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Brenda Boykin

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NOTE

The Nonprofit Corporation in North Carolina: Recognizing a Right to Member Derivative Suits

Nonprofit corporations are an increasingly important part of the American economy. Although they control a "staggering"¹ amount of wealth, nonprofit corporations have received far less attention from scholars, courts, and legislatures than "for-profit" corporations.² In most states, including North Carolina, an important legal mechanism for discouraging mismanagement on the part of corporate directors and officers—the right to bring a derivative suit—is not given members of nonprofit corporations.³

Under existing law in North Carolina and most other states, a member who suspects that a nonprofit corporation director or officer has breached a duty to the corporation either must prevail on the directors to sue on behalf of the corporation or bring his complaint to the Attorney General's attention.⁴ When the directors are benefitting from the wrongdoing and the Attorney General's office is unresponsive, there is no redress for a wrong to the corporation. This Note examines the basis of derivative suits and analyzes the desirability of recognizing a right for members of nonprofit corporations in North Carolina to bring such suits. It concludes that recognition of such a right would provide a valuable means of supervising the management of many of the state's nonprofit corporations.⁵

A nonprofit corporation by definition is organized for a purpose other than the direct pecuniary gain of its incorporators or members.⁶ Unlike for-profit

1. Henn & Boyd, *Statutory Trends in the Law of Nonprofit Organizations: California, Here We Come!*, 66 CORNELL L. REV. 1103, 1104 n.3 (1981). One commentator has estimated that there are now at least as many nonprofit corporations as "for-profit" corporations in the United States. H. OLECK, *NONPROFIT CORPORATIONS, ORGANIZATIONS AND ASSOCIATIONS* 4 (4th ed. 1980). Nonprofit corporations are increasing in number. See J. DUKEMINIER & S. JOHANSON, *WILLS, TRUSTS, AND ESTATES* 608-09 (1984); H. OLECK, *supra*, at 5-6; Tivnan, *Foundations: A Time for Review*, N.Y. Times, Sept. 9, 1984, § 6 (Magazine), at 135.

2. Henn & Boyd, *supra* note 1, at 1106-07. This Note will refer to general business corporations as "for-profit" corporations to distinguish them from nonprofit corporations. A for-profit corporation is organized for the pecuniary profit of its shareholders, although it may never in fact earn profits. See 1 W. FLETCHER, *CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS* § 68 (rev. perm. ed. 1983); H. HENN & J. ALEXANDER, *LAW OF CORPORATIONS* § 1, at 2-3 (3d ed. 1983). Conversely, a nonprofit corporation may earn profits, but is forbidden to distribute them to its members. See *infra* notes 6-10 and accompanying text.

3. See H. OLECK, *supra* note 1, at 1149-50; see also Goshien, *Relocation of Publicly Supported Charitable Organizations*, 19 CLEV. ST. L. REV. 316 (1970) (discussing supervision of charitable nonprofit corporations). This Note will refer to those participating in for-profit corporations as "shareholders," while referring to participants in nonprofit corporations as "members."

4. See *infra* notes 74-82 and accompanying text.

5. Legislation amending North Carolina's Nonprofit Corporation Act, N.C. GEN. STAT. §§ 55A-1 to -89.1 (1982), to provide procedures for derivative suits by members and directors has been proposed by the General Statutes Commission and introduced in the General Assembly. H. 939, 1st Sess. (1985).

6. 1 W. FLETCHER, *supra* note 2, § 68. The Model Non-Profit Corporation Act of the Ameri-

corporations, nonprofit corporations cannot distribute profits or net income to their members, officers, or directors⁷ and are prohibited from issuing shares of stock or paying dividends to those who have contributed capital.⁸ All income must be retained and used to advance the purpose of the corporation.⁹ Directors or officers of such a corporation may receive only reasonable compensation for services they render to the corporation.¹⁰ This broad definition allows a wide variety of associations to incorporate as nonprofits, including organizations for charitable or altruistic purposes,¹¹ religious groups, social clubs, and homeowner associations.¹²

Today most states have statutes that deal explicitly with nonprofit corpora-

can Bar Association and American Law Institute defines a nonprofit corporation as "a corporation no part of the income or profit of which is distributable to its members, directors or officers." MODEL NON-PROFIT CORPORATION ACT § 2 (1980), *reprinted in* 1 W. FLETCHER, *supra* note 2, § 2.75 [hereinafter cited as MODEL ACT].

7. MODEL ACT, *supra* note 6, § 2(c); see 1 W. FLETCHER, *supra* note 2, § 68; H. OLECK, *supra* note 1, at 17; Hansmann, *Reforming Nonprofit Corporation Law*, 129 U. PA. L. REV. 497, 501 (1981).

8. 1 W. FLETCHER, *supra* note 2, § 68.

9. *Id.* Many states permit distribution of assets to members upon dissolution. North Carolina's Nonprofit Corporation Act authorizes distribution to members upon dissolution of the corporation if the corporation's charter or by-laws so provide. N.C. GEN. STAT. § 55A-45(4) (1982). Assets received subject to limitations on their use, such as donations for a specific charitable purpose, must upon dissolution be transferred or conveyed to an organization "engaged in activities substantially similar to those of the dissolving corporation." *Id.* § 55A-45(3). This provision is a variation of the equitable doctrine of *cy pres*, which allows a court to order that charitable trust funds be applied in a manner different from—but as close as possible to—the settlor's express directions when accomplishment of the original purpose of the trust has become impossible or impracticable. G.G. BOGERT & G.T. BOGERT, *HANDBOOK OF THE LAW OF TRUSTS* § 147 (5th ed. 1973); M. FREMONT-SMITH, *FOUNDATIONS AND GOVERNMENT* 31-34, 127-28 (1965); Haskell, *The University as Trustee*, 17 GA. L. REV. 1, 6-8 (1982).

10. 1 W. FLETCHER, *supra* note 2, § 68; Hansmann, *supra* note 7, at 501.

11. A founder can organize a charity either as a charitable trust or a nonprofit corporation. J. DUKEMINIER & S. JOHANSON, *supra* note 1, at 608. Approximately two-thirds of all charities are organized as corporations. *Id.* at 608-09. According to Professor Haskell, the corporate form is preferred more by charities that operate an organization such as a hospital, school, or church than charities that invest money to subsidize charitable undertakings. P. HASKELL, *PREFACE TO THE LAW OF TRUSTS* 77 (1975). The corporate form protects trustees of charitable organizations from the harsh rules of personal liability in contract and tort actions. See *id.* at 130-34; see generally Henn & Pfeifer, *Nonprofit Groups: Factors Influencing Choice of Form*, 11 WAKE FOREST L. REV. 181 (1975) (discussing factors to be weighed by a nonprofit group choosing its form and recommending that most groups give serious consideration to incorporation).

12. H. BALLANTINE, *BALLANTINE ON CORPORATIONS* § 7 (rev. ed. 1946). The Model Non-Profit Corporation Act provides that a nonprofit corporation may be organized:

for any lawful purpose or purposes, including, without being limited to, any one or more of the following purposes: charitable; benevolent; eleemosynary; educational; civic; patriotic; political; religious; social; fraternal; literary; cultural; athletic; scientific; agricultural; horticultural; animal husbandry; and professional, commercial, industrial or trade association; but labor unions, cooperative organizations, and organizations subject to any of the provisions of the insurance laws of this State may not be organized under this Act.

MODEL ACT, *supra* note 6, § 4.

Schemes for classifying nonprofit corporations can be complex. Hansmann, *supra* note 7, at 502-04, for example, places nonprofit corporations into four categories according to whether the corporation receives most of its income from donations and contributions or from charging for the services it provides and whether the corporation is controlled by its donors or by a centralized group of managers. Cf. CAL. CORP. CODE §§ 5.000-10.841 (West 1977 & Supp. 1985) (California Non-profit Corporation Law divides nonprofit corporations into three categories according to purpose: mutual benefit, religious, or public benefit.).

tions.¹³ Many of these acts are based on the Model Non-Profit Corporation Act of the American Bar Association and American Law Institute.¹⁴ Despite the proliferation of statutes governing nonprofits, the law of nonprofit corporations is considerably less developed than the law of for-profit corporations.¹⁵ This relative lack of development is due in part to the close relationship between charitable nonprofit corporations and charitable trusts.¹⁶ Because of the similarities between charitable trusts and charitable corporations, courts fashioning rules for charitable corporations frequently borrow from the law of trusts when the state has no nonprofit statute or when its statute is silent on the matter at issue.¹⁷

The law pertaining to charitable nonprofits—and with it the law of nonprofit corporations in general—thus evolved into a hybrid of corporate and trust principles.¹⁸ For example, courts have disagreed over the duty of loyalty to which directors of nonprofit corporations should be held. A trustee traditionally is held to a higher loyalty standard than a director of a for-profit corporation.¹⁹ When the conduct of a nonprofit's director is in question, some courts apply a

13. See 1 W. FLETCHER, *supra* note 2, § 2.65 (listing states having such statutes).

14. North Carolina's Nonprofit Corporation Act, N.C. GEN. STAT. §§ 55A-1 to -89.1 (1982) is among the state acts based on the Model Act. R. ROBINSON, NORTH CAROLINA CORPORATION LAW AND PRACTICE 5 n.1 (3d ed. 1983). As of 1983, 37 other states had enacted nonprofit corporation acts based on the Model Act. See 1 W. FLETCHER, *supra* note 2, § 2.65. The Model Non-Profit Corporation Act was approved in 1952 and currently is being revised. H. HENN & J. ALEXANDER, *supra* note 2, § 1, at 3 n.4.

15. See Leshner, *The Non-profit Corporation—A Neglected Stepchild Comes of Age*, 22 BUS. LAW. 951, 951 (1967).

16. Whereas a private trust may be established to benefit one or more individuals, a charitable trust is created to accomplish a "substantial" benefit to a reasonably large portion of the public. G.G. BOGERT & G.T. BOGERT, *supra* note 9, § 54. A charitable trust also must advance one of several judicially recognized charitable purposes, which include the relief of poverty, the advancement of religion, the advancement of health, the advancement of government purposes, and other purposes of benefit to the community. *Shenandoah Valley Nat'l Bank v. Taylor*, 192 Va. 135, 63 S.E.2d 786 (1951); *Haskell*, *supra* note 9, at 3. If the trust serves one of these purposes, it need not benefit directly a large group, because it will benefit indirectly the entire community. Thus, a trust to provide college scholarships to only a few people each year is a valid charitable trust because it advances education and benefits the community as a whole. J. DUKEMINIER & S. JOHANSON, *supra* note 1, at 588.

A charitable nonprofit corporation may be established to serve one of the recognized purposes of a charitable trust. P. HASKELL, *supra* note 11, at 78. A corporation also may be considered "charitable" by the public although it serves a purpose other than those considered charitable under trust law. *Id.*

17. See M. FREMONT-SMITH, *supra* note 9, at 41; Note, *The Charitable Corporation*, 64 HARV. L. REV. 1168, 1168 (1951).

18. According to one court, "the charitable corporation is a relatively new legal entity which does not fit neatly into the established common law categories of corporation and trust." *Stern v. Lucy Webb Hayes Nat'l Training School for Deaconesses and Missionaries*, 381 F. Supp. 1003, 1013 (D.D.C. 1974); see Note, *supra* note 17, at 1168. Confusion has been furthered by the decisions of some courts that a charitable corporation holds its assets in trust for the benefit of the community. See cases cited in *Haskell*, *supra* note 9, at 4 n.11. Another source of confusion is the practice of designating directors of charitable corporations as "trustees." See Note, *supra* note 17, at 1168-69.

19. The duty of loyalty applied to trustees precludes self-dealing. G.G. BOGERT & G.T. BOGERT, *supra* note 9, § 543; P. HASKELL, *supra* note 11, at 98-102; Note, *The Fiduciary Duties of Loyalty and Care Associated With the Directors and Trustees of Charitable Organizations*, 64 VA. L. REV. 449, 451-52 (1978). Self-dealing by a director of a for-profit corporation, however, generally is valid if approved by a majority of the shareholders acting with full disclosure, if approved by a disinterested majority of the board of directors upon full disclosure, or if the transaction is fair. H. HENN & J. ALEXANDER, *supra* note 2, at 637-44; Note, *supra*, at 452-53.

trust standard of loyalty²⁰ or another standard stricter than that applicable to a business corporation director.²¹

The rights of members of nonprofit corporations also are somewhat uncertain. The Model Non-Profit Corporation Act defines a "member" as "one having membership rights in a corporation in accordance with the provisions of its articles of incorporation or by-laws."²² The Act also provides that members may be given voting rights, including the right to elect directors.²³ Under the Act a corporation may have no members or may have members with no voting rights; in either case the directors have sole voting power.²⁴ The designation of members with voting rights is particularly convenient when those contributing to the organization are likely to expect a voice in corporate management, as with nonprofit organizations such as social clubs and homeowner associations, which

20. See, e.g., *Wellesley College v. Attorney Gen.*, 313 Mass. 722, 723-24, 49 N.E.2d 220, 223 (1943).

21. See, e.g., *Mountain Top Youth Camp, Inc. v. Lyon*, 20 N.C. App. 694, 202 S.E.2d 498 (1974). In *Lyon* the court held that self-dealing by a charitable corporation's directors or officers is not automatically void. *Id.* at 697, 202 S.E.2d at 500. Although it can be ratified by the corporation, the transaction is void per se when there has been no disclosure, and the directors or officers may not raise a defense of fairness. But see *Fowle Memorial Hosp. Co. v. Nicholson*, 189 N.C. 44, 49, 126 S.E. 94, 97 (1925) (applying for-profit corporation standard to an allegation of self-dealing on part of a director of a nonprofit hospital corporation).

Some of the same uncertainty exists about the standard of care to be applied to nonprofit directors and officers. Under the for-profit corporation standard of care, a director or officer must exercise the care of an ordinarily prudent person under similar circumstances and is given the benefit of the business judgment rule when transactions result in loss to the corporation. *H. HENN & J. ALEXANDER*, *supra* note 2, § 232, at 613, 661-63. A trustee, on the other hand, is held to the standard of care usually expressed as "that of a prudent man dealing with his own property." *G.G. BOGERT & G.T. BOGERT*, *supra* note 9, § 93. The trust standard is stricter in application, and there is no counterpart to the business judgment rule. *Stern v. Lucy Webb Hayes Nat'l Training School for Deaconesses and Missionaries*, 381 F. Supp. 1003, 1013 (D.D.C. 1974); Note, *supra* note 19, at 453-54.

Courts have applied the trust standard of care to nonprofit directors. See, e.g., *Wellesley College v. Attorney Gen.*, 313 Mass. 722, 49 N.E.2d 220 (1943). There is authority, however, for applying the same standard of care to nonprofit directors and officers as to for-profit directors and officers. *Stern*, 381 F. Supp. at 1013; *Pasley, Non-Profit Corporations—Accountability of Directors and Officers*, 21 BUS. LAW. 621, 638 (1966). Some commentators have argued that because nonprofit directors often serve without compensation, they should be held to a standard of care even more lenient than that applied to for-profit directors (such as liability only for gross negligence). See *id.* at 622-27; Note, *supra* note 17, at 1174. The Uniform Management of Institutional Funds Act provides that the managers of organizations for educational, religious, or charitable purposes shall be held to the same standard of care as directors of for-profit corporations. UNIF. MANAGEMENT OF INSTITUTIONAL FUNDS ACT § 6, 7A U.L.A. 421 (1978). The Act has been adopted in about half the states, but not in North Carolina. See *id.* § 5, 7A U.L.A. at 405. Although the *Lyon* decision delineates the standard of loyalty for directors and officers of nonprofit corporations in North Carolina, there is no case law in North Carolina addressing the standard of care for nonprofit corporation directors.

22. MODEL ACT, *supra* note 6, § 2(f); see also N.C. GEN. STAT. § 55A-2(7) (1982) (identical definition of "members").

23. MODEL ACT, *supra* note 6, § 2(f); see also N.C. GEN. STAT. §§ 55A-20(c), -32 (1982) (similar provisions).

24. MODEL ACT, *supra* note 6, § 2(f); see *Hansmann, supra* note 7, at 502 (noting that most statutes provide for a self-perpetuating board of directors in the event that a nonprofit corporation gives its members no voting rights or has no members). North Carolina's Nonprofit Corporation Act also provides that the corporation may have no members, or may have members with no voting rights. N.C. GEN. STAT. § 55A-29(a) (1982). If there are no members or they cannot vote, the directors are to be "elected or appointed in the manner and for the terms as provided in the bylaws." *Id.* § 55A-20(c).

are organized for the mutual benefit of their members.²⁵ The designation of members, however, is not limited to mutual benefit nonprofits.²⁶

When members of a nonprofit corporation have a right to elect directors and vote on major corporate matters, they are similar to shareholders. Courts and legislatures, however, have not extended to members one of the principal tools shareholders use to oversee corporate managers—the right to bring a derivative suit against a director or officer.

In a derivative suit, a shareholder sues not on his own rights, but on behalf of the corporation.²⁷ The shareholder is the nominal plaintiff and the corporation is the real party in interest.²⁸ In a for-profit corporation, a shareholder may be unable to prevail on the corporation to sue on its own behalf; the wrongdoers may be in control of the corporation or a majority of the shareholders may be benefitting from the wrongful acts.²⁹ Even if a shareholder could prevail on the majority to elect directors who would sue on the corporation's behalf, such an effort would be expensive and time-consuming for a large, publicly held corporation.³⁰ Recognizing the potential for an unredressed wrong to the corporation, courts of equity historically allowed shareholders to sue on behalf of the corporation.³¹

25. H. BALLANTINE, *supra* note 12, § 7.

26. For example, a charitable nonprofit corporation may designate contributors of a certain amount as "members" or even "life members." A charitable nonprofit corporation is less likely to designate members, however, than a mutual benefit nonprofit corporation simply because donors to a charitable enterprise usually do not expect the right to elect directors and other privileges that generally are incidents of "membership." When a charitable nonprofit designates donors as members, the common-law rules on donor standing govern whether members can sue managers. See *infra* note 114 and cases cited *infra* note 41. But see cases cited *infra* note 73.

27. 13 W. FLETCHER, *supra* note 2, § 5939. The derivative cause of action stems from a wrong to the corporation as a whole and must be distinguished from a direct cause of action arising from a wrong to the shareholder. In general, a breach of the membership contract between the shareholder and the corporation gives rise to an individual or direct cause of action whereas a derivative claim arises when there has been a breach of a duty owed to the corporation. H. HENN & J. ALEXANDER, *supra* note 2, § 360, at 1048. This distinction may be difficult to make because performance of the shareholders' membership contract is one aspect of the duty that management owes the corporation. *Id.* § 360, at 1049. Among the claims usually deemed to give rise to direct or individual shareholder actions are suits to compel payment of declared or mandatory dividends, suits to enforce a right to inspect corporate books, suits to enforce the right to vote, and suits to enjoin a threatened wrong before its consummation. *Id.* In contrast, actions to recover damages from a consummated ultra vires act and actions to recover damages from directors or officers for mismanagement of the business, appropriation of corporate funds or corporate opportunities, sale of control, and other breaches of duties owed to the corporation all have been held to give rise to a derivative rather than a direct shareholder action. *Id.* § 360, at 1049-50.

28. 13 W. FLETCHER, *supra* note 2, § 5939.

29. W. CARY & M. EISENBERG, *CASES AND MATERIALS ON CORPORATIONS* 888 (5th ed. 1980); H. HENN & J. ALEXANDER, *supra* note 2, § 358, at 1036 n.1.

30. W. CARY & M. EISENBERG, *supra* note 29, at 886.

31. *Ross v. Bernhard*, 396 U.S. 531, 534 (1970). For an early case recognizing a derivative suit and discussing the rationale behind such a cause of action, see *Hawes v. Oakland*, 104 U.S. 450 (1882). Professor Prunty argues that recognition of the derivative suit followed from the application of two bodies of law to an action by a shareholder: the trust law theory that a director is a trustee for the shareholders and the doctrine of the "corporate entity," which recognizes that the corporation is a separate right-holding entity. Prunty, *The Shareholders' Derivative Suit: Notes on its Derivation*, 32 N.Y.U. L. REV. 980, 986-90 (1957). When only the rights of the corporation are at stake, the shareholder has no individual cause of action and must sue in a derivative or representative capacity. *Id.*

As elaborated in the cases, one precondition for the suit was a valid claim on which the corporation could have sued; another was that the corporation itself had refused to proceed after suitable demand Thus the dual nature of the stockholder's action: first the plaintiff's right to sue on behalf of the corporation and, second, the merits of the corporation's claim itself.³²

As derivative suits became more common, they proved subject to abuse by plaintiffs who sued not to recover on behalf of the corporation but to extract a lucrative settlement from the corporation.³³ In response courts and legislatures attempted to curb such "strike suits" by limiting the derivative suit.³⁴ The following requirements were added: that the plaintiff be a shareholder at the time of the challenged transaction;³⁵ that the shareholder demand that the directors bring suit on behalf of the corporation unless such a demand would be futile;³⁶ that the shareholder post a security bond for the defendants' litigation expenses;³⁷ and that any recovery, including a settlement, go to the corporation rather than to the individual shareholder.³⁸

The shareholder derivative suit has become a successful technique for discouraging mismanagement and abuse of fiduciary duties.³⁹ It has remained, however, primarily a device for calling managers of for-profit corporations to account; a similar action generally has not been available against a director or officer of a nonprofit corporation. Most nonprofit statutes are silent on whether a member may bring a derivative suit; consequently, the limits on such suits stem primarily from the common law.⁴⁰ When members of charitable nonprofits have attempted to bring derivative suits, some courts have denied them standing by analogy to the rule that only the attorney general can sue to enforce charitable trusts.⁴¹ Courts also have denied standing to members of noncharita-

32. *Ross v. Bernhard*, 396 U.S. 531, 534-35 (1970).

33. W. CARY & M. EISENBERG, *supra* note 29, at 888; H. HENN & J. ALEXANDER, *supra* note 2, § 358, at 1039; see *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 741-43 (1975) (even a plaintiff with a patently groundless claim may extract a settlement from a corporation since the plaintiff can threaten extensive discovery and disruption of corporate business).

34. H. HENN & J. ALEXANDER, *supra* note 2, § 358, at 1039-40. These limits are unique to the shareholder derivative action. *Id.*

35. This provision prevents a plaintiff from buying a cause of action. W. CARY & M. EISENBERG, *supra* note 29, at 914-17; H. HENN & J. ALEXANDER, *supra* note 2, § 362, at 1048.

36. See W. CARY & M. EISENBERG, *supra* note 29, at 926-27; H. HENN & J. ALEXANDER, *supra* note 2, § 365, at 1069-70.

37. This requirement may be limited to shareholders with holdings below a prescribed minimum. If the plaintiff is unsuccessful, he forfeits the bond. According to Henn and Alexander, the bond requirement saddles an unsuccessful small shareholder with the expenses of both sides of the litigation—"an awesome and rather unique situation." H. HENN & J. ALEXANDER, *supra* note 2, § 372, at 1092.

38. This requirement lessens a plaintiff's motivation to bring a strike suit, but does not lessen the motivation of a plaintiff's attorney, who may be the actual instigator of the suit and may hope that the court will allow him generous fees out of any recovery. See *id.* § 372, at 1093 n.22.

39. W. CARY & M. EISENBERG, *supra* note 29, at 888.

40. See *supra* notes 27-38 and accompanying text.

41. See, e.g., *Lopez v. Medford Community Center*, 384 Mass. 171, 175, 424 N.E.2d 229, 232 (1981) (only attorney general can initiate judicial proceedings to correct abuses in administration of public charities); *Dillaway v. Burton*, 256 Mass. 568, 574, 153 N.E. 13, 16-17 (1926) (member of a charitable corporation is without standing to sue to enjoin alleged unlawful acts of "trustees" of corporation because plaintiff's complaint concerns public interest rather than his private interest as a

ble nonprofit corporations, without distinguishing between the charitable and noncharitable purposes of the two types of corporations.⁴²

During the past twenty years, the New York and California legislatures and the courts of several other states have reversed the common-law ban on derivative suits by members of nonprofit corporations. New York's Not-For-Profit Corporation Law (N-PCL), enacted in 1969, provides that:

An action may be brought in the right of a domestic or foreign corporation to procure a judgment in its favor by five percent or more of any class of members or capital certificate holders of record or owners, not of record, of a beneficial interest in the capital certificates of such corporation.⁴³

The N-PCL is designed to parallel New York's Business Corporation Law (BCL).⁴⁴ Accordingly, the nonprofit derivative suit provisions are modeled after the BCL provisions for shareholder derivative suits against directors and officers.⁴⁵ A derivative action under the N-PCL must meet the following requirements: the plaintiffs must have been members at the time the action was brought;⁴⁶ the complaint must allege with particularity the plaintiffs' efforts to secure board action prior to suit;⁴⁷ the action must not be compromised or settled without court approval;⁴⁸ and the court may award expenses to the plaintiffs if the action is successful.⁴⁹

The New York N-PCL, however, differs from the BCL derivative suit pro-

member); *Voelker v. St. Louis Mercantile Library Ass'n*, 359 S.W.2d 689, 694-95 (Mo. 1962) (charitable corporation is subject to the principles applicable to charitable trusts, and because a charitable corporation is organized for benefit of others, its members do not have pecuniary interest analogous to that of shareholders); *Carroll v. City of Beaumont*, 18 S.W.2d 813, 820 (Tex. Civ. App. 1929) (attorney general is the proper party to sue on behalf of a charitable corporation).

The power to enforce a charitable trust, which includes the right to call the trustee to account for any breach of his fiduciary obligations, historically rested with the attorney general as the representative of the public at large. *M. FREMONT-SMITH*, *supra* note 9, at 198. Unlike the beneficiary of a private trust, members of the public have been denied the right to sue to enforce a charitable trust under the rationale that the unlimited grant of this right would expose the trustee to vexatious lawsuits and overburden the courts. G.G. BOGERT & G.T. BOGERT, *THE LAW OF TRUSTS AND TRUSTEES* § 414, at 436 (rev. 2d ed. 1977); *M. FREMONT-SMITH*, *supra* note 9, at 87. For a discussion of the right of a charitable corporation's beneficiaries to bring a derivative suit, see *infra* note 114.

42. *Hansmann*, *supra* note 7, at 606. *Hansmann* notes that some courts group charitable corporations within the single category of "charities" and thus should be willing to apply a different standing rule to noncharitable nonprofits. He notes, however, that "the courts apparently do not pay much attention to the distinction." *Id.*

43. N.Y. NOT-FOR-PROFIT CORP. LAW § 623(a) (McKinney Supp. 1984-85).

44. *Henn & Boyd*, *supra* note 1, at 1114; see Joint Legislative Committee to Study Revision of Corporation Laws xvi, in N.Y. NOT-FOR-PROFIT CORP. LAW (McKinney 1970). The corresponding for-profit corporation statute sections are N.Y. BUS. CORP. LAW §§ 1-2001 (McKinney 1963).

45. N.Y. NOT-FOR-PROFIT CORP. LAW § 623, note on legislative studies and reports (McKinney 1970).

46. *Id.* § 623(b) (McKinney 1970). The corresponding BCL provision is N.Y. BUS. CORP. LAW § 626(b) (McKinney 1963).

47. N.Y. NOT-FOR-PROFIT CORP. LAW § 623(c) (McKinney 1970). The corresponding BCL provision is N.Y. BUS. CORP. LAW § 626(c) (McKinney 1963).

48. N.Y. NOT-FOR-PROFIT CORP. LAW § 623(d) (McKinney 1970). The corresponding BCL provision is N.Y. BUS. CORP. LAW § 626(d) (McKinney 1963).

49. N.Y. NOT-FOR-PROFIT CORP. LAW § 623(e) (McKinney Supp. 1984-85). The corresponding BCL provision is N.Y. BUS. CORP. LAW § 626(e) (McKinney 1963).

visions in three respects. Although section 627 of the BCL requires a shareholder holding less than five percent of any class of outstanding shares to post security for "reasonable expenses" incurred by the defendants,⁵⁰ the N-PCL contains no analogous provision. Instead, the N-PCL states that a member derivative action cannot be brought by fewer than five percent of any class of members.⁵¹ The comments to the N-PCL indicate that the drafters believed the five percent limit was needed in the absence of a security-for-expenses requirement, presumably to reduce the risk of vexatious litigation.⁵² In addition, the N-PCL contains no equivalent to the contemporaneous ownership rule.⁵³ The drafters apparently believed that a membership version of the contemporaneous ownership rule—generally a guard against strike suits⁵⁴—was unnecessary in light of the five percent requirement.⁵⁵

California's Nonprofit Corporation Law (NCL)⁵⁶ divides nonprofit corporations into three types—"mutual benefit," "public benefit," and "religious"⁵⁷—and provides for derivative suits by members of "public benefit" and "mutual benefit" corporations.⁵⁸ The NCL parallels the state's provisions for shareholder derivative suits in many respects. Like the California General Corporation Law (GCL),⁵⁹ the NCL includes a contemporaneous membership rule⁶⁰ and a requirement that the plaintiff allege with particularity his efforts to secure action by the board.⁶¹ The NCL also authorizes the court to grant a defendant's motion requiring the plaintiff to provide up to \$50,000 as security for the defend-

50. N.Y. BUS. CORP. LAW § 627 (McKinney Supp. 1984-85). The plaintiff need not provide security for expenses if the value of his shares exceeds \$50,000. *Id.*

51. N.Y. NOT-FOR-PROFIT CORP. LAW § 623(a) (McKinney Supp. 1984-85).

52. *Id.* § 623, note on legislative studies and reports; Note, *New York's Not-For-Profit Corporation Law*, 47 N.Y.U. L. REV. 761, 787-88 (1972). For a criticism of the five percent limit, see Henn & Boyd, *supra* note 1, at 1124. Professors Henn and Boyd argue that the five percent requirement is "overly burdensome" and "likely to stifle many meritorious actions." *Id.*

53. Section 626(b) of the BCL states that the plaintiff must have been a shareholder "at the time of the transaction of which he complains, or that his shares or his interest therein devolved upon him by operation of law." N.Y. BUS. CORP. LAW § 626(b) (McKinney 1963).

54. See *supra* note 35.

55. The "contemporaneous ownership" provision in paragraph (b) of section 626 of the Bus. Corp. L. has been eliminated in the new law as inappropriate for not-for-profit corporations, since the likelihood is remote that an interest in such corporations would be purchased solely for the purpose of initiating a derivative suit.

N.Y. NOT-FOR-PROFIT CORP. LAW § 623, note on legislative studies and reports (McKinney 1970); see Henn & Boyd, *supra* note 1, at 1123 n.158.

56. CAL. CORP. CODE §§ 5000-10841 (West Supp. 1985). The statute went into effect in 1980. Nonprofit Corporation Law, ch. 567, 1978 Cal. Stat. 1740.

57. CAL. CORP. CODE §§ 5059-5061 (West Supp. 1985). For a discussion of the public policy and first amendment considerations that caused the drafters to distinguish religious corporations, see Hone, *California's New Nonprofit Corporation Law—An Introduction and Conceptual Background*, 13 U.S.F.L. REV. 733 (1979).

58. CAL. CORP. CODE §§ 5710, 7710 (West Supp. 1985). The statute also provides for derivative suits by directors of corporations that have no members. *Id.* §§ 5310(b), 7310(b)(2); see also *infra* note 114 (discussing statutory and judicial recognition of the right of directors to bring a derivative suit).

59. CAL. CORP. CODE §§ 1-2319 (West 1977 & Supp. 1985).

60. *Id.* §§ 5710(b)(1) (public benefit corporations), 7710(b)(1) (mutual benefit corporations). The corresponding provision of the GCL is *id.* § 800(b)(1).

61. *Id.* §§ 5710(b)(2), 7710(b)(2). The corresponding provision of the GCL is *id.* § 800(b)(2).

ant's litigation expenses;⁶² a corresponding provision is contained in the GCL.⁶³ Unlike the GCL, the NCL states that no security shall be required if the action is brought by 100 or more members or by some other "authorized number."⁶⁴

Courts in several jurisdictions also recently have recognized the right of members to bring derivative suits on behalf of nonprofit corporations. In most of the decisions, the courts have reasoned that common-law precedent giving shareholders a derivative suit right conferred such a right on members of nonprofit corporations by implication and that this right continues until the state's legislature, through the corporation laws, expressly denies it. In *Bourne v. Williams*⁶⁵ the Tennessee Court of Appeals held that members of a property owners association organized as a nonprofit corporation had standing to sue the directors for wasting corporate assets for personal gain. The court examined the "well developed" common law that established a shareholder's right to a derivative suit and held that "[i]t has . . . been established as part of the general law of corporations that members of nonprofit corporations have the same rights in this regard as stockholders of corporations for profit."⁶⁶ In response to defendants' argument that the statute recognizing derivative suits referred only to actions on behalf of a "corporation for profit,"⁶⁷ the court noted that other sections of the same chapter used the term "member" and "shareholder" simultaneously.⁶⁸ Thus, the statute "clearly indicate[d] . . . that the drafters had in mind a nonprofit corporation, as well as a corporation for profit."⁶⁹

Similarly, in *Atwell v. Bide-A-Wee Home Association*,⁷⁰ decided by the New York Supreme Court prior to the effective date of the N-PCL, a member of a nonprofit homeowner association was held to have standing to sue the directors.⁷¹ At the time of the decision the derivative suit provisions of the Business Corporation Law referred only to shareholders.⁷² Because some types of corporations were excluded expressly from the Business Corporation Law and nonprofit corporations were not among these, the court reasoned that nonprofits

62. *Id.* §§ 5710(d), 7710(d).

63. *Id.* § 800(d).

64. *Id.* §§ 5710(a), 7710(a). Section 5036 defines "authorized number" to be five percent of the voting power or

[w]here (disregarding any provision for cumulative voting which would otherwise apply), the total number of votes entitled to be cast for a director is 1,000 or more, but less than 5,000 the authorized number shall be 2-1/2 percent of the voting power, but not less than 50.

Where . . . the total number of votes entitled to be cast for a director is 5,000 or more, the authorized number shall be one-twentieth of 1 percent of the voting power, but not less than 125.

Id. § 5036(b)-(c).

65. 633 S.W.2d 469 (Tenn. Ct. App. 1981).

66. *Id.* at 471-72.

67. *Id.* at 472.

68. *Id.*

69. *Id.*

70. 59 Misc. 2d 321, 299 N.Y.S.2d 40 (Sup. Ct. 1969).

71. *Id.* at 324, 299 N.Y.S.2d at 43.

72. *Id.* at 323, 299 N.Y.S.2d at 42.

impliedly were within the statute.⁷³

North Carolina's Nonprofit Corporation Act⁷⁴ makes no provision for derivative suits by members of nonprofit corporations. It does, however, authorize the Attorney General to oversee nonprofit corporations under some circumstances. Section 55A-50 of the Act grants the Attorney General authority to bring an action for involuntary dissolution of the corporation⁷⁵ on several grounds,⁷⁶ including the ground that the corporation has "continued to exceed or abuse the authority conferred upon it by law, to the injury of the public, or of its members, creditors, or debtors"⁷⁷ Section 55A-51 imposes a duty on the Attorney General to bring such an action whenever he has reason to believe

73. *Id.* at 322-23, 299 N.Y.S.2d at 41; *see also* *Wickes v. Belgian Am. Educ. Found.*, 266 F. Supp. 38 (S.D.N.Y. 1967) (neither New York nor Delaware law prohibited plaintiffs, who were members and directors of a charitable nonprofit corporation, from bringing a derivative suit); *Valle v. North Jersey Auto. Club*, 125 N.J. Super. 302, 310 A.2d 518 (Ch. Div. 1973) (the word "shareholder" in the statute recognizing a derivative action included members of nonprofit corporations), *modified*, 74 N.J. 109, 376 A.2d 1192 (1977); *Leeds v. Harrison*, 7 N.J. Super. 558, 570, 72 A.2d 371, 377 (Ch. Div. 1950) (members of a charitable nonprofit corporation had standing to bring a derivative suit because "[t]he same rights and liabilities exist between the trustees of a non-profit corporation and the members as exist between the directors and stockholders of a corporation for profit").

74. N.C. GEN. STAT. §§ 55A-1 to -89.1 (1982). The Act was enacted in 1955 and took effect in 1957. Nonprofit Corporation Act, ch. 1230, 1955 N.C. Sess. Laws 1239. It defines "member" as "one having membership rights in a corporation in accordance with the provisions of its charter or bylaws." N.C. GEN. STAT. § 55A-2(7) (1982). The Act also provides that a nonprofit corporation "may have one or more classes of members or may have no members." *Id.* § 55A-29(a). If a nonprofit corporation does not have members or does not allow members to vote for directors, the directors are to be elected or appointed in the manner and for the terms as provided in the bylaws. *Id.* § 55A-20(c). Prior to the enactment of this Act, nonprofit corporations in North Carolina were governed by the provisions of the General Corporation Act. R. ROBINSON, *supra* note 14, at 5 n.4.

75. An involuntary dissolution is a court-ordered wind-up of the corporation's business affairs that ends the corporation's legal existence. *See* H. HENN & J. ALEXANDER, *supra* note 2, § 280, at 751-55, § 382, at 1148. In North Carolina the Attorney General may bring an action for involuntary dissolution of a for-profit corporation on grounds that it: procured its charter by fraud; refuses to produce books, records, or documents; has abused its authority; or has failed to maintain a registered agent or office. N.C. GEN. STAT. § 55-122 (1982). A shareholder may bring such an action on the following grounds: that the directors are deadlocked; that the shareholders are deadlocked; that the shareholders have actual notice of written agreement allowing dissolution; or that dissolution is "reasonably necessary" to protect the interests of the complaining shareholder. *Id.* § 55-125(a)(1)-(4) (1982 & Cum. Supp. 1983). A creditor also can bring an action for involuntary dissolution in some situations. *See id.* § 55-125(b). *See generally* R. ROBINSON, *supra* note 14, at 425-40 (discussing in detail the grounds and procedures for an involuntary dissolution decree).

76. N.C. GEN. STAT. § 55A-50(1)-(5) (1982). The grounds for involuntary dissolution are:

- (1) The corporation procured its charter through fraud; or
- (2) The corporation has, after written notice by the Attorney General given at least 20 days prior thereto, continued to exceed or abuse the authority conferred upon it by law, to the injury of the public, or of its members, creditors, or debtors; or
- (3) The corporation has, after written notice by the Attorney General given at least 20 days prior thereto, failed for 30 days to appoint and maintain a registered agent in this State, as required by G.S. 55A-11; or
- (4) The corporation has, after written notice by the Attorney General given at least 20 days prior thereto, failed for 30 days after change of its registered office or registered agent to file in the office of the Secretary of State a statement of such change, as required by G.S. 55A-12; or
- (5) The corporation has without justification refused to comply with a final court order for the production of its books, records, or other documents as required to be kept by G.S. 55A-27.

Id.

77. *Id.* § 55A-50(2).

that the case "involves the public interest."⁷⁸ Additionally, the laws governing trusts and trustees⁷⁹ give the Attorney General authority to bring an action in the name of the State against the trustees when "there is reason to believe that the property has been mismanaged through negligence or fraud"⁸⁰ and to administer a charitable trust should the settlor's intent become impossible to fulfill.⁸¹ North Carolina has no express statutory provision for member derivative suits, and North Carolina courts have not yet recognized such a cause of action.⁸²

Under existing North Carolina law, members of a nonprofit corporation who believe management has breached a duty to the corporation have only two options. They cannot sue in their own right if the injury is to the corporation,⁸³ but can use their voting power to remove the wrongdoers from office and then prevail on the corporation to sue the directors or officers to recover damages. Alternatively, members can report their complaint to the Attorney General's office which will investigate and, if warranted, bring an enforcement action.⁸⁴

These options may limit severely members' ability to redress a wrong to the corporation. If a majority of the members are indifferent or are benefitting from the breach of duty, the complaining member may not be able to prevail on the corporation to sue.⁸⁵ Limits on the resources of the Attorney General's office may make it equally unresponsive. Several commentators have argued that state attorneys general lack both the finances and the incentive to oversee effectively nonprofit corporation managers.⁸⁶ In a decision recognizing the right of minority directors to bring derivative suits on behalf of a charitable corporation, the California Supreme Court noted that "[t]he Attorney General may not be in a position to become aware of wrongful conduct or be sufficiently familiar with the

78. *Id.* § 55A-51.

79. *Id.* §§ 36A-1 to -115.

80. *Id.* § 36A-48.

81. *Id.* § 36A-53(a). North Carolina common law also gives the Attorney General authority to enforce charitable trusts. See Sigmund Sternberger Found., Inc. v. Tannenbaum, 273 N.C. 658, 678-79, 161 S.E.2d 116, 131 (1968); see also Edmisten, *The Common Law Powers of the Attorney General of North Carolina*, 9 N.C. CENT. L.J. 1, 24-25 (1977) (discussing the statutory and common-law powers of the Attorney General to oversee charitable trusts). See generally Hansmann, *supra* note 7, at 600 ("Virtually all states authorize the attorney general, either by common law or by statute, to ensure that the managers of charitable organizations fulfill their fiduciary obligations.").

Notably absent from North Carolina law are requirements that nonprofit corporations file periodic disclosures with the Attorney General's office. See M. FREMONT-SMITH, *supra* note 9, at 486.

82. Apparently, no North Carolina appellate court has addressed whether a member has standing to bring a derivative suit.

83. See *supra* note 27.

84. See *supra* notes 75-81 and accompanying text.

85. See *supra* text accompanying notes 29-30.

86. See Karst, *The Efficiency of the Charitable Dollar: An Unfulfilled State Responsibility*, 73 HARV. L. REV. 433, 448-60 (1960); see also M. FREMONT-SMITH, *supra* note 9, at 234 (surveys show that the attention of attorneys general to the affairs of charitable organizations is "minimal" in many states); Hansmann, *supra* note 7, at 601 ("Commonly, little or no staff in the attorney general's office is assigned to look after the affairs of nonprofits, and no effective system of financial reporting by nonprofits exists in any state."); Oleck, *Non-Profit Types, Uses, and Abuses: 1970*, 19 CLEV. ST. L. REV. 207, 235-36 ("State attorneys-general practically shun investigations of nonprofit organizations.").

situation to appreciate its impact."⁸⁷ One commentator who examined attorney general supervision of charitable associations found it to be "irregular and infrequent."⁸⁸

Recognition by statute or judicial decision of a right for North Carolina members of nonprofit corporations to bring derivative suits would provide members a valuable tool for enforcing the duties directors and officers owe the corporation. Such a decision would have the obvious advantage of providing consistency in the state's corporate law; members and shareholders alike would have the right to bring a derivative suit, and management of both types of corporations would be subject to similar oversight mechanisms.

Recognition of member derivative suits in North Carolina would not contradict the state's existing corporation laws. The provisions of the Business Corporation Act⁸⁹ recognizing shareholder derivative suits do not expressly exclude members.⁹⁰ Similarly, although the provision on the applicability of the Business Corporation Act states that the Act applies to "every corporation for profit" and "every corporation not for profit having a capital stock,"⁹¹ the Act does not expressly exclude nonprofit membership corporations.

There also is a common-law basis for member derivative suits in North Carolina. In 1929 the North Carolina Supreme Court applied the corporate statute providing for distribution of assets to shareholders after dissolution of the corporation to nonprofit corporation members, despite the absence of any reference to members in the statute.⁹² The court held that "In the case of nonstock corporations, the members, while not usually denominated stockholders, are in point of principle stockholders, having an interest in the corporate property similar to that of stockholders in an ordinary corporation."⁹³

Furthermore, the history of the shareholder derivative suit in North Carolina supports an interpretation that statutory silence on a remedy against management does not mean that the legislature intended to deny the remedy. North Carolina General Statutes section 55-55, recognizing shareholder derivative actions, was not enacted until 1973.⁹⁴ The common-law right to a shareholder derivative suit, however, already was well established.⁹⁵ In the years between

87. *Holt v. College of Osteopathic Physicians & Surgeons*, 63 Cal. 2d 750, 755, 394 P.2d 932, 935, 40 Cal. Rptr. 244, 247 (1964).

88. *Karst*, *supra* note 86, at 437; *see also City of Paterson v. Paterson Gen. Hosp.*, 97 N.J. Super. 514, 527-28, 235 A.2d 487, 495 (Ch. Div. 1967) ("The manifold duties of [the attorney general's] office make readily understandable the fact that . . . supervision [by that office] is necessarily sporadic.").

89. N.C. GEN. STAT. §§ 55-1 to -175 (1982).

90. *Id.* § 55-55.

91. *Id.* § 55-3(a).

92. *Smith v. Dicks*, 197 N.C. 355, 148 S.E. 464 (1929). The suit was brought by a member of a social and literary club organized as a nonprofit corporation. The lower court held that when the corporation failed to renew its charter, plaintiff and the other members were vested with an equal, undivided interest in the club's property. *Id.* at 359, 148 S.E. at 466. The supreme court affirmed. *Id.* at 364, 148 S.E.2d at 469.

93. *Id.* at 363, 148 S.E. at 468 (quoting *RULING CASE LAW (Corporations)* § 754 (1920)).

94. Act of May 14, 1973, ch. 469, 1973 N.C. Sess. Laws 547-48.

95. *See, e.g., Coble v. Beall*, 130 N.C. 533, 41 S.E. 793 (1902) (recognizing a shareholder's right to bring a derivative suit, subject to the "one prerequisite" that the plaintiff show in his complaint

the enactment of the first state corporation law in 1852⁹⁶ and the enactment of section 55-55 in 1973, the courts apparently did not consider the statutory silence on derivative suits as evidence of legislative intent to bar such suits.⁹⁷

A potential drawback to recognition of member derivative suits is that such a provision may encourage strike suits against nonprofit directors and officers. Unlike directors of for-profit corporations, nonprofit directors usually work on a part-time basis without financial compensation.⁹⁸ If serving on a nonprofit corporation's board subjects the director to the expense and inconvenience of defending spurious lawsuits, there may be few volunteers. Likewise, a nonprofit corporation's officers, who are allowed reasonable compensation,⁹⁹ may not wish to serve if one of the incidents of employment is a significant risk of being named a defendant in a vexatious lawsuit.

To minimize a nonprofit director's or officer's exposure to vexatious litigation, the right of members to bring derivative suits should be limited in much the same way that shareholder derivative suits are limited. The California and New York statutes include in their provisions for member derivative suits most of the limits applied to shareholder derivative suits.¹⁰⁰ In North Carolina, the right to a shareholder derivative suit under section 55-55 is limited by the following: a contemporaneous ownership rule;¹⁰¹ a requirement that the plaintiff allege a demand on the directors;¹⁰² a requirement that any compromise or settlement have court approval;¹⁰³ and a provision that the court may require the plaintiff to pay defendant's attorney's fees if the court finds that the action was brought without "reasonable cause."¹⁰⁴ The last provision reverses the common-law reluctance to grant such relief, even when the defendant was successful, unless the defense in some way benefitted the corporation.¹⁰⁵

The North Carolina Nonprofit Corporation Act also provides that a director or officer of a nonprofit corporation is entitled to indemnification for defending an action alleging dereliction of a duty if his defense is successful.¹⁰⁶ Even if a director or officer has been found liable for breach of a duty to the corporation, the court may award indemnification if it finds that "such person has acted hon-

that he made a demand on the directors to bring the action and that they refused to do so); *see also* R. ROBINSON, *supra* note 14, at 213 (comparing North Carolina case law on derivative suits with that of other states).

96. R. ROBINSON, *supra* note 14, at 1. The North Carolina legislature first enacted a statute permitting organization of private corporations without a legislative charter in 1795, but the first statute authorizing the organization of corporations for a wide range of business purposes was not enacted until 1852. *Id.*

97. *See, e.g.,* *Fulton v. Talbert*, 255 N.C. 183, 120 S.E.2d 410 (1961) ("[W]here . . . an officer of a corporation so utilizes his authority as to benefit himself to the detriment of the corporation, a right of action accrues to the corporation.").

98. H. OLECK, *supra* note 1, at 612.

99. *See supra* text accompanying note 10.

100. *See supra* notes 46-55 and accompanying text; notes 60-64 and accompanying text.

101. N.C. GEN. STAT. § 55-55(a) (1982).

102. *Id.* § 55-55(b).

103. *Id.* § 55-55(c).

104. *Id.* § 55-55(e).

105. H. HENN & J. ALEXANDER, *supra* note 2, § 378, at 1115-16.

106. N.C. GEN. STAT. § 55A-17.3(a)(1) (1982).

estly and reasonably and that, in view of all the circumstances of the case, his conduct fairly and equitably merits such relief."¹⁰⁷ This provision, if interpreted broadly for member derivative suits, could reduce greatly the financial risks that strike suits pose for nonprofit directors. That a nonprofit director works without compensation and on a part-time basis should be a relevant "circumstance" for determining whether his conduct was "reasonable." If these existing limits on shareholder derivative suits and provisions for indemnification of nonprofit directors and officers are extended to member derivative suits, the risk of strike suits probably will not discourage individuals from serving as nonprofit officers or directors.¹⁰⁸

Another objection to the recognition of member derivative suits is that members lack sufficient interest in the corporation to sue on its behalf. A shareholder's pecuniary interest in the corporation is part of the basis of his right to bring a derivative suit; when the corporation will not sue on a valid claim, the shareholder's equity interest is imperiled and thus he is entitled to sue derivatively.¹⁰⁹ Although a member may have no equity interest in a nonprofit corporation, he usually has a significant pecuniary interest in the organization. Membership often is conditioned on the payment of dues.¹¹⁰ Furthermore, in the case of a homeowner association the decisions of the directors and officers may affect the value of each member's property.

A member does not expect the same return on his money as an investor in shares of stock, but he expects that his money will be used in the manner represented to him when he became a member. Apart from a concern over vexatious litigation, there is no compelling reason why this pecuniary interest should be insufficient to justify a derivative suit by a member. Of course, because section 55A-29(a) of the Act allows nonprofit incorporators to define membership as they choose,¹¹¹ the corporation might have members with no financial stake. Should the prospect of derivative litigation by such members trouble the incorporators, they could frame the bylaws or charter to condition membership on some form of financial contribution or to have no members at all.¹¹²

107. *Id.* § 55A-17.3(a)(2). The Act also provides that a nonprofit corporation may expand the statutory indemnification provisions in its bylaws or charter. *See id.* § 55A-17.1(a); R. ROBINSON, *supra* note 14, at 238 n.27.

108. *See supra* note 33. The Nonprofit Corporation Act also expressly gives nonprofit corporations power "to purchase and maintain insurance on behalf of any person who is or was a director, officer, employee or agent of the corporation . . ." N.C. GEN. STAT. § 55A-17.1(c) (1982).

109. *See supra* note 32 and accompanying text.

110. *See Henn & Pfeifer, supra* note 11, at 185 n.10; Pasley, *Organization and Operation of Non-Profit Corporations—Some General Considerations*, 19 CLEV. ST. L. REV. 239, 248 (1970); *see also* Lopez v. Medford Community Center, Inc., 384 Mass. 171, 173 & n.5, 174, 424 N.E.2d 229, 231 & n.5, 232 (1982) (trial court's findings of fact included charter provision that membership in defendant charitable corporation was conditioned on payment of annual dues).

111. N.C. GEN. STAT. § 55A-29(a) (1982).

112. To discourage nonprofit corporations from choosing not to have members solely because of the possibility of a derivative suit, the proposed amendment to the North Carolina Nonprofit Corporation Act would recognize derivative actions by directors as well as members. *See supra* note 5. *See* Minutes of Nonprofit Corporation Act Drafting Committee of the North Carolina General Statutes Commission (Sept. 20, 1984). *See generally infra* note 114 (discussing statutory recognition in other jurisdictions of derivative suits by directors).

As noted earlier, a charitable corporation may designate as "members" donors with no voice in

The existing provisions for supervision of nonprofit corporations in North Carolina are inadequate. Commentators and those state courts and legislatures that have considered the issue have concluded that supervision by the attorney general's office is likely to be sporadic and ineffective.¹¹³ When a nonprofit corporation has been wronged but a member cannot prevail on the directors to sue on behalf of the corporation, the member may be without recourse. To correct this problem, the North Carolina legislature or the state courts should recognize the right of members of nonprofit corporations to bring a derivative suit on behalf of the corporation.¹¹⁴ Such a provision would be consistent with North

the affairs of the corporation. To avoid the prospect of derivative suits by such honorary members, a statute recognizing member derivative suits also could provide that a "member" must be given some voice in the corporation's affairs, such as the right to elect directors or vote on changes in the charter and bylaws. The California Nonprofit Corporation Law limits members in this fashion. CAL. CORP. CODE § 5056 (West Supp. 1985). Such a provision would require a charitable corporation to bestow a title other than "member" on donors it wanted to recognize but not give a voice in the operation of the corporation.

113. See *supra* notes 86-88 and accompanying text.

114. A court or legislature recognizing a right for members to bring a derivative suit should consider other means of improving the supervision of nonprofit corporations as well. In the New York and California statutes, the provision for member derivative suits was accompanied by expanded powers for the attorney general's office. CAL. CORP. CODE § 5250 (West Supp. 1985); N.Y. NOT-FOR-PROFIT CORP. LAW § 720 (McKinney 1970 & Supp. 1983). Another option is to give directors a right to bring a derivative suit. The California Nonprofit Corporation Law authorizes directors to bring derivative suits if the corporation has no members. CAL. CORP. CODE §§ 5059-5061 (West Supp. 1985). In New York, where the Business Corporation Law authorizes derivative suits by directors of for-profit corporations, N.Y. BUS. CORP. LAW § 720(b) (McKinney 1963 & Supp. 1984), it has been held that the director or officer must have held his corporate office at the time the derivative suit was commenced, a requirement analogous to the contemporaneous ownership limitation on shareholder derivative suits. *Alan v. Landau-Alan Gallery, Inc.*, 66 Misc. 2d 350, 320 N.Y.S.2d 853 (1971); see 13 W. FLETCHER, *supra* note 2, at § 5972. For a pre-1980 California decision recognizing the right of directors of a nonprofit corporation to bring derivative suits, see *Holt v. College of Osteopathic Physicians & Surgeons*, 63 Cal. 2d 750, 394 P.2d 932, 40 Cal. Rptr. 244 (1964).

The donors or beneficiaries of a charitable nonprofit corporation also could be given standing. Hansmann, *supra* note 7, at 607-09, argues that a charitable corporation's donors and beneficiaries are more likely than any other parties to take an interest in the corporation's affairs and thus may be proper parties to bring suit. There is some historical basis for giving donors standing; founding donors of a charitable trust were given a right of "visitation" over the trust, including the right to inspect the trustees' actions and correct abuses. See *M. FREMONT-SMITH*, *supra* note 9, at 206; Hansmann, *supra* note 7, at 607-09. This right, however, has fallen into disfavor and donors today commonly are denied standing to sue. Hansmann, *supra* note 7, at 607; see also *Shields v. Harris*, 190 N.C. 520, 130 S.E. 189 (1925) (heirs of the settlor of a charitable trust do not have standing to sue for enforcement of the trust). The rationale for this denial usually is either that the donor's legal interest ends once he makes the gift to the corporation or that potential suits by charitable donors would expose charitable corporation managers to a risk of excessive liability. Hansmann, *supra* note 7, at 607-09; Karst, *supra* note 86, at 447.

Under trust law, beneficiaries of a charitable trust generally were denied standing to sue unless they could show a "special interest" in the benefits of the trust, beyond the benefit conferred on the public at large. *M. FREMONT-SMITH*, *supra* note 9, at 86-87; see also *supra* note 41 (discussing denial of a public right to enforce a charitable trust). The same principle has been applied to deny standing to beneficiaries of a charitable corporation who could not show a "special interest." *City of Paterson v. Paterson Gen. Hosp.*, 97 N.J. Super. 514, 527, 235 A.2d 487, 495 (Ch. Div. 1967).

Recent decisions in some states have expanded the right of beneficiaries of a charitable trust or corporation to bring a derivative suit or to sue to enforce the trust. See, e.g., *Stern v. Lucy Webb Hayes Nat'l Training School for Deaconesses & Missionaries*, 367 F. Supp. 536 (D.D.C. 1973) (patients of a hospital organized as a charitable corporation have standing to sue the management); *Jones v. Grant*, 344 So. 2d 1210 (Ala. 1977) (students, staff, and faculty of a college operated as a charitable trust have standing to sue the trustees). A recent decision by the North Carolina Supreme Court on beneficiary standing is *Kania v. Chatham*, 297 N.C. 290, 254 S.E.2d 528 (1979). In *Kania*

Carolina case law recognizing the similarities between members and shareholders. The threat of strike suits could be reduced by limiting members' suits as shareholder derivative suits are limited in the existing Business Corporation Act and by enforcing indemnification provisions of the nonprofit act. Finally, because the right of shareholders to bring a derivative suit against business corporation managers is well established in North Carolina, a statute giving members a right to bring such an action would provide consistency in the state's corporation law and would fulfill members' expectations.

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a nominee for a college scholarship sued the trustees of the charitable trust that provided the scholarship program. The court held that plaintiff lacked standing to bring the suit because mere nomination for a scholarship did not give him a "special interest." *Id.* at 292, 254 S.E.2d at 530. In the absence of such an interest, the court held, the proper party to sue for enforcement of a charitable trust is the attorney general. *Id.* at 292-93, 254 S.E.2d at 530.

As with donors, one reason frequently given for denying standing to beneficiaries is a fear of exposing trustees or directors to excessive liability. This fear may be unfounded. Hansmann notes that a Wisconsin statute adopted in 1945 permitted any 10 or more donors or beneficiaries of a charitable trust to bring a suit to enforce the trust. The statute later was replaced, but there are no reported cases in which donors or beneficiaries brought such a suit. Hansmann, *supra* note 7, at 609-10.