDO SEIDMAN LLP 6 (2009).

225. In 2009, Blue Plus compensated directors between \$0 and \$9500. HMO Minnesota (Blue Plus), *IRS Form 990* Part VII, at 7 (2009) (<http://www.health.state.mn.us/divs/hpsc/mcs/990s/990blue09.pdf>). Group Health Plan compensated directors between \$15,000 and \$31,750. HealthPartners compensated directors between \$11,250 and \$31,750. Group Health Plan, Inc., *IRS Form 990* Part VII, at 7 (2009) (<http://www.health.state.mn.us/divs/hpsc/mcs/990s/990ghi09.pdf>). Medica compensated directors between \$30,000 and \$86,000 with an average more than double the aforementioned plans. Medica Health Plans, *IRS Form 990* Part VII, at 7 (2009) (<http://www.health.state.mn.us/divs/hpsc/mcs/990s/990ghi09.pdf>). Blue Cross and Blue Shield of South Carolina compensated their directors between \$99,158 and \$158,086 in 2010. Blue Cross and Blue Shield of South Carolina, *Supplemental Compensation Exhibit* at 460 ([http://media.charleston.net/2011/pdf/2010BCBSSC\\_Supplemental%20Comp.pdf](http://media.charleston.net/2011/pdf/2010BCBSSC_Supplemental%20Comp.pdf)). Board compensation at the company more than doubled between 2009 and 2010. *Id.*

226. See *supra* notes 26–34 and accompanying text (regarding hospitals and other nonprofits that operate a business).

of the fifty largest foundations indicated that seventy-six percent pay their directors.<sup>227</sup> With respect to grant-making nonprofits generally, a study conducted in 2006 found that twenty-eight percent of the 10,000 foundations surveyed compensated their directors or trustees.<sup>228</sup> Some foundations mandate director compensation in their charter or indenture.<sup>229</sup> The rationale in these instances is that compensation is necessary to attract the best directors.<sup>230</sup> A number of scandals<sup>231</sup> make this rationale highly questionable. In fact, although it has not yet been enacted into law, the Massachusetts senate voted for a provision that would have banned compensation to nonprofit directors.<sup>232</sup> Also, as noted earlier, the Massachusetts and Oregon attorneys general called for legislation to require the attorney general's approval for any nonprofit that compensates its directors.<sup>233</sup> At a minimum, the authors firmly believe that if a nonprofit

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227. Lisa Chiu, *Most of America's 50 Richest Funds Pay Their Board Members*, CHRON. OF PHILANTHROPY, July 24, 2011 (noting that thirty-eight of the fifty largest foundations pay their directors).

228. ELIZABETH T. BORIS ET AL., FOUNDATION EXPENSES AND COMPENSATION: HOW OPERATING CHARACTERISTICS INFLUENCE SPENDING, 31 (finding that although 23.8% of independent foundations compensated trustees, fewer corporate (7.6%) and community foundations (3.2%) compensated their directors). For those 2,181 foundations that compensated trustees, 2,110 (96.7%) were independent foundations. *Id.* About 2% of independent foundation trustees received compensation, while only 3.2% of corporate foundation trustees and less than 1 percent of community foundation trustees were compensated. *Id.* For those foundations compensating directors, the median compensation was \$7,750; the 75th percentile was \$20,036. *Id.* The average (mean) compensation was \$15,637; when uncompensated trustees are included, the mean drops to \$2,417. *Id.*

229. For example, the original indenture for the Duke Endowment stated: "Each trustee shall be paid at the end of each calendar year one equal fifteenth part of three percent of the incomes, revenues and profits received by the trustees upon the trust properties and estate during such year . . . ." ROBERT FRANKLIN DURDEN, LASTING LEGACY TO THE CAROLINAS: THE DUKE ENDOWMENT, 1924-1994 337 (1998). The current version, as modified by court order, provides that trustees shall be compensated annually pursuant to the order. THE DUKE ENDOWMENT: INDENTURE OF TRUST 4 (2009).

230. *See* Chiu, *supra* note 227 (noting however that some foundations, following the trend of most nonprofits, have moved away from compensating directors).

231. Robert Weisman, *Insurer's Board Suspends Own Pay*, THE BOSTON GLOBE, 2011 WLNR 4566359 (Mar. 9, 2011); *see also* Letter from David G. Spackman, Chief, Non-Profit Organizations/Public Charities Division, Office of the Att'y General, to Four Chairmen of the Boards of Various Massachusetts Health Care Organizations (Apr. 14, 2011) (<http://www.mass.gov/ago/docs/nonprofit/director-compensation-report-4-14-11.pdf>) (finding director compensation does not meet the minimum standards of good governance).

232. Lisa Chiu, *Mass. May Soon Ban Pay for Trustees of Nonprofit Groups*, CHRON. OF PHILANTHROPY, June 24, 2011 (noting that Massachusetts "is on the verge of passing the first state ban on payments to trustees of all nonprofit organizations").

233. Lisa Chiu, *Lawmakers in 2 States Strike Down High-Profile Bills to Regulate Nonprofits*, CHRON. OF PHILANTHROPY, July 6, 2011, <http://philanthropy.com/article/High-Profile-Bills-to-Regulate/128152> (noting that "[e]fforts in Massachusetts and Oregon to



organization compensates its governing board members, those directors or trustees should not be absolved from liability for their misconduct.<sup>234</sup>

Director or trustee compensation is not necessary in most cases nor is it feasible for most nonprofits. Nonprofit directors who volunteer may be viewed as motivated by “psychic pay.”<sup>235</sup> This may include board members’ personal satisfaction, believing that good work is being done and that their volunteer efforts as board members have contributed to that public good. In any event, the authors firmly believe, and generally accepted nonprofit governance principles reflect, that volunteering for board service includes an agreement to exercise due diligence in board oversight responsibilities.<sup>236</sup>

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place new financial restrictions on nonprofits have failed to become law”).

234. For example, the liability shield in volunteer statutes is not applicable to directors who are compensated. *See infra* notes 327–43 and accompanying text.

235. Lisa Chiu, *supra* note 227 (

Many of the biggest foundations have also decided they don’t want to pay board members.

Of the top 50 foundations, *The Chronicle* surveyed, 12 did not compensate their directors, including the Charles Stewart Mott Foundation, the William and Flora Hewlett Foundation, and the David and Lucile Packard Foundation.

While the Bill & Melinda Gates Foundation does not pay its board, which consists of the Gateses and Warren Buffett, 16 members of the foundation’s three advisory panels are offered an honorarium of \$4,000 for each of the two meetings held annually; chairs of those committees are offered \$5,000.

At the Packard Foundation, its vice president, Chris DeCardy, says, “Our approach of not compensating our trustees, beyond travel expenses, has worked well with our history and values as an organization. We have consistently heard from our trustees that they find it an honor to serve on the board.”

And while donor intent is often cited as a rationale for board compensation, sometimes donor intent holds the exact opposite.

The automotive pioneer Charles Stewart Mott, who established his foundation in Flint, Mich., in 1926, specifically stated in the charter that board members would not receive compensation.

“We have never paid, nor will we,” says William White, the Mott Foundation’s president. But he says he’s not necessarily against board pay at other organizations.

“There has to be some type of compensation whether it’s pay or psychic pay. If you’re not going to pay, the way you get good trustees is by emotionally connecting with them. They need to believe in what you are doing, and if they don’t, you probably wouldn’t even want them.”

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236. ALI NONPROFIT PRINCIPLES, *supra* note 37.

## XI. CONSIDERATION OF BEST PRACTICES FOR NONPROFIT BOARDS

A number of best practices can be identified as a result of the foregoing enhancements to IRS Form 990. A number of organizations provide lists or guides to suggested best practices.<sup>237</sup> Consider, for example, the following list of suggested best practices recommending that nonprofits:

Implement an annual disclosure questionnaire to determine each board member's independence and the family or business relationships between and among directors/trustees, officers and key employees.

Adopt (if not already adopted) or Review (if a policy currently exists) a Conflict of Interest Policy. The policy should:

- Cover trustees/directors, officers, key employees, others with substantial influence
- Require disclosure of actual/potential conflicts of interest
- Implement annual disclosure process to determine if conflicts exist
- Include procedures for determining whether a relationship, financial interest or business affiliation results in a conflict
- Prescribe a course of action when a conflict is identified
- Require independent directors to review and approve transactions where a conflict of interest exists
- Require appropriate documentation of actions
- Require conflicted person to leave room and recuse him/herself from discussion and decision
- Require contemporaneous documentation of board and committee meetings and establish recommended practices for contents of documentation and for retaining such documentation. For this purpose, contemporaneous means the document must be prepared by the later of (1) the next meeting of the governing body or committee, or (2) 60 days after the date of the meeting and reviewed and approved by the governing body or committee within a reasonable time period thereafter.

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237. For a particularly useful accountability self-assessment tool, see Arizona Grantmakers Forum, *Self-Assessment Tool*, <http://www.arizonagrantsmakersforum.org/resources/Accountability-Self-Assessment-Tool.aspx> (last visited July 30, 2011); see also COUNCIL OF MICHIGAN FOUNDATIONS, ACCOUNTABILITY SELF-ASSESSMENT TOOL FOR PRIVATE FOUNDATIONS (Forum of Regional Associations of Grantmakers, ed., 2007).

- Adopt an executive compensation process that includes a determination of the positions whose compensation is to be reviewed; review and approval of the compensation decisions by an independent committee based on appropriate comparability data; and contemporaneous documentation of the decision.<sup>238</sup>

Suggested best practices also detail appropriate processes for setting executive and employees' compensation.<sup>239</sup>

The IRS does not explicitly *require* nonprofits to adopt compensation and conflict of interest policies. However, a nonprofit's failure to adopt practices and policies governing executive compensation can result in the organization not qualifying for the benefit of the IRS safe harbor that results in a rebuttable presumption of reasonableness for executive compensation decisions. A rebuttable presumption applies if executive

238. YAFFE & CO., THE NEW FORM 990 AND EXECUTIVE COMPENSATION: "BEST PRACTICE" RECOMMENDATIONS FOR BOARDS AND COMPENSATION COMMITTEES 4-5 (2009).

239. The following compensation practices were also recommended as stemming from the IRS changes to Form 990:

Adopt an executive compensation philosophy that outlines the process and procedures for reviewing and approving the total compensation paid to senior executives and "key employees"

Appoint a compensation committee comprised of independent members of the board

Adopt a compensation committee charter that sets out, among other things, the purpose, responsibility and authority of the compensation committee, including the following:

- Adherence to the compensation philosophy
- Compliance with the rebuttable presumption of reasonableness
- Use of an independent compensation consultant to provide comparability data

Adopt an expense reimbursement policy that outlines the procedure for the payment, reimbursement or provision of the following expenses, including requiring substantiation prior to reimbursement:

- First class or charter travel
- Travel for companions
- Tax indemnification and gross-up payments
- Discretionary spending accounts
- Housing allowance or residence for personal use
- Payments for business use of personal residence
- Health or social club dues or initiation fees
- Personal services (maid, chauffeur, chef, etc.)

*Id.* at 6.

compensation decisions are based on appropriate comparability data and are approved by an “independent” body whose approval is documented contemporaneously.<sup>240</sup>

It is true that the IRS disclosures do not require better governance practices. However, they clearly are designed to strongly encourage transparency and accountability in setting executive compensation. It seems that the state-law imposed duties of care and good faith at a minimum require the board to consider whether to adopt appropriate governance practices and procedures for setting compensation. Given the cost of losing a tax exemption (even on a temporary basis), the board should think long and hard before making a decision *not* to follow best practices in this area.

The enhanced IRS 990 filings are not the only example of increased scrutiny for nonprofits. In June 2011, the IRS posted a list of more than 275,000 nonprofits that lost their nonprofit tax-exempt status for failure to file their Form 990.<sup>241</sup> It is quite astounding that the minimal task of filing a Form 990 with the IRS was ignored by so many nonprofit organizations. The large number is certainly at least circumstantial evidence that many nonprofit boards are not doing their due diligence in overseeing operations.

Nonprofit corporations—especially those with a charitable mission—comprise a public good.<sup>242</sup> If anything, this warrants holding nonprofit directors to higher standards of care and loyalty than in the for-profit sector. On the other hand, while corporate directors of larger companies are generally compensated, nonprofit directors are usually volunteers.<sup>243</sup> It has been suggested that imposing high fiduciary duties on nonprofit directors will deter good people from serving on nonprofit boards.<sup>244</sup> Due to the public benefit from encouraging nonprofit volunteers, most states

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240. Treas. Reg. § 53.4958-6 (2011).

241. IRS, AUTOMATIC REVOCATION OF TAX EXEMPT STATUS (Jun. 8, 2011); *see also* IRS, *Recent Revocations of 501(c)(3) Determinations—Latest Additions and Table of Links*, <http://www.irs.gov/charities/charitable/article/0,,id=141466,00.html> (last visited Jan. 20, 2012).

242. *See, e.g.*, Leshner, *supra* note 48, at 969 (“The justification [for a higher fiduciary duty] seems to lie in the fact that the assets of the non-profit corporation come in many cases from public solicitations or contributions and therefore are more like a trust res than corporate capital.”).

243. There have been some controversial examples of nonprofit director compensation. For example, Massachusetts Blue Cross voluntarily suspended directors’ compensation in light of a mounting controversy. *See, e.g.*, Robert Weisman, *Insurer’s Board Suspends Own Pay*, BOSTON GLOBE 1 (Mar. 9, 2011) (reporting that Blue Cross and Blue Shield of Massachusetts “voted to suspend their five-figure annual directors’ payments”); Leter from Spackman, *supra* note 231 (noting excessive compensation involving various healthcare nonprofits).

244. Leshner, *supra* note 48, at 969.

have volunteer statutes that insulate volunteers (including directors of charitable nonprofit corporations) from liability even more than the exculpatory provisions of the nonprofit statutes.<sup>245</sup> The resulting conundrum is the heightened director duties that are imposed as a result of nonprofit corporation and tax laws are counterbalanced by extreme limitations on liability of nonprofit directors. There are some commentators who maintain that even existing liability provisions go too far, and nonprofit directors should be further immunized.<sup>246</sup> Alternatively they argue that fiduciary duties should be scaled back or eliminated.<sup>247</sup> We disagree. There may be merit in retaining high fiduciary standards combined with the limited liability and immunity provisions that already exist. Although some suggest that the remedies should be expanded,<sup>248</sup> the absence of more robust liability provisions does not necessarily mean that the law's message with respect to oversight obligations is hollow.

The preceding discussion has explored the wisdom of such a divergence and concluded that the current balance of responsibility and accountability is appropriate and is sufficient to encourage proper director behavior in the nonprofit world.

Nonprofits have the option of establishing governing boards, which have a monitoring function, or advisory boards, which do not. When a nonprofit adopts a governing board, nonprofit corporation acts typically require a board of directors and that board of directors by definition has a monitoring function. Although there may be a temptation for a nonprofit board of directors to act as a rubber stamp for the executive director's or management's recommendations, this type of blind allegiance to management clearly does not satisfy even the most minimal due diligence obligations.<sup>249</sup> Unfortunately, many nonprofit boards in fact act as a rubber

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245. See, e.g., *infra* notes 327–43 and accompanying text (discussing volunteer immunity statutes).

246. See, e.g., Leshner, *supra* note 48.

247. See, e.g., Rummana Alam, Note, *Not What the Doctors Ordered: Nonprofit Hospitals and the New Corporate Governance Requirements*, 2011 U. ILL. L. REV. 229 (2011).

248. See, e.g., Carter G. Bishop, *The Deontological Significance of Nonprofit Corporate Governance Standards: A Fiduciary Duty of Care Without a Remedy*, 57 CATH. U. L. REV. 701 (2008) (arguing that the fiduciary duty of care plays an important role in curbing director misbehavior in the nonprofit context, but enforcement mechanisms could be greatly improved); Danne L. Johnson, *Seeking Meaningful Nonprofit Reform in a Post Sarbanes-Oxley World*, 54 ST. LOUIS U. L.J. 187 (2009) (arguing that reform is needed); see also James Fishman, *Standards of Conduct for Directors of Nonprofit Corporations*, 7 PACE L. REV. 389 (1986) (same).

249. Judith L. Miller, *The Board as a Monitor of Organizational Activity: The Applicability of Agency Theory to Nonprofit Boards*, 12 NONPROFIT MGMT. & LEADERSHIP

stamp, and this reflects inattention or an “abdication” of directors’ oversight responsibilities.<sup>250</sup> Surprisingly, there is some evidence that the lack of meaningful oversight increases with the size of the nonprofit.<sup>251</sup> This is counter intuitive and a bad result if true since the larger the amount of assets under supervision, the higher the board members’ responsibility should be.

One of the suggested causes of too many rubber stamp directors is an organization’s failure to have appropriate selection criteria for nonprofit directors.<sup>252</sup> Nominating and/or governance committees should be mindful of seeking out candidates that will not simply be rubber stamps but at the same time will be a good fit for the organization. Many nonprofit boards are small and often consist of family members or paid executives of the organization.<sup>253</sup> Having a homogeneous<sup>254</sup> board composed primarily of

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429, 438 (2002); *see also*, Johnson, *supra* note 248, at 206; Consuelo Lauda Kertz, *Executive Compensation Dilemmas in Tax-Exempt Organizations: Reasonableness, Comparability, and Disclosure*, 71 TUL. L. REV. 819, 855 (1997) (stating that “[b]oard membership often consists of the executive’s friends and cronies, and there is often reciprocity—individuals sitting on one another’s boards”).

250. *Stern v. Lucy Webb Hayes Nat’l Training Sch. for Deaconesses & Missionaries*, 381 F. Supp. 1003, 1014 (D.D.C. 1974) (finding that directors failed to engage in even the most cursory supervision by defendant directors and this amounted to a “[t]otal abdication” of their responsibilities).

251. Edward L. Glaeser, *Introduction*, THE GOVERNANCE OF NOT-FOR-PROFIT ORGANIZATIONS 1, 36 (Edward L. Glaeser ed., 2003); *see also* Ralph M. Kramer, VOLUNTARY AGENCIES AND THE PERSONAL SOCIAL SERVICES, IN THE NONPROFIT SECTOR: A RESEARCH HANDBOOK 240, 244 (Walter W. Powell ed., 1987) (“Large or small . . . most voluntary agencies are unusually dependent on the quality of their executive leadership and, therefore, more subject to idiosyncratic rather than structural factors.”) *quoted in* Johnson, *supra* note 248, at 206–07.

252. James J. Fishman, *Standards of Conduct for Directors of Nonprofit Corporations*, 7 PACE L. REV. 389, 397 (1987) (

Because nonprofits tend to have many directors who are on the board for “window dressing” only, a common phenomenon of nonprofit boards is directors who do not direct. The “figurehead” directors assume non-involved roles on the board, rarely attending meetings, and certainly never involving themselves in oversight responsibilities. They are corrosive to nonprofit corporations in that they allow employees or fellow directors to dominate the organization.

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253. Consider, for example, a nonprofit that the Missouri Attorney General convinced to increase its board size so as to wrest control from one individual. Grant Williams, *Changes at Kauffman Foundation Approved by Missouri Attorney General*, CHRON. OF PHILANTHROPY, Sept. 16, 2004; Stephen Roth, *Nixon says Kauffman has Beefed Up KC Commitment*, KANS. CITY BUS. J., Sept. 1, 2004. A number of nonprofits lost a good deal of money investing in Bernard Madoff funds and most of those nonprofits had small governing boards. Ian Wilhelm, *Madoff Foundation Victims Lacked Adequate Board Size, Says Report*, CHRON. OF PHILANTHROPY, June 25, 2009, <http://philanthropy.com/article/Madoff->

insiders can lead to complacency as compared to a board containing a mix of inside and outside (or independent) directors.<sup>255</sup> Instead, an effective governing board should consist of members from diverse backgrounds<sup>256</sup> with a wide range of skills, including financial expertise.<sup>257</sup> At a minimum, each board member should have sufficient financial literacy to be able to read and understand balance sheets and cash flow.<sup>258</sup> The importance of having qualified and diverse board members should not be underestimated. In other words, “[d]irectors can no longer afford to be merely passive or honorary, but must be involved and informed to mitigate the risk to themselves and the organization.”<sup>259</sup>

A director’s due diligence obligations and duty to remain informed mean that the director must ask probing questions in order to make an informed decision as to what he or she reasonably believes to be in the organization’s best interests. To avoid being a rubber stamp, a director must not have an overdeveloped sense of collegiality or fear being viewed

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Foundation-Victims/63116 (“Of the 150 or so nonprofit organizations affected by the Madoff Ponzi scheme, 105 lost 30 percent to all of their assets. Of that group, the median board size was three people, said the report by the National Committee for Responsive Philanthropy, a foundation watchdog group in Washington.”); *see also*, NIKI JAGPAL & JULIA CRAIG, *LEARNING FROM MADOFF: LESSONS FOR FOUNDATION BOARDS* 4 (2009) (recommending that foundation boards have at least five members with diverse perspectives and backgrounds, and that maintaining policies and practices supporting ethical behavior can help retain the public trust).

254. Wilhelm, *supra* note 253.

255. *See, e.g.*, Donald C. Langevoort, *The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability*, 89 *GEO. L.J.* 797 (2001) (discussing rationales for a mix of inside and outside directors).

256. *See, e.g.*, Thomas Lee Hazen, *Board Diversity and Corporate Performance Filling in the Gaps, Limits of the Business Case and the Connection Between Supporting Rationales and the Appropriate Response of the Law*, 89 *N.C. L. REV.* 887 (2011) (providing an overview of rationales for increased board diversity).

257. Cardinaels, *supra* note 151 (suggesting a positive correlation between board expertise and effective monitoring of executive compensation).

258. *See, e.g.*, BONNIE G. HILL, *THE HOME DEPOT: CORPORATE GOVERNANCE OVERVIEW, SIXTH ANNUAL DIRECTORS’ INSTITUTE ON CORPORATE GOVERNANCE* 1 (2008), (“Those nominated for director must demonstrate integrity, accountability, informed judgment, financial literacy, passion, creativity and vision.”); *see also*, Robert T. Harper & Stephanie W. Schreiber, *Hospital Boards of Directors—The Challenges of Being a Hospital Director—Fiduciary Duties, Governance Issues and Board Composition*, 78 *PA. BAR ASSOC. Q.* 130 (2007) (“[A]ll board members, as part of their board training, should receive basic financial literacy training so that they can understand board financial reports and budgets.”); *Principles for Good Governance and Ethical Practice*, *INDEP. SECTOR* 14 (2007) (Because the board must ensure that all financial matters of the organization are conducted legally, ethically and in accordance with proper accounting rules, it should make every effort to ensure that at least one member has “financial literacy”).

259. Rucci, *supra* note 19.

as not a team player.

A number of observers and commentators contend that holding nonprofit directors to high fiduciary standards is an undue interference with decision-making.<sup>260</sup> Others have argued that the standards should be raised,<sup>261</sup> or that standing should be expanded to increase remedies for nonprofit board member failures.<sup>262</sup> Existing law seems ample if properly applied. Courts have imposed relatively broad standing requirements where appropriate. For example, in one case a federal district court allowed patients of a nonprofit hospital to maintain a class action for alleged breach of trust to prevent continued injury to the hospital caused by the trustees' alleged self-dealing and overreaching.<sup>263</sup> Furthermore, as professor and former SEC Commissioner Harvey Goldschmid has pointed out, increasing the standard of care or expanding standing requirements would likely result in increased efforts to insulate directors from liability.<sup>264</sup> Although the remedies to redress failures of nonprofit directors remain

260. See, e.g., Lumen N. Mulligan, *What's Good for the Goose is Not Good for the Gander: Sarbanes-Oxley-Style Nonprofit Reforms*, 105 MICH. L. REV. 1981 (2007) (arguing that Sarbanes-Oxley governance reforms would be of little use for nonprofits); Karen Donnelly, Note, *Good Governance: Has the IRS Usurped the Business Judgment of Tax-Exempt Organizations in the Name of Transparency and Accountability?*, 79 U.M.K.C. L. REV. 163 (2010) (criticizing the IRS's expansion of Form 990 as an unfortunate intrusion on corporate governance and the business judgment rule).

261. See, e.g., Denise Ping Lee, Note, *The Business Judgment Rule: Should it Protect Nonprofit Directors?*, 103 COLUM. L. REV. 925 (2003).

262. See, e.g., Joshua B. Nix, Note, *The Things People Do When No One Is Looking: An Argument for the Expansion of Standing in the Charitable Sector*, 14 U. MIAMI BUS. L. REV. 147 (2005) (arguing for expanded standing requirements). *But cf.* Rob Atkinson, *Unsettled Standing: Who (Else) Should Enforce the Duties of Charitable Fiduciaries?*, 23 J. CORP. L. 655 (1998) (discussing the complex nature of deciding whether to expand traditional standing doctrines for challenging nonprofit fiduciaries). Notably, Professor Atkinson refers to H.L. Mencken's admonition that "there is always a well-known solution to every human problem—neat, plausible, and wrong." H.L. Mencken, PREJUDICES 158 (2d ed. 1977), quoted in Atkinson, *supra* note 262, at 657; see also, e.g., Mark Hall & John Columbo, *The Charitable Status of Nonprofit Hospitals: Toward a Donative Theory of Tax Exemption*, 66 WASH. L. REV. 307, 330 n.76 (1991) ("[F]or every complex problem, there is a solution which is simple, elegant . . . and wrong.").

263. *Stern v. Lucy Webb Hayes Nat'l Training Sch. for Deaconesses & Missionaries*, 381 F. Supp. 1003 (D.D.C. 1974) (finding that at the same time the court denied standing under the antitrust laws and also denied a class action seeking damages for the alleged improprieties).

264. Goldschmid, *supra* note 51, at 643 ("the absence of enforcement (because of forbearance by state charity regulators, understaffing, and highly restricted standing), not the "lowness" of care standards, makes [nonprofit] care standards largely aspirational. . . . [I]f enforcement opportunities are enhanced, nonprofit law may have to build in . . . mitigating provisions found in the for-profit sector.") (footnotes omitted) (quoting AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS 134, § 7.19 at 239–60 (1994)).



limited, there has long been a sense by many observers that nonprofit directors have and should have a higher duty than directors of for-profit corporations.<sup>265</sup>

We would like to think that increased education and best practices could help increase the oversight role of nonprofit directors because it is the right thing to do.<sup>266</sup> However, as one observer pointed out, quoting H.L. Mencken, “Conscience is the inner voice that warns us somebody may be looking.”<sup>267</sup> Although state attorneys general have oversight responsibilities for nonprofit organizations,<sup>268</sup> it is clear that many do not have time or resources to get involved except in extreme cases.<sup>269</sup> There is only so much that we can realistically expect from state policing of charities.<sup>270</sup>

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265. See, e.g., Leshner, *supra* note 48 (“It may well be argued, as in fact seems to be the law in most jurisdictions, that the duty of a director in a non-profit corporation is higher than that in a profit corporation and is in the nature of a trustee’s duty to his beneficiary.”).

266. Increased education and the establishment of best practices have been among the suggested solutions. See, e.g., Goldschmid, *supra* note 51, at 649–50 (recommending “Self-Help: More Precise Specification of Functions, Guidelines, and Enhanced Educational Efforts”).

267. Nix, *supra* note 262, at 147 (quoting H.L. Mencken, *A MENCKEN CHRESTOMATHY* (1949)).

268. See, e.g., *State ex rel. Petro v. Gold*, 850 N.E.2d 1218 (Ohio Ct. App. 2006) (finding breach of fiduciary duties by executive director in connection with use of professional solicitation firms).

269. See, e.g., Susan Gary, *Regulating the Management of Charities: Trust Law, Corporate Law, and Tax Law*, 21 U. HAW. L. REV. 593, 623 (1999) (discussing the understaffing of state attorneys general and their inability to address nonprofit abuses); Kenneth L. Karst, *The Efficiency of the Charitable Dollar: An Unfulfilled State Responsibility*, 73 HARV. L. REV. 433, 476 (1960) (suggesting a centralized state board to supervise private charities rather than the attorney general); Nix, *supra* note 262, at 167–81 (discussing the relative ineffectiveness of state attorneys general in policing nonprofits). The National Association of Attorneys General acknowledged this problem many years ago. See *Number of Full-Time Equivalent (FTE) Attorney Positions by Selected Practice Areas: “Public Protection”*, NAT’L ASS’N OF ATTORNEYS GENERAL 18, 20 (1997) (identifying staff available for charitable supervision). The National Association of Attorneys General website lists a number of important initiatives but charitable supervision is not one of them. See *Initiatives*, NAT’L ASS’N OF ATTORNEYS GENERAL, <http://www.naag.org/initiatives.php> (last visited June 16, 2011) (including, among other things, Amber Alert, DEA National Drug Take Back Day, Federal Trade Commission Money Matters for Consumers, Financial Fraud Enforcement Task Force, Global Justice Information Sharing Initiative (Global)). The association nevertheless cosponsored a conference on the Intersection of Technology, the Charitable Sector and State Regulators. *NAGTRI Co-Sponsors Charities Conference*, NAT’L ASS’N OF ATTORNEYS GENERAL, <http://www.naag.org/nagtri-co-sponsors-charities-conference.php> (last visited June 16, 2011).

270. See, e.g., Evelyn Brody, *Whose Public?, Parochialism and Paternalism in State Charity Law Enforcement*, 79 IND. L.J. 937 (2004) (discussing the appropriate role of the state in policing charities); Jennifer L. Komoroski, Note, *The Hershey Trust’s Quest to*

## XII. LIMITED REMEDIES FOR DIRECTOR MISCONDUCT

### A. Overview of Enforcement Issues

Nonprofit statutes typically give their state attorneys general the authority to police nonprofits. In some states, such as California, the attorney general is given broad authority to assure that nonprofit corporations are operating properly and in accordance with law.<sup>271</sup> Whereas in other states, the attorney general's authority is more limited.<sup>272</sup> The California Attorney General has taken an aggressive stance in the face of abuses. For example, in a highly publicized situation involving the foundation for the Museum of Contemporary Art (MOCA) in Los Angeles, it was suggested that a possible sanction for misuse of funds could be to hold the directors who approve those expenses accountable even though they did not receive the benefits.<sup>273</sup> This would be a striking provision in

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*Diversify: Redefining the State Attorney General's Role When Charitable Trusts Wish to Diversify*, 45 WM. & MARY L. REV. 1769 (2004) (discussing the attorney general's role in policing charities).

271. CAL. CORP. CODE § 5250 (2005); *see also*, Summers v. Cherokee Children & Family Serv., Inc., 112 S.W.3d 486, 506–07 (Tenn. Ct. App. 2002) (“The drafters of the Revised Model Act intended that the Attorney General of the incorporating state have wide discretion and broad powers in regulating public benefit corporations to ensure that they operate as nonprofits.”).

272. *See, e.g.*, Blumenthal Gen. v. Robin Barnes, 804 A.2d 152, 157 (Conn. 2002) (finding that the attorney general lacked statutory authority to challenge corporation's use of noncharitable receipts). The court concluded that the attorney general did not have the authority under common law. *Id.*; *see also, e.g.*, Lefkowitz v. Lebensfeld, 68 A.D.2d 488, 495 (N.Y. App. Div. 1979) (finding that attorney general did not have standing to enforce a charity's right to receive dividends, but noted that the attorney general could effectuate the purpose of donations). On the other hand, the court noted:

[I]t is clear that the Attorney-General's powers of representation and enforcement, whether of statutory or equity origin, are not limited to express trusts, but encompass those charitable dispositions where property has been donated for a specific purpose. In such cases a trust will be implied in the sense that the donated property will be required to be used for the purposes for which it was given and it is the duty and responsibility of the attorney general to require that these purposes be effectuated.

*Id.* at 495 (internal quotation marks omitted).

273. Mike Boehm, *State tells MOCA to Shape Up*, L.A. TIMES, Apr. 17, 2010, at 1 (“A spokeswoman for the Attorney General's office said Thursday penalties could include a requirement that board members repay money drawn improperly from an endowment, but ‘whether and how that occurs is based on the facts and circumstances of each situation.’”). The attorney general asserts this as one of his general powers with respect to nonprofits. *See* EDMUND G. BROWN JR., CALIFORNIA ATTORNEY GENERAL'S GUIDE FOR CHARITIES 34 (2005) (stating that the attorney general can sue directors for mismanagement and the proceeds from the suit will go to the charity).

light of the qualified immunity that attaches to nonprofit director wrongdoing.<sup>274</sup>

Under an outmoded view in California, only the state attorney general and not the donor could bring suit complaining about a charity's management of funds.<sup>275</sup> However, California overruled the holding that the attorney general has the exclusive right to sue for foundation mismanagement.<sup>276</sup> California is now in line with the general view that the attorney general's role in challenging nonprofit corporations is not exclusive.<sup>277</sup> Accordingly, the trustees or directors of a foundation have standing to challenge mismanagement by the foundation's managers.<sup>278</sup> For example, in one case the trustees were allowed to challenge the foundation manager and defendant trustees causing an amendment of the articles of incorporation to change the name and the purpose of the foundation.<sup>279</sup> Attempts to change a charity's mission can result in tremendous controversy.<sup>280</sup>

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274. See, e.g., CAL. CORP. CODE § 5231 (2010) (after setting forth the general duty of care, the statute provides that except in self-dealing transactions, directors generally have no liability); see also *id.* § 5239 (qualified immunity for negligence to third parties). It is noteworthy that liability in actions by the attorney general is expressly excluded from this immunity provision in actions by third parties. Curiously, however, this provision does not address the exculpatory language in § 5231. *Id.* § 5239(e)(2). Volunteer and nonprofit director immunity statutes are discussed *infra* notes 333–43 and accompanying text.

275. See *George Pepperdine Found. v. Pepperdine*, 271 P.2d 600 (Cal. App. 1954) (dismissing donor's lawsuit and holding that the attorney general was the exclusive way to challenge management of foundation funds); see also, Robert L. Gray, *State Attorney General—Guardian of Public Charities*, 14 CLEV. ST. L. REV. 236 (1965) (discussing the *Pepperdine* case and the attorney general's role in policing nonprofits). Cf. *O'Donnell v. Sardegna*, 646 A.2d 398 (Md. 1994) (Blue Cross Blue Shield subscribers did not have standing to challenge alleged mismanagement; attorney general would be the appropriate person to sue).

276. *Holt v. Coll. of Osteopathic Physicians & Surgeons*, 394 P.2d 932 (Cal. 1964).

277. See, e.g., *Smithers v. St. Luke's-Roosevelt Hosp. Ctr.*, 723 N.Y.S.2d 426, 434 (N.Y. App. Div. 2001) (finding that attorney general is not the exclusive enforcer; noting that “[t]he donor of a charitable gift is in a better position than the Attorney General to be vigilant and, if he or she is so inclined, to enforce his or her own intent”). Cf. *Lopez v. Medford Cmty. Ctr., Inc.*, 424 N.E.2d 229 (Mass. 1981) (members' suit claiming mismanagement by nonprofit directors could not be brought without joining attorney general); *Gilbert M. and Martha H. Hitchcock Found. v. Kountze*, 720 N.W.2d 31 (Neb. 2006) (finding that although derivative suit against nonprofit was appropriate, notice to the attorney general is a condition to the court considering the merits of the suit).

278. *Holt*, 394 P.2d at 932.

279. *Id.* at 938; see also, *Queen of Angels Hosp. v. Younger*, 136 Cal. Rptr. 36 (Cal. Ct. App. 1977) (finding, in action brought by the state attorney general, that nonprofit using funds for medical clinics instead of operating a hospital breached the duty of obedience).

280. See, e.g., Chris Abbinmante, *Protecting “Donor Intent” in Charitable Foundations: Wayward Trusteeship and the Barnes Foundation*, 145 U. PA. L. REV. 665 (1997)

*B. Remedies for Director Abuses: Director Removal*

It is clear from the foregoing discussion that meaningful accountability for nonprofit directors' breaches of duty is extremely limited. The basic remedies for director misconduct would include action by the attorney general,<sup>281</sup> and in a membership nonprofit, there is the possibility of a derivative suit.<sup>282</sup>

In an extreme case of director misconduct, the director may be subject to removal for cause.<sup>283</sup> Following the pattern for business corporations,<sup>284</sup> the Model Nonprofit Corporation Act provides for removal of directors by directors or members (if any) as well as judicial removal for cause.<sup>285</sup> Many states also allow for director removal without cause unless that authority is denied in the articles of incorporation.<sup>286</sup> At least thirty states

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(discussing the Barnes Foundation and other examples of trustees disregarding donor intent); Eisenstein, *supra* note 223 (discussing the tension between donor intent and charitable interest in conjunction with attempts to change the mission of the Barnes Foundation established to manage an art collection); *see also*, Jonathan Klick & Robert H. Sitkoff, *Agency Costs, Charitable Trusts, and Corporate Control: Evidence from Hershey's Kiss-Off*, 108 COLUM. L. REV. 749 (2008) (detailing the Hershey Trust's attempt to sell a controlling interest in Hershey Co. to diversify the trust's investments); Jennifer L. Kmoroski, *The Hershey Trust's Quest to Diversify: Redefining the State Attorney General's with Charitable Trusts Wish to Diversify*, 45 WM. & MARY L. REV. 1769 (2004) (same); Mark Sidel, *The Struggle for Hershey: Community Accountability and the Law in Modern American Philanthropy*, 65 U. PITT. L. REV. 1 (2003) (same).

281. *See, e.g.*, REVISED MODEL NONPROFIT CORP. ACT § 14.30(1) (2008) (authorizing the attorney general to bring suit to dissolve noncompliant nonprofit corporations).

282. *See, e.g.*, CAL. CORP. CODE § 5250 (West 2005) (describing members' derivative suits); N.C. GEN. STAT. § 55A-7-40 (2009) (describing derivative suits by a member or a director); REVISED MODEL NONPROFIT CORP. ACT ch. 13 (2009) (describing derivative suits generally); *id.* § 13.02 (authorizing a derivative suit to be brought by the lesser of five percent or fifty persons with voting rights or any member or director of a designated body).

283. *See, e.g.*, N.C. GEN. STAT. § 55A-8-10(a) (2009) (explaining that a court may remove a director if: "(1) The director engaged in fraudulent or dishonest conduct, or gross abuse of authority or discretion, with respect to the corporation, or a final judgment has been entered finding that the director has violated a duty set forth in [N.C. GEN. STAT. §] G.S. 55A-8-30 through [N.C. GEN. STAT. §] G.S. 55A-8-33, and (2) Removal is in the best interest of the corporation"). The action for judicial removal may be brought by either the corporation or ten percent of the members if it is a membership nonprofit corporation. *Id.* § 8-08. In addition to judicial removal for cause, directors may be removed with or without cause (unless the articles limit removal to for cause) by the directors or members who elected them. *Cf. Vacco v. Diamandopoulos*, 715 N.Y.S.2d 269, 272 (N.Y. Sup. Ct. 1998) (describing how the Board of Regents recommended the removal of eighteen university trustees for neglect of their duty of due care) (internal quotation marks omitted).

284. MODEL BUS. CORP. ACT §§ 8.08, 8.09 (2007).

285. REVISED MODEL NONPROFIT CORP. ACT §§ 8.08, 8.09 (2008).

286. *See, e.g., id.* § 8.08 (2008) (providing that directors can be removed with or without cause unless the articles of incorporation state that directors can only be removed for cause); *see also*, *Nevins v. Bryan*, 885 A.2d 233 (Del. Ch. 2005), *aff'd*, 884 A.2d 512 (Del. 2005)

have nonprofit director removal statutes that are fairly similar to Model Act § 8.08, including deference to rules stated in articles of incorporation or bylaws.<sup>287</sup> Twenty-one states have adopted judicial removal statutes for nonprofit directors that are fairly similar to Model Act § 8.09. Most of the statutes authorizing judicial removal of directors for cause require the action be brought by plaintiffs having a minimum stated amount of voting power (usually ten percent) when the action is brought by voting members or directors, as opposed to an action brought by the attorney general.<sup>288</sup> Even in the absence of a statutory definition, director misconduct can be sufficiently egregious to constitute cause for removal.<sup>289</sup> For example, a director's misuse of the organization's funds for personal purposes is grounds for removal.<sup>290</sup> Similarly, a director's ignoring the conflict of interest statutes<sup>291</sup> and setting his salary in excess of an organization's rules would also qualify as grounds for removal for cause.<sup>292</sup> Other types of self-dealing are grounds for removal as well.<sup>293</sup> A significant failure to comply with the organization's rules and procedures can be grounds for director removal.<sup>294</sup> A director's refusal to participate in board meetings and a

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(upholding the removal of a nonprofit director who allegedly inappropriately used about \$55,000 and noting that removal without cause is allowed by the Delaware statute).

287. *See, e.g.*, ARIZ. REV. STAT. § 10-3808 (2011) (providing that a director may be removed pursuant to the articles of incorporation or bylaws); CAL. CORP. CODE § 5222 (West 2005) (same); N.C. GEN. STAT. § 55A-8-09 (2009) (same).

288. CAL. CORP. CODE § 5223 (West 2005).

289. *See, e.g., In re Charles M. Bair Family Trust*, 183 P.3d 61 (Mont. 2008) (removing a museum board for a breach of fiduciary duties, including the failure to follow the museum's purpose and closing the museum); *Lutz v. Tanglwood Lakes Cmty. Ass'n*, 866 A.2d 471, 472 (Pa. Commw. Ct. 2005) (permitting questionable practices without informing that auditors could be removed for cause).

290. *See, e.g., People v. Winston*, No. 007180/10 (N.Y. Sup. Ct. Dec. 17, 2010) (finding sufficient cause for removal under New York Not-for-Profit Corporate Law § 706 where two directors had used approximately \$13,000 in company debit cards for personal purchases); *John v. John*, 450 N.W.2d 795, 802 (Wis. Ct. App. 1989) (affirming the removal of an officer and trustee for "gross misconduct"); *see also Turkish v. Kasenetz*, 832 F. Supp. 565, 574 (E.D.N.Y. 1993) (dismissing a claim under the Racketeer Influenced and Corrupt Organizations ("RICO") Act, 18 U.S.C. §§ 1961-68, while noting that the New York nonprofit director removal statute was enacted to deal with abuses such as fraud).

291. *See, e.g., REVISED MODEL NONPROFIT CORP. ACT* § 8.60 (2008) (providing conflict of interest provisions).

292. *Nixon v. Lichtenstein*, 959 S.W.2d 854, 861 (Mo. Ct. App. 1997).

293. *See, e.g., Cuomo v. Daniels*, 906 N.Y.S.2d 771 (N.Y. App. Div. 2009) (holding that removal for cause could be established where a director transferred real property to himself from a non-profit without paying any consideration or seeking approval for the transaction).

294. *See, e.g., Simoni v. Civil Serv. Emps. Ass'n, Local 1000*, 507 N.Y.S.2d 371, 377 (N.Y. Sup. Ct. 1986) (finding that a board member or officer's failure to comply with CSEA's constitution and bylaws could be a ground for removal for cause); *see also, Matzel v. Stonecrest Ranch Prop. Owners' Ass'n*, 305 S.W.3d 368, 373 (Tex. App. 2010)

complete disregard of the organization's requirements are causes for removal.<sup>295</sup> A single or isolated instance of noncompliance will not ordinarily be grounds for removal for cause.<sup>296</sup> Quite properly, courts are reluctant to order removal for cause except in extreme cases.<sup>297</sup> For example, disagreement among directors is not sufficient to justify removal for cause.<sup>298</sup> In fact, a director's obligation to do what he or she reasonably believes is in the best interest of the organization may lead him or her to voice disagreement rather than remain silent in order to fit in as a team player.

### C. *Role of the Attorney General*

As noted above, director removal may be initiated by the attorney general.<sup>299</sup> The attorney general's authority to institute an action for removal is viewed as part of his equitable powers, even in the absence of

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(dismissing a lawsuit challenging plaintiff's removal from the board).

295. *Gilbert M. & Martha H. Hitchcock Found. v. Kountze*, 720 N.W.2d 31, 33–35 (Neb. 2006), *aff'd*, 751 N.W.2d 129 (Neb. 2008) (upholding judicial removal of a nonprofit director for gross abuse of authority where the director refused to participate in board meetings for the preceding four years, changed the corporation's registered office without board approval, and attempted to hold elections for new directors without giving notice to other directors).

296. *See, e.g., Pullins v. Holmes*, 2007 Ohio 4603, ¶ 51 (Ohio Ct. App. 2007) (holding that defendant's refusal to recuse herself from meetings discussing a lawsuit filed against the corporation by the defendant's father did not constitute a conflict of interest, and therefore her removal under the bylaws was inappropriate); *Loveless v. Pocono Forest Sportman Club, Inc.*, 972 A.2d 572, 575–76 (Pa. Commw. Ct. 2009) (finding that paying other board members to perform snow removal and other maintenance work without soliciting bids is not sufficient to warrant removal of board members).

297. *See, e.g., Fox v. Cody*, 141 Misc. 552, 553–54 (N.Y. Sup. Ct. 1930) (suggesting substantial grounds for showing a breach of trust); *In re Lord's New Church*, 817 A.2d 559, 561 (Pa. Commw. Ct. 2003) (dismissing action for removal where defendants "had employed some heavy-handed tactics" to gain control of the board, but "had not 'run afoul of the Non-Profit Law so as to justify . . . imposing the drastic remedy of judicial supervision of the corporation's affairs'") (internal citations omitted).

298. *See, e.g., Campbell v. Loew's, Inc.*, 134 A.2d 852, 860–62 (Del. Ch. 1957) (holding that trying to change corporate policy is not grounds for removal for cause of a business corporation's director); *Mortimer v. McKeithan Lumber Corp.* 120 S.E. 723 (S.C. 1923) (finding that mere disagreement or friction between directors or officers is not cause for removal unless disagreement is extreme and interferes with the functioning of the corporation).

299. *Cuomo v. Daniels*, 906 N.Y.S.2d 771 (N.Y. App. Div. 2009) (holding that removal for cause could be established in action by the attorney general); *see also, State by & Through Pierotti v. Sundquist*, 884 S.W.2d 438, 445 (Tenn. 1994) (holding that a *quo warranto* action is consistent with the state's removal statute where the director is found to be grossly negligent for mismanagement of funds).

express statutory authority.<sup>300</sup> As noted earlier, state nonprofit statutes typically give state attorneys general broad authority to assure compliance with law. Although on occasion the state attorneys general initiate action against nonprofits to address abuses,<sup>301</sup> attorneys general simply do not have the resources to focus on nonprofits as an effective monitor of directors' duties.<sup>302</sup>

California has been one of the notable exceptions in terms of state attorneys general oversight of nonprofit corporations. As mentioned earlier, California adopted the Nonprofit Integrity Act of 2004<sup>303</sup> that imposes heightened audit and disclosure requirements on California nonprofits.<sup>304</sup> In addition, the California attorney general has been active in pursuing nonprofit charitable corporations that run afoul of the state's law.<sup>305</sup> For example, the attorney general will review the nonprofit's disclosures to determine if the directors are living up to their fiduciary responsibilities.<sup>306</sup> In another instance, mentioned earlier, the California

300. See *State v. Family Life Serv., Inc.*, 616 N.W.2d 826, 843 (N.D. 2000) (acknowledging equitable authority to remove nonprofit directors).

301. See, e.g., *NC AG Takes Action Against Nonprofit After Channel 9 Investigation*, WSOCTV (Feb. 4, 2011), <http://www.wsocvt.com/news/news/nc-ag-takes-action-against-nonprofit-after-channel/nGTck/> (Attorney General investigation into alleged NACA information mishandling settled) (on file with the University of Pennsylvania Journal of Business Law); see also Soughata Mukherjee, *Right Call on MCNC*, TRIANGLE BUS. J. (July 30, 2001), <http://www.bizjournals.com/triangle/stories/2001/07/30/editorial2.html> (discussing the Durham and Wake County district attorneys' investigation of private investments made by some nonprofit board members).

302. See *Nix*, *supra* note 262, at 176 (discussing problems with understaffing and fiscal constraints on attorneys general). Cf. *Holt v. Coll. of Osteopathic Physicians & Surgeons*, 394 P.2d 932 (Cal. 1964) (describing how an attorney general did not find a problem with the actions about which plaintiff trustees complained). In *Holt*, the attorney general was not the exclusive party to sue. *Id.* The court allowed the plaintiff-trustees to bring suit challenging the change in name and mission of the foundation. *Id.* The attorney general had found that the change was not a proper one since the funds were still going towards the public good even though the plaintiff trustees disagreed. *Id.*

303. CAL. GOV'T CODE § 12586 (West 2011). Other states have similar laws. See, e.g., 2005 CONN. ACTS 101 (Reg. Sess.); N.H. REV. STAT. ANN. § 7:28 (2004).

304. CAL. GOV'T CODE § 12586 (West 2011).

305. See, e.g., Mike Boehm, *MOCA Ordered to Revamp Its Budget Practices*, L.A. TIMES (Apr. 16, 2010), <http://articles.latimes.com/2010/apr/16/entertainment/la-et-moca-20100417> (alleging the mismanagement of museum funds); *Thomas & Schmidt, Practices of Dodgers' Charity*, *supra* note 58 (investigating the Dodgers' charity); *Thomas & Schmidt, Questions*, *supra* note 58 (same).

306. See, e.g., Letter from California Attorney General to Robert S. Bower, Esq., CAL. DEP'T OF JUST. OFFICE OF THE ATT'Y GEN. (Aug. 6, 2010) ([http://ag.ca.gov/cms\\_attachments/press/pdfs/n1968\\_closing\\_letter\\_for\\_csu\\_stanislaus\\_foundation.pdf](http://ag.ca.gov/cms_attachments/press/pdfs/n1968_closing_letter_for_csu_stanislaus_foundation.pdf)) (noting a failure to implement an auditor's recommendations, a failure to adequately protect charitable assets, and the board's failure to fully understand its duties and responsibilities).

attorney general suggested that a possible sanction for misuse of a charitable organization's funds could be to hold the directors who approve those expenses accountable even though they did not receive the benefits.<sup>307</sup> This is a very robust stance in light of immunity that attaches to nonprofit director wrongdoing.<sup>308</sup> In addition, the California attorney general publishes an extensive guide for charities,<sup>309</sup> which, among other things, asserts the attorney general's ability to recover misused assets from directors.<sup>310</sup> A number of states have useful information for directors on their website.<sup>311</sup> Other state attorneys general have been proactive. For example, the Massachusetts and Oregon attorneys general called for legislation to require the attorney general's approval for any nonprofit that compensates its directors.<sup>312</sup> The Oregon attorney general has been very aggressive in pursuing violations<sup>313</sup> and also publishes a list of the twenty worst charities in terms of the percentage of contributions that actually go to the charitable cause.<sup>314</sup> New York Governor Cuomo announced an investigation into nonprofit compensations, noting that nearly 2,000 nonprofit employees make just under \$169,000.<sup>315</sup> Some states have also

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307. Boehm, *supra* note 305.

308. *See, e.g.*, CAL. CORP. CODE § 5231(c) (West 2011) (providing, after setting forth the general duty of care, that except in self-dealing transactions, "a person who performs the duties of a director in accordance with subdivisions (a) and (b) shall have no liability based upon any alleged failure to discharge the person's obligations as a director, including, without limiting the generality of the foregoing, any actions or omissions which exceed or defeat a public or charitable purpose to which a corporation, or assets held by it, are dedicated"); *see also id.* § 5239 (providing qualified immunity for negligence to third parties). It is noteworthy that liability in actions by the attorney general is expressly excluded from this immunity provision in actions by third parties but does not address the exculpatory language in section 5231. *Id.* § 5239(e)(2). Volunteer and nonprofit director immunity statutes are discussed in the text accompanying notes 327–43 *infra*.

309. EDMOND G. BROWN, JR., CALIFORNIA ATTORNEY GENERAL, CALIFORNIA ATTORNEY GENERAL'S GUIDE FOR CHARITIES, [http://ag.ca.gov/charities/publications/guide\\_for\\_charities.pdf](http://ag.ca.gov/charities/publications/guide_for_charities.pdf) (last visited Nov. 10, 2011).

310. *Id.* at 34.

311. *See, e.g.*, CHARITIESNYS.COM: ACCESS, REFORM, ACCOUNTABILITY, N.Y. OFFICE OF THE ATT'Y GEN., <http://www.charitiesnys.com/> (including a link to "Guides and Publications" consisting of a collection of documents published to assist charitable organizations).

312. Lisa Chiu, *supra* note 233.

313. Press Release, Or. Dep't of Just., *Attorney General Kroger Announces Crackdown on Non-profits that Exploit Respect for U.S. Military Veterans*, (May 18, 2010) (<http://www.doj.state.or.us/releases/2010/rel051810.shtml>) (listing enforcement actions and settlements).

314. Press Release, Or. Dep't of Justice, *Oregon Attorney General Announces Oregon's Worst Charities and Landmark Legislation to Combat Irresponsible Non-profits*, (Dec. 9, 2010) (<http://www.doj.state.or.us/releases/2010/rel120910.shtml>).

315. Michael Gormley, *NY Investigates Wages, Bureaucracy at Nonprofits*, WALL ST. J., (Aug. 3, 2011, 4:57 PM), <http://online.wsj.com/article/AP4581db54fc74471dae49c55>



taken an active role in questioning nonprofit organizations' qualifications for state property tax exemptions.<sup>316</sup>

With respect to for-profit corporations, courts and the law generally are reluctant to get involved in the details of a corporation's operations.<sup>317</sup> However, in the case of nonprofits, the public interest may warrant intervention by the attorney general. For example, in one instance involving suspected conflict of interest allegations, the Missouri attorney general recommended changes in a nonprofit corporation's bylaws and governance structure that were eventually accepted by the foundation.<sup>318</sup> This type of proactive involvement by state attorneys general into corporate affairs is appropriate when called for in the case of nonprofits since public goods are involved.<sup>319</sup>

In some states the attorney general posts on his or her website notices of nonprofit corporations that have lost their status because of noncompliance with law.<sup>320</sup> Some state attorneys general also provide

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cd0572df6.html (“[A] task force will investigate salaries and other compensation at nonprofit agencies where [Gov. Andrew Cuomo] says about 2,000 workers are paid more than \$100,000 a year.”).

316. *See, e.g.*, *Provena Covenant Med. Ctr. v. Dep’t of Revenue*, 925 N.E.2d 1131 (Ill. 2010) (denying a state property tax exemption to a hospital that was not providing the charitable care necessary to retain nonprofit status); Kathy Bergin, *Illinois Department of Revenue Denies Tax Exemptions for 3 Hospitals*, CHIC. TRIBUNE, Aug. 17, 2011 (denying property tax exemptions to three hospitals for operating businesses rather than truly charitable operations); Stephanie Strom, *California Scrutinizes Nonprofits, Sometimes Ending a Tax Exemption*, N.Y. TIMES, Aug. 14, 2011, at B3 (discussing the increased vigor of the California attorney general in scrutinizing tax-exempt status with respect to the question of whether the organization provides sufficient benefits to in-state residents). As noted earlier, there is some movement seeking to cancel state property tax exemptions for all nonprofits as a way to raise revenue. *See* Fleischer, *supra* note 23, at 601 (discussing the charitable tax exemption as a *subsidy*). One counter to the property tax issue has been a compromise in terms of voluntary payments in lieu of taxes (PILOTs). PILOTs are beyond the scope of this article. For a report analyzing such programs, see DAPHNE A. KENYON & ADAM H. LANGLEY, *PAYMENTS IN LIEU OF TAXES: BALANCING MUNICIPAL AND NON PROFIT INTERESTS* (2010).

317. For example, this is one of the justifications for the business judgment rule. *See supra* text accompanying notes 146–48.

318. *See* Williams, *supra* note 253 (discussing approved changes to the Kauffman Foundation's bylaws); *Nixon says Kauffman has Beefed up KC Commitment*, KANS. CITY BUS. J., Sept. 1, 2004 (discussing the policy changes outlined by the Kauffman Foundation's Board of Trustees). The attorney general's recommendations also included that the foundation's bylaws be rewritten to require the CEO to move to Kansas City. *Id.*

319. *See, e.g.*, Eisenstein, *supra* note 223 (arguing that the public interest should always be considered when assessing the appropriate role for the state in monitoring charities).

320. *See, e.g.*, *Notice of Non-Compliant and De-Activated Charitable Organizations*, THE OFFICIAL WEBSITE OF THE ATT’Y GEN. OF MASS., <http://www.mass.gov/ago> (search “noncompliant charity” and follow “Notice of Non-Compliant and De-Activated Charitable

helpful compliance information for nonprofits and their directors.<sup>321</sup>

For years, standing to challenge nonprofit directors was extremely limited. This remains the case notwithstanding the fact that modern nonprofit corporation acts authorize derivative litigation.<sup>322</sup>

#### D. *Derivative Suits*

In business corporations, the shareholder derivative suit is a powerful weapon for challenging mismanagement.<sup>323</sup> Nonprofits do not have shareholders, but there may still be constituencies who arguably should be able to bring derivative suits. For example, in a membership nonprofit, the ability to bring a derivative suit could be conferred on members. Directors, as members of the governing board, could also be given the ability to sue derivatively on the organization's behalf. At one time it was unclear whether derivative litigation could be brought on behalf of nonprofit organizations.<sup>324</sup> Today, most nonprofit corporation acts recognize a derivative suit by members or directors.<sup>325</sup> The potential for significant attorneys' fees is a major motivator in the business world for bringing derivative suits.<sup>326</sup> It is not likely that derivative suits in the nonprofit world offer the potential for similar rewards, and thus the expense of retaining counsel in most situations may itself be a damper on the derivative suit as a meaningful remedy against nonprofit directors. In addition, beyond the problematic standing issues, statutory limitations on

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...” hyperlink).

321. See, e.g., EDMOND G. BROWN, JR., CALIFORNIA ATTORNEY GENERAL, CALIFORNIA ATTORNEY GENERAL'S GUIDE FOR CHARITIES (2005); *Charities*, THE OFFICIAL WEBSITE OF THE OFFICE OF THE MINN. ATT'Y GEN., <http://www.ag.state.mn.us/charities/> (last visited Oct. 30, 2011); MARK DEWINE, OHIO ATTORNEY GENERAL, GUIDE FOR CHARITY BOARD MEMBERS (N.D.).

322. See, e.g., REVISED MODEL NONPROFIT CORP. ACT ch. 13 (2008) (providing derivative suit provisions).

323. See generally COX & HAZEN, *supra* note 70, ch. 15 (discussing shareholder derivative suits).

324. See Atkinson, *supra* note 262 (discussing standing issues); Mary Grace Blasko, Curt S. Crossley & David Lloyd, *Standing to Sue in the Charitable Sector*, 28 U.S.F. L. REV. 37 (1993) (same); Brenda Bykin, *The Nonprofit Corporation: in North Carolina: Recognizing a Right to Member Derivative Suits*, 63 N.C. L. REV. 999 (1985) (arguing in favor of derivative suits for nonprofit corporations).

325. See, e.g., CAL. CORP. CODE § 5250 (2005) (discussing members' derivative suits); N.C. GEN. STAT. § 55A-7-40 (2009) (discussing derivative suits by a member or a director); REVISED MODEL NONPROFIT CORP. ACT ch. 13 (2009) (discussing derivative suits generally); *Id.* § 13.02 (noting that a derivative suit may be brought by the lesser of five percent or fifty persons with voting rights or any member or director of a designated body).

326. See generally COX & HAZEN, *supra* note 70, § 15:20 (discussing the awarding of attorneys' fees in derivative suits).

nonprofit directors' liability make derivative suits unworkable in many situations.

*E. Qualified Immunity from Suit*

The remedies for directors' lapses are quite limited. Nonprofit directors may take advantage of provisions in the nonprofit corporation act that permit directors to rely on officers and others in carrying out their duties, but directors will be held accountable for a lack of good faith and for not acting like a reasonable director under like circumstances.<sup>327</sup> This means that directors must have a basis for believing that they are acting in the best interests of the corporation.

Nonprofit directors in most states may take advantage of the limited immunity for volunteers.<sup>328</sup> The rationale is that immunity will encourage volunteerism.<sup>329</sup> Although some states remain outliers,<sup>330</sup> the law in most states is that volunteers for charitable organizations, including directors who are not compensated, are absolved from liability if they act in good faith and are not guilty of reckless, wanton, or intentional misconduct.<sup>331</sup> Some states supplement volunteer immunity with specific statutes limiting liability for directors of charitable nonprofit corporations.<sup>332</sup>

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327. See REVISED MODEL NONPROFIT CORP. ACT § 8.30 (2009) (stating general standard for directors). For examples of representative statutes, see CAL. CORP. CODE § 24001.5 (2005) (discussing liability of officers and directors of nonprofit medical corporations); N.C. GEN. STAT. § 55A-8-30 (2011) (discussing duties of nonprofit directors); TEX. BUS. ORG. CODE § 22.221 (same).

328. MASS. GEN. LAW ch. 231, § 85K (2011); N.C. GEN. STAT. § 1-539.10 (2011).

329. Jill R. Horwitz & Joseph Mead, *Letting Good Deeds Go Unpunished: Volunteer Immunity Laws and Tort Deterrence*, 6 J. EMP. LEG. STUD. 585 (2009) (suggesting a positive correlation between immunity statutes and increased volunteerism).

330. See, e.g., CONN. GEN. STAT. ANN. § 53-557d (2011) (abolishing the common law defense of charitable immunity).

331. See, e.g., MASS. GEN. LAW ch. 231, § 85K (2011) (granting qualified immunity for uncompensated directors of charitable educational institutions who act "in good faith and within the scope of his official functions and duties, unless such damage or injury was caused by willful or wanton misconduct"); N.C. GEN. STAT. § 1-539.10(a)(2) (2011) (granting qualified immunity except for "gross negligence, wanton conduct, or intentional wrongdoing"); N.J.S.A. 2A:53A-7 (2011) (granting qualified immunity for charitable volunteers, including directors).

332. REVISED MODEL NONPROFIT CORP. ACT § 8.31(d) (2009) (stating a director of a charitable nonprofit is not liable for acts or inaction except to the extent of any benefit received for having approved an unlawful distribution or for an intentional infliction of harm or an intentional criminal act).

In order to deal with outlier states, the federal Volunteer Protection Act<sup>333</sup> was passed in 1997. The Volunteer Protection Act, which excludes certain civil rights violations and violent acts,<sup>334</sup> grants a qualified immunity for volunteers of nonprofit and also government organizations provided “the harm was not caused by willful or criminal misconduct, gross negligence, reckless misconduct, or a conscious, flagrant indifference to the rights or safety of the individual harmed by the volunteer.”<sup>335</sup> The federal act, which applies to both federal and state claims,<sup>336</sup> subject to stated exceptions,<sup>337</sup> preempts state law unless the state law provides greater protection to the volunteer.<sup>338</sup>

The general qualified immunity for volunteers may be supplemented in some states by statutes specifically granting a qualified immunity to nonprofit directors and officers.<sup>339</sup> Some states provide that the immunity for directors does not extend to actions by the attorney general.<sup>340</sup>

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333. Volunteer Protection Act of 1997, Pub. L. No. 105-19, 111 Stat. 219 (1997).

334. 42 U.S.C. § 14503(f) (2011).

335. 42 U.S.C. § 14503(a)(3) (2011).

336. *Armendarez v. Glendale Youth Ctr., Inc.*, 265 F. Supp. 2d 1136 (D. Ariz. 2003) (holding that the Volunteer Protection Act applies to both state and federal claims).

337. The Volunteer Protection Act further provides that state law is not preempted in certain additional circumstances:

If the laws of a State limit volunteer liability subject to one or more of the following conditions, such conditions shall not be construed as inconsistent with this section:

(1) A State law that requires a nonprofit organization or governmental entity to adhere to risk management procedures, including mandatory training of volunteers.

(2) A State law that makes the organization or entity liable for the acts or omissions of its volunteers to the same extent as an employer is liable for the acts or omissions of its employees.

(3) A State law that makes a limitation of liability inapplicable if the civil action was brought by an officer of a State or local government pursuant to State or local law.

(4) A State law that makes a limitation of liability applicable only if the nonprofit organization or governmental entity provides a financially secure source of recovery for individuals who suffer harm as a result of actions taken by a volunteer on behalf of the organization or entity. A financially secure source of recovery may be an insurance policy within specified limits, comparable coverage from a risk pooling mechanism, equivalent assets, or alternative arrangements that satisfy the State that the organization or entity will be able to pay for losses up to a specified amount. Separate standards for different types of liability exposure may be specified.

42 U.S.C. § 14503(d) (2011).

338. 42 U.S.C. § 14502 (2011).

339. *See, e.g.*, CAL. CORP. CODE § 5239(a) (2011); N.C. GEN. STAT. ANN. § 55A-8-60(a)

Under the law of some states,<sup>341</sup> as well as under federal law,<sup>342</sup> the charitable director's qualified immunity is waived to the extent that the volunteer is covered by liability insurance. While at first glance, this might appear to mean that nonprofit directors should not ask for director and officer (D&O) liability insurance, this would not be a good approach. One of the major benefits of D&O insurance is that the insurance covers not only liability but also the defense of any suit. If suit is brought and the director wins on the basis of the qualified statutory immunity, the prevailing director would still be out of pocket for his or her legal defense costs. Accordingly, it is prudent for nonprofit directors to make sure that the charity carries D&O insurance for its board members.<sup>343</sup>

### XIII. IS THE ABSENCE OF A MORE MEANINGFUL REMEDY A FATAL FLAW?

Qualified potential candidates would be less likely to serve on nonprofit boards if the law did not limit liability of nonprofit directors. Limited liability does not mean that directors lack incentive to perform their fiduciary duties. There are collateral consequences a director has to worry about. A nonprofit director who breaches his or her duty most likely will have that reputation follow them into the for-profit world. Many nonprofit directors, especially of larger nonprofits, have significant positions with for-profit corporations and thus this collateral reputational taint is significant.

The law imposing responsibilities and standards on nonprofit directors may also be viewed as largely aspirational. Even in the for-profit world, it

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(2009).

340. See, e.g., N.Y. NOT-FOR-PROFIT CORP. LAW § 720-a (2011).

341. N.C. GEN. STAT. § 1-539-10(b) (2011) ("To the extent that any charitable organization or volunteer has liability insurance, that charitable organization or volunteer shall be deemed to have waived the qualified immunity herein to the extent of indemnification by insurance for the negligence by any volunteer."); TEX. CIV. PRAC. & REM. CODE § 84.004 (2011) ("[A] volunteer of a charitable organization is immune from civil liability for any act or omission resulting in death, damage, or injury if the volunteer was acting in the course and scope of the volunteer's duties or functions, including as an officer, director, or trustee within the organization.").

342. 42 U.S.C. § 14503(d)(4) (2011).

343. While it is true that some personal umbrella policies and homeowners' insurance may cover nonprofit board service as well, the authors recommend a belt and suspenders approach by suggesting that corporation sponsored D&O insurance should be a candidate's prerequisite to his or her willingness to serve on a nonprofit board regardless of the presence of homeowners' or umbrella insurance that the candidate may otherwise have. In addition to insurance, the Nonprofit Corporation Act provides for both mandatory and permissive indemnification by the corporation for a director's expenses in litigating claims. REVISED MODEL NONPROFIT CORP. ACT §§ 8.50–8.58 (2008).

has been suggested that the law has not had a demonstrably significant impact on tightening directors' standards of conduct.<sup>344</sup> Heightened IRS and state attorney general involvement appear to be making the law a more significant factor in the context of nonprofit boards.

#### XIV. CONCLUSION

As pointed out above, there has been criticism of enhanced scrutiny of nonprofit governance structures and operations.<sup>345</sup> At the same time, the more vigorously the tax laws and state nonprofit laws are enforced, the more likely it is that abuses come to light.<sup>346</sup> Based on this alone, it is difficult to conclude that there is too much regulation of nonprofit charitable organizations. At the other extreme, many observers call for increased accountability and heightened regulation of nonprofits.<sup>347</sup> After analyzing the existing regulation, we conclude that there is ample authority to vigorously enforce nonprofit directors' obligations.

State statutes clearly subject directors to high standards of keeping informed and overseeing the organization's operations.<sup>348</sup> These high standards are counterbalanced by immunity provisions that apply when no self-dealing is involved. This appears to be an appropriate balance in order to deter inappropriate derivative litigation. In cases of extreme misconduct, derivative litigation remains an option in most states. Such private remedies, however, are merely ancillary.

Charities and many other nonprofits provide a public benefit. Since they are dealing in public goods, federal tax-exempt status provides a government subsidy. State law also provides tax subsidies as well as providing the governing rules through nonprofit corporation acts and the like. It is thus appropriate for the government agencies to step up as they have. The IRS should continue its enhanced disclosure obligations and step up its vigorous enforcement efforts. States such as California have

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344. See, e.g., Donald C. Langevoort, *The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability*, 89 GEO. L.J. 797, 800 (2001) (agreeing with "many commentators that the law has played a relatively minor role in the evolution of board structure and behavior; market and other social forces are far more important") (citing Melvin A. Eisenberg, *Corporate Law and Social Norms*, 99 COLUM. L. REV. 1253, 1279–81 (1999)); Edward B. Rock & Michael L. Wachter, *Norms & Corporate Law*, 149 U. PA. L. REV. 1607, 1608, 1617 (2001) (emphasizing attention to norms in a corporate setting).

345. See *supra* text accompanying note 126 (criticizing IRS policy).

346. See I.R.S. Form 990 (requiring disclosures of certain governance practices).

347. See Mayer & Wilson *supra* note 73, at 479 (arguing that state-based regulation is more appropriate than relying on IRS rules).

348. REVISED MODEL NONPROFIT CORP. ACT §§ 8.30–8.31 (2008).

demonstrated that enhanced state law enforcement is effective. State attorneys general should be given more resources in order to allow more aggressive pursuit of nonprofits similar to those that have occurred in California, New York, Oregon, and a few other states.