THE BOARD OF NONPROFIT ORGANIZATIONS: PUZZLING THROUGH THE GAPS BETWEEN LAW AND PRACTICE

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INTRODUCTION

Scholars of American corporate governance—both for-profit and nonprofit—have long remarked on the contrast between the sketchiness of the legal regime and the robust and diverse set of practices inside boardrooms and executive suites. To many, this state of affairs is the desired result of a laissez-faire legal structure that sets forth minimum rules of the road but that otherwise provides only default rules for conduct. Indeed, the Delaware Supreme Court—speaking for the state in which most large U.S. corporations are incorporated—recently observed, “All good corporate governance practices include compliance with statutory law and case law establishing fiduciary duties. But the law of corporate fiduciary duties and remedies for violation of those duties are distinct from the aspirational goals of ideal corporate governance practices.”

This laissez-faire legal construct makes sense for corporations that have private owners. Minimal laws put a lower bound on behavior to prevent

1. Continental European countries are only beginning to debate the desirability of having a standard legal corporate form for nonprofit organizations, the parameters of such a form, and whether their governance should be determined by law or voluntary codes of practice. See Klaus J. Hopt, The Board of Nonprofit Organizations: Some Thoughts from the European Continent (Heidelberg, Germany, July 6–9, 2006) (unpublished manuscript, presented at the Conference on Comparative Corporate Governance for Nonprofit Organizations, on file with the Fordham Law Review). See generally The European Foundation: A New Legal Approach (Klaus J. Hopt, W. Rainer Walz, Thomas von Hippel, & Volker Then eds., 2006) [hereinafter The European Foundation].

opportunistic behavior, but otherwise get out of the way. Where corporate statutes set forth rules of practice, they can, in most cases, be overridden by the corporate charter or bylaws. After all, the theory goes, owners do not need to be protected from themselves and the contracts they might enter into. To contractarian purists, fiduciary duties in the business context impose only a duty of loyalty and good faith, and do not expose fiduciaries to monetary liability for breaches of the duty of care waived by the shareholders unless there is lack of good faith.\(^3\)

Is such a laissez-faire legal structure appropriate for nonprofit corporations? This question is particularly important for charities, the largest category of nonprofit organizations (and thus the category on which this essay focuses). As a threshold matter, the absence of shareholders is, in practice, more a difference of degree than kind.\(^4\) Still, important differences exist. Most temptingly, one might wish the law were a tad more helpful in providing guidance to nonprofit boards, many of which are stocked with amateurs (in the best sense of the word)—but that is what “best practices” guides are for. Certainly, we do not want laws to try to force the variety of types and sizes of nonprofit organizations into a single mold.

When drafting began on the American Law Institute’s (ALI) project on Principles of the Law of Nonprofit Organizations (for which this author is reporter), the business sector was enduring a full-blown governance crisis, culminating in the federal Sarbanes-Oxley Act of 2002. As described in Tentative Draft No. 1 (2007):

The revelations of passive boards, dissembling executives, and inattentive (or conflicted) auditors, bankers, and counsel challenged the fundamental model of corporate governance—the same model, in general, that has been created for the modern nonprofit organization. However, subsequent reforms in law—and, perhaps more important, self-imposed good business practices—only serve to emphasize that alternatives are not obvious, suggesting that performance shortfalls are more to blame than the articulation of legal duties.\(^5\)

Nevertheless, the American legal structure for nonprofit governance embraces a series of puzzles that add up to a paradoxical message: legal

\(^3\) See, e.g., Principles of Corp. Governance: Analysis and Recommendations § 7.19 cmt. a (1992) (commenting that, in states whose corporate statutes do not explicitly provide for charter liability shields, shareholders’ authority to waive directors’ liability can be analogized to the ability of “a trustee to relieve itself by contract from liability for negligence, but not for liability from breaches that were in bad faith, intentional, or recklessly indifferent to the interests of a beneficiary”); see also Del. Code Ann. tit. 6, § 18-1101(e) (2005) (permitting limited liability company agreements to waive any liability other than “for any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing”).


duties apply, but few people can call the governing board or board members to account, and, even when legal process ensues, nothing much of legal consequence will follow. In particular, the legal regime contains a series of gaps between the law "on the books" and the law as carried out in practice, and between what the law requires and how boards behave. This essay explores the following gaps:

A. Corporate law provides that fiduciary duties are owed to "the corporation." This is a difficult concept in the business corporation world; what does it mean in a world without owners? Should there be a duty to the charitable purpose (or even to the charitable sector) greater than preserving the charity on whose board the fiduciary sits?

B. Corporate law states a single, uniform standard of conduct for all board members, regardless of the type or size of organization. Should the law recognize differences for small charities, as business law does for close corporations, or does the absence of owners make this analogy inapt?

C. Nonprofit corporate law provides that the organization is "managed by or under the direction of" the board of directors, without saying much at all about the board's core functions (or the functions of officers, or the relationship between the board and management). The management literature, by contrast, is full of prescriptions.

D. Corporate law empowers the governing board to act only as a group, yet imposes sanctions for breach of fiduciary duties on board members only as individuals. Moreover, corporate law holds each and every governing board member responsible for governance, yet in practice, different board members bring a variety of attributes that benefit the organization. How should the law handle "Mr. Checkbook" and others who want to be on the board but do not want to participate in governance?

E. Nonprofit statutory law simply substitutes the word "members" for "shareholders" in provisions that call for an additional check on the board (usually in extraordinary transactions). The definition of member for legal purposes, however, is limited to those with the right to elect members of the board. Thus, no additional oversight applies to the majority of U.S. charities that lack members, and whose boards are self-perpetuating. Even where there are members of the charity, are they the right constituency to have shareholder-like authority?

F. For corporations that are charities, the law endows only the state attorney general, co-fiduciaries, and (rarely granted) persons with a special interest with "standing" to bring a legal complaint for fiduciary wrongdoing. (The charity itself can also bring suit.) With the burden of proof falling on the plaintiff to show who caused harm to the organization and to quantify that harm, the risk of personal monetary liability is slight. Additional
protections from monetary liability separately shield a governing board member who acted in good faith and did not engage in self-dealing. Should nonprofit-corporation fiduciaries be more, less, or equally protected from personal monetary risk compared with business-corporation fiduciaries?

An examination of these gaps reveals how weak a force the law is in the area of charity governance—but also reveals why “tightening” the law is not the answer. The Conclusion offers the hope that regulators will make greater use of appropriate non-monetary equitable remedies to address poor governance. To a large degree, though, good governance will always depend on adoption of recommended practices and adherence to what a leading charity trade group calls “obedience to the unenforceable.”

Finally, a caveat: This essay primarily addresses corporate governance; different considerations might arise in the case of a charitable trust, particularly one governed by a single trustee or cotrustees not functioning as a board. Some of the differences between corporate and trust law are touched on below. In light of the spectacular $30 billion gift announced in 2006 by Warren Buffett to the Gates Foundation—a charitable trust whose current trustees are Bill and Melinda Gates (Buffett will join them)—additional governance issues for charity trustees lie tantalizingly beyond the scope of this discussion.

I. DISCUSSION

A. To Whom (or What) Are Board Duties Owed?

1. What the Law Requires

The duty of loyalty of an individual board member requires acting in a way that he or she reasonably believes to be in the best interests of the organization. This duty is usually applied structurally, by looking to fiduciaries who lack incentives or relationships that would compromise their ability to make objective decisions in the best interests of the


organization. As I have explained elsewhere, this structural goal comprises two overlapping, but analytically distinct, concepts: independence and (usually financial) disinterest.

Independence does not, of course, require board member independence from key constituents, to whom the board remains accountable in practice, if not by law. Notably, for charities, the founders may specify structural terms in the organizational documents, donors may restrict the charity’s discretion in the use of gifts, and major donors might be named to the governing board. If the organization has voting members, they not only elect the governing board, but also participate in decisions to take certain extraordinary actions. Even within these legitimate constraints, though, every board member’s duties run to the organization regardless of how that board member obtained his or her seat. The fiduciaries must be free to exercise their judgment in the best interests of the organization.

In legal terms, trustees of a private trust owe their fiduciary duties to the beneficiaries, while board members of a business corporation owe their duties to the corporation (generally taken to mean putting the interests of the shareholders above those of other stakeholders). The duties of fiduciaries of nonprofit mutual-benefit organizations (i.e., non-charitable nonprofits) might seem to run to the members, but all nonprofits have an element of public interest in their purposes (this appears most clearly in the federal requirements for tax exemption). As for a charitable trust, which lacks ascertainable beneficiaries who can enforce their rights, fiduciary duties are said to run to the charitable purpose.

For charities in general, adopting either the trust approach (duties are owed to the charitable

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9. Of course, current law permits a wide variety of forms of governance for formal charitable activity. In the simplest form, a single person might be the trustee of a charitable trust, and perform all the management functions himself or herself. A voluntary organization might take the form of a corporation in which members of the governing body serve as the officers, whether or not the organization also engages professional staff. Family foundations typically limit their boards to family members. See infra Part I.B-C.

10. See Brody, supra note 8.

11. See infra Part I.C.

12. See infra Part I.E.


14. The official comment to the 1998 changes to section 8.30(a) of the Model Business Corporation Act explains,

The phrase “best interests of the corporation” is key to an explication of a director’s duties. The term “corporation” is a surrogate for the business enterprise as well as a frame of reference encompassing the shareholder body. In determining the corporation’s “best interests,” the director has wide discretion in deciding how to weigh near-term opportunities versus long-term benefits as well as in making judgments where the interests of various groups within the shareholder body or having other cognizable interests in the enterprise may differ.


purpose) or the corporate approach (duties are owed to the entity itself), the legal result should be the same. Most important, the law does not allow general societal interests, or even charitable goals unrelated to a given charity’s purposes, to override the charity’s privately determined purposes. Moreover, the law does not require that the fiduciaries keep this particular entity in existence when merger or liquidation might better serve its charitable purposes. Indeed, the law generally endows the governing board with the power and right, under appropriate circumstances, to amend or modify the organization’s charitable purposes (or to go to court to do so, depending on the legal form and the terms of the organizational documents). 16

Stating the duty of loyalty the other way around, nonprofit law prohibits fiduciaries from governing for private purposes—that is, for the benefit of board members, executives, donors, or other private parties. Of course, private individuals—including employees and beneficiaries—will necessarily benefit from the entity’s activities, but incidental benefit is not the legal focus.

2. What Occurs in Practice

The “to whom are duties owed?” question remains a persistent one in the nonprofit sector. A nonprofit organization frequently has multiple “stakeholders,” all of whom seek to speak for the organization and its purposes. 17 Board members sometimes feel beholden to the person or group that recommended, nominated, or elected them to the board. Indeed, it is not uncommon—as in perhaps more business corporations than we want to admit—that the board as a whole defers excessively to the chief executive officer (CEO) for this very reason. 18 Of course, the variety of perspectives brought to the boardroom by the board members enhances governance, and the board members might reasonably differ on what decisions they believe to be in the organization’s best interests. More broadly, the purposes of a given charity do not necessarily (or even usually) coincide with “the public interest.” 19 Occasionally the attorney

16. See generally Principles of the Law of Nonprofit Orgs. § 310 cmt. a(1) (Tentative Draft No. 1, 2007). The members, if any, of a corporate charity usually must approve amendments to the articles of incorporation. See infra Part I.E. In the case of a charitable trust, the court (if not otherwise specified in the trust instrument) determines how existing assets may be used. Whether a corporate charity that amends its purpose can use previously acquired assets (other than explicitly restricted gifts) for the new purpose is under debate. See Principles of the Law of Nonprofit Orgs. §§ 240, 250 (Council Draft No. 5, 2007).


18. See infra Part I.C.

19. In concurring in the Bob Jones University v. United States decision, Justice Lewis Powell observed that over 106,000 organizations filed information returns as § 501(c)(3) organizations in 1981. He found “it impossible to believe that all or even most of those organizations could prove that they demonstrably serve and [are] in harmony with the public interest or that they are beneficial and stabilizing influences in community life.” Bob Jones
general has purported to protect the public interest when he or she perceives that interest to clash with the organization’s interests as determined by its board. Judges, too, might be overly deferential to the dead hand, invoking the trust law doctrine of cy pres to disallow the redeployment of charitable assets held by a nonprofit corporation for other than the corporation’s original purpose.

B. Organizational Type, Organizational Size

1. What the Law Requires

Nonprofit corporate law imposes the same standards of conduct on fiduciaries of all types of nonprofits—charity or mutual benefit—and on nonprofits of all sizes. More precisely, some laws make accommodations based on type or size with respect to filing requirements or attorney general oversight authority, but the law, at least facially, imposes uniform duties on all fiduciaries. Both trust and corporate law impose minimum, nonwaivable obligations of loyalty and the good faith exercise of care.

Some have called for requiring the fiduciaries of charities, perhaps even more than mutual benefit nonprofits, to be subject to the highest fiduciary standards. However, legislators, regulators, and judges try to balance the attractiveness of board service against requirements that might better protect charitable assets. Many charities operate enterprises subject to the management demands of a complex business, and the standards of fiduciary liability for charities regardless of their organizational form have been trending toward the business-corporation standard. Courts defer to the business judgment of charity managers; state legislatures have relaxed the investment duties of institutional fund managers; and Congress permits independent board members of public charities to set management’s compensation and other benefits.

Univ. v. United States, 461 U.S. 574, 609 (1983) (Powell, J., concurring) (alteration in original) (internal quotation marks omitted).


21. See Henry B. Hansmann, The Role of Nonprofit Enterprise, 89 Yale L.J. 835, 838–40 (1980); see also James J. Fishman, The Development of Nonprofit Corporation Law and an Agenda for Reform, 34 Emory L.J. 617, 618 (1985). State law does make special provision for ensuring that the value of charitable assets remains in charitable solution; similarly, the Internal Revenue Code contains specific prohibitions on self-dealing by insiders of private foundations and excise taxes on insiders who engage in “excess benefit transactions” with public charities and social welfare organizations. Separately, as described in Part I.E, the law sets forth minimal member rights for membership organizations.

2. What Occurs in Practice

Some nonprofit fiduciaries seem to believe that passion and good intentions produce a halo that protects those who neglect their legal responsibilities. No one denies that it would be cheaper, for example, to have a single employee handle all aspects of financial matters—checks and balances and other internal controls are deliberately inefficient. The constant stream of news stories of charity embezzlement and other wrongdoing, however, constitute an unacceptable blemish on the nonprofit sector.

A sympathetic view of fiduciary behavior in small nonprofits was presented by James Fishman in 1985: “Many nonprofit corporations, particularly smaller organizations, ignore directors’ statutory responsibilities and corporate formalities. . . . Should differing corporations, united only by the proscription against private inurement and their desire to obtain an exemption from income tax, be treated by state corporation statutes in the same way?” He argues for “a nonprofit equivalent to the close corporation” in state nonprofit corporation law. Under Fishman’s proposal, the legal consequences would be as follows:

The private inurement proscription and restrictions on the distribution of assets upon dissolution would remain. For tax and corporate law purposes, the close nonprofit corporation would be treated as an incorporated partnership. The receipt of funds from patrons or governmental donors would be treated as partnership income, yet such income would not be taxed so long as the income and monies dispersed for salaries and expenses were reasonable. Enforcement would rest upon state and federal tax authorities.

Finally, Fishman proposes, “Liability for the misuse of public monies and the advantages of tax-exempt status would shift directly to the individuals


25. Fishman, supra note 21, at 665–66.

26. Fishman explains, The close nonprofit corporation would have the definitional characteristics of an integration of directors and employees and an upper level of permitted assets. A certain percentage of budget allocations for salaries of staff and directors might be another indicator of close corporation status. Most importantly, the close nonprofit corporation would be eligible for classification under section 501(c)(3) and section 170(c) of the Internal Revenue Code. Id. at 666.

27. Id. at 667–68.
in the organization and away from an artificially separated board of directors."²⁸

The draft ALI Nonprofit Principles do not make substantive distinctions among nonprofits based on their size, although how fiduciary duties are carried out might vary with the nonprofit’s organizational form, as well as with its size, structure, and type. Charities in particular should all be required to have sufficient governance capacity to protect the public interest.

C. Inside the Black Box: Board/Management Relations

1. What the Law Requires

a. The Independent-Board Monitoring Model

Historian Peter Dobkin Hall traces the modern corporate governance structure to the charter of the colonial Massachusetts Bay Company, “which created the first American board” and separated executive authority from legislative authority.²⁹ U.S. corporate law has generally converged on the “independent-board monitoring model” of organizational governance: the exercise of informed oversight by a group of individuals, a majority of whom are separate from management.³⁰ However, this separation is not always easy to achieve.³¹

The ALI’s 1992 Principles of Corporate Governance pointed out that legislatures commonly fail to address the distinct governance role of the board of a public company by improperly assigning it management responsibility. The ALI commented, “Although the statutes literally seem to require the board to either manage or direct the management of the corporation, it is widely understood that the board of a publicly held corporation normally cannot and does not perform those functions in the usual sense of those terms.”³² The ALI articulated and embraced the

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²⁸ Id. at 668.
³⁰ See Henry Hansmann & Reinier Kraakman, The End of History for Corporate Law, 89 Geo. L.J. 439, 455–56 (2001). Compare the two-tier German model described in Klaus J. Hopt, The German Two-Tier Board: Experience, Theories, Reforms, in Comparative Corporate Governance: The State of the Art and Emerging Research 227 (Klaus J. Hopt, Hideki Kanda, Mark J. Roe, Eddy Wymeersch & Stefan Prigge eds., 1998). Professor Hopt describes how the unitary model (as found in the United States and the United Kingdom) has come to resemble the two-tier European model of a management board controlled by a supervisory board, in light of the recent moves in the United States to separate the functions of the chief executive officer (CEO) and the board chair and to require that a majority of the board be independent. See Hopt, supra note 1.
³¹ See supra Part I.A.
independent-board monitoring model, under which an unconflicted board oversees a separate staff that carries out day-to-day operations.33

A different approach can be found in the proposal for a new legal structure for European Foundations.34 Article 4.2 of that proposal would permit a European Foundation to have a supervisory board (consisting of at least three members), but would make a supervisory board mandatory for a foundation whose assets exceed a threshold amount (unspecified).35 The role of the supervisory board would be broader than that of an audit committee (discussed below), because the supervisory board "should monitor the decisions of the Board of Directors for compliance at all times with the foundation's formation deed and statutes [bylaws]... as well as with the relevant law of the country where the foundation is registered and of the countries in which it is active."36 Finally, the proposal provides, "If the Supervisory Board discovers serious irregularities which, after reasonable written notice, the Board of Directors fails to correct or prevent, it shall report these facts to the auditors and/or to the State supervisory authority as may be appropriate."37 Commentary addresses the composition and operations of the supervisory board, but it does not say who guards the guardians—that is, who makes sure that the supervisory board performs its duties.38

In attempting to separate oversight and management, a few state nonprofit corporation statutes require that a majority of directors be uncompensated (other than as board members), or that a minimum number of board members be unrelated to each other, or that certain core committees comprise only independent directors.39 More cautiously, the

34. In continental Europe, as discussed further in Part I.E, the law distinguishes foundations, which have no members and thus are perceived as needing additional supervision, from associations, which are monitored by their members. See generally The European Foundation, supra note 1; see also infra note 136.
35. See The European Foundation, supra note 1, at 115.
36. Id. at 118.
37. Id. at 115 (citations omitted).
38. Cf. Part I.D (describing the “sterilization option” of which some U.S. charities avail themselves). But see The European Foundation, supra note 1, at 121 (relating to the powers of a founder, which are discussed further in Part I.F.2). Moreover, article 4.1.1, paragraph 4, provides, “The members of the Board of Directors and of the Supervisory Board are personally liable to the European Foundation for losses deemed attributable to any negligence, reckless acts or willful defaults on their part.” The European Foundation, supra note 1, at 86.
39. In the business sector, some corporation statutes or stock exchange listing requirements require the board to be composed of a majority of disinterested directors, or require certain committees (such as the audit committee or special litigation committee) to be composed of exclusively disinterested directors. Some states are considering importing these and other corporate governance reforms into their nonprofit corporation statutes. See Principles of the Law of Nonprofit Orgs. § 310 cmt. c(3), § 325 cmt. b(5) (Tentative Draft
Revised Model Nonprofit Corporation Act (approved by the American Bar Association in 1987) includes an optional provision for legislatures to adopt that requires a majority of the board to consist of financially disinterested members, commenting, "The section is optional as many members of the Subcommittee... felt that its provisions would be ineffective in preventing intentional abuses, while presenting a burdensome or inconvenient requirement. Legitimate public benefit corporations might have difficulty in finding active and competent directors who had no financial interest in the corporation." The 2006 Exposure Draft of the Proposed Model Nonprofit Corporation Act, Third Edition does not contain a provision requiring independent directors, even as an optional provision.

Distinct from positional independence, a fiduciary might have a conflict of interest with respect to a particular transaction. Transactional conflicts of interest cannot always (and sometimes should not) be eliminated, but rather must be managed in a way that serves the organization's interests. Accordingly, the governing board may, if consistent with its fiduciary duties, waive a potential conflict of interest. This usually requires that the board adopt and follow procedures to protect the charity. As a starting point, advisors today strongly recommend that every organization adopt and enforce an appropriate conflict of interest policy. Generally, as to a particular transaction or conduct, the conflicted fiduciary must make appropriate disclosures and refrain from participating in the decision reached by the unconflicted board members, who must determine and document that the transaction is fair to and in the best interests of the organization. The ALI's draft Nonprofit Principles encourage charities to require disclosure of nonfinancial dualities of interest as well as of financial conflicts of interest.

b. What the Board Does

The law provides few affirmative statements of the functions of the board, in contrast to broad declarations of the duties that the fiduciaries owe to the organization. The ALI's Principles of Corporate Governance observe...
that, "[i]n general, state corporation statutes have not defined the functions of directors and officers with specificity," and "have not provided realistic guidance as to such matters as the board's core functions . . . or the functions of important committees."\footnote{43} The law generally assumes that the governing board confines itself to setting policy and overseeing those who actually engage in the management. The ALI observed, "[T]he board can normally satisfy the requirements of present statutes without either actively managing or directing the management of the corporation, as long as it oversees management and retains the decisive voice on major corporate actions."\footnote{44}

While the board is thus encouraged to delegate the conduct of functions, it may not abdicate its oversight duties over how those functions are carried out. Courts typically draw the line at the "abdication" of responsibilities, as well as the delegation of core activities.\footnote{45} As described in Part I.D below, these fiduciary duties apply at the individual level. Thus, the 1998 amendments to the Model Business Corporation Act describe the required oversight in the following terms:

While the facts will be outcome-determinative, deficient conduct involving a sustained failure to exercise oversight—where found actionable—has typically been characterized by the courts in terms of abdication and continued neglect of a director's duty of attention, not a brief distraction or temporary interruption. However, embedded in the oversight function is the need to inquire when suspicions are aroused. This duty . . . does not entail proactive vigilance, but arises when, and only when, particular facts and circumstances of material concern (e.g., evidence of embezzlement at a high level or the discovery of significant inventory shortages) suddenly surface.\footnote{46}

Similarly, in the nonprofit sector, Judge Gerhard Gesell declared in the influential Sibley Hospital case:

Total abdication of the supervisory role . . . is improper even under traditional corporate principles. A director who fails to acquire the information necessary to supervise investment policy or consistently fails even to attend the meetings at which such policies are considered has violated his fiduciary duty to the corporation. While a director is, of course, permitted to rely upon the expertise of those to whom he has delegated investment responsibility, such reliance is a tool for interpreting the delegate's reports, not an excuse for dispensing with or ignoring such reports. A director whose failure to supervise permits negligent mismanagement by others to go unchecked has committed an independent

\footnote{43}{Principles of Corp. Governance: Analysis and Recommendations § 4.01, 4.01(a) cmt. b (1992).}
\footnote{44}{Id. § 3.02 cmt. a.}
\footnote{45}{See Principles of the Law of Nonprofit Orgs. § 325 cmt. a(1) (Tentative Draft No. 1, 2007).}
\footnote{46}{Model Bus. Corp. Act § 8.31(a)(2)(iv) cmt. 1(f) (2005).}
As to the important question of the relationship between the board and day-to-day management, the ALI's Principles of Corporate Governance comment,

The board's obligation to oversee the performance of the principal senior executives does not imply an antagonistic relationship between the board and the executives. Rather, it contemplates a collegial relationship that is supportive as well as watchful. . . . [T]he relationship between the board and the executives should be challenging yet positive, arm's length but not adversary.48

Following recent scandals in the business world, legislatures, regulators, courts, and advisors have been calling for a reexamination of the relationship between board and senior executives, as a matter of best practice, if not of law.

2. What Occurs in Practice

a. Board/Staff Relationship

The independent-board monitoring model has attracted thoughtful criticism. For example, James Cox observes, "[T]he outside director wins the position of monitor by default. The task assigned to the outside director is justified not by what outside directors actually do, but rather by an abstract belief in what outside directors can do relative to other potential monitoring mechanisms."49 Lawrence Mitchell concludes,

It may be that the monitoring board, in its ideal form or as an aspirational model, could be a reasonable tool of corporate oversight. But as a legal model it fails and has become an institution of corporate governance that is essentially a fraud, designed not to govern but to protect corporate directors from liability. The recent Disney decision is the judicial perfection of that fraud.50

Board members, in both business and nonprofit corporations, are part-timers, often volunteers, serving for a variety of altruistic, social, and even selfish reasons, and (for the outside directors) not likely to be technically skilled in the business of the enterprise. By contrast, many CEOs, in both types of corporations, are often more energetic, dominating, "true believers," and technically proficient. (Of course, many nonprofits—particularly small ones—have no paid staff either.) These features of the relationship do not, however, detract from the important function of having management prepare themselves to explain and justify their actions on a regular basis to a separate body. For such a process to be effective, however, the board must be sufficiently well constituted and vigilant to spur management to take this activity seriously.

In the case of nonprofits, some observers believe that the absence of shareholders emphasizes an inappropriate reversal of the power relationship between the board and the officers. In 2004, the Missouri attorney general analyzed the oversight performed by the board of the Ewing Marion Kauffman Foundation. The report recommended, The Board needs to re-assess and formalize its oversight and control of the organization at every level, both with respect to internal operations and the Foundation's programmatic decision-making. To achieve this, the Board should establish clear policies and procedures for ordinary operations of the Foundation, and make clear and express delegations of authority to management within those policies and procedures. Just as important, the Board should clearly identify those operations and decisions of extraordinary import that merit direct Board control and oversight. This is the only means by which the Board can effectively ensure that management is being successful in implementing the Board's vision for the Foundation, and not the other way around.

The management literature on the board-staff relationship abounds in a variety of prescriptive models—cooperative (partnership), hierarchical (board dominates), or deferential (CEO dominates). Those models, however, fail to capture the complexity of the real world. Francie Ostrower and Melissa Stone's recent survey of the academic literature identifies the myriad influences and factors that determine how a board functions, including the personal characteristics of board members and of the CEO (such as gender, prestige or wealth of board members, length of CEO tenure, and degree of CEO professionalism), organizational factors (such as the life cycle of the organization, its size, and its degree of bureaucratization), and environmental factors (such as interorganizational relationships and other boundary-spanning ties, resource dependency, and organizational financial health or crisis).

52. Id.
In assessing how boards monitor authority delegated to management, attention is turning to the importance of "deciding what the board should decide."\(^{54}\) Michael Useem and Andy Zelleke recently explored the striking contrast between the isomorphism of the "outward features"\(^ {55}\) of the governance structure of U.S. public companies—"clear observables"\(^ {56}\) such as the separation of the chair and CEO, board size, and compensation—with the necessary variety of internal practices that occur below the radar screen. After all, they observe, a corporation's "decision protocol is treated as a confidential document, and directors and executives have generally never had opportunity to examine decision protocols of companies other than their own," and so "no shared norm for what constitutes best form has yet emerged."\(^ {57}\) Nevertheless, they find that, "[w]hatever the membership and configuration of the board, and despite the institution of annual calendars and decision protocols, decisions on what deserves board attention when new issues arise are still largely the preserve of management."\(^ {58}\) They conclude, however, that recent legal reforms that require independent directors to meet periodically without the chief executive, that "restor[e] director dominion over major company decisions," and that populate key committees with only independent directors "are pressing directors to become more alert and engaged in decisions for which they may be held more accountable."\(^ {59}\) Accordingly, "[a] culture of governance is emerging at the corporate apex in which executives are expected by directors to be more mindful of what the board has decided it wants to decide."\(^ {60}\)

Yet despite the recent Sarbanes-Oxley legislation and stock-exchange independence requirements, even the boards of large publicly traded companies appear to follow a governance model that cedes a great deal of authority to management. PricewaterhouseCoopers recently found,

> When the 2005 What Directors Think study surveyed directors about who is primarily responsible for setting their board meeting agendas, 74%

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\(^{55}\) Id. at 4.
\(^{56}\) Id. at 3.
\(^{57}\) Id. at 10.
\(^{58}\) Id. at 9.
\(^{59}\) Id. at 11.
\(^{60}\) Id.
said agenda direction comes from the CEO. Only 14% said a nonexecutive chair sets the agenda and 10% said leadership emanates primarily from either a lead director or the general counsel/corporate secretary. . . . This finding might raise eyebrows among strict proponents of board independence, but it appears to be ingrained in many companies’ culture. When asked where board leadership should emanate from, 47% believe it should come from the CEO. . . . Only 38% of directors believe board leadership should emanate from a nonexecutive chair.61

Some studies, furthermore, emphasize the power relationships within the board, with board members often deferring to, among others, the board chair, longer-tenured or dominating members, and those with expertise (particularly financial expertise). One study of three museum boards found that those who participate in governance thought someone else made the decisions—except for the executive directors, who are “aware of their power and willing to acknowledge that they had used it.”62

In small organizations, the line between oversight and management blurs, reflecting an “associational” organization more than a “bureaucratic” one.63 Consider one recent account of the spiral that leads to an ever-diminishing group taking an increasing share of the work:

An inner group emerged as people who were seen to have the skills, knowledge, enthusiasm or time volunteered or were persuaded to undertake tasks for the agency. . . . As their experience and confidence grew, they took on more and more of the work. In the long run they could find it increasingly difficult to reduce the load. Those outside the inner circle were reluctant to take over partly because the time commitment had become significant and partly because they felt that they lacked the knowledge and experience of those in the inner group. When some of the active minority eventually left the agency, those who were left tended to find it easier to take on additional responsibilities rather than to persuade other people to join the inner group. . . . In extreme cases the active members struggled on until, exhausted or “burned out,” they were forced to drop out and create an organisational crisis.64

For larger governing boards, most of the work occurs in committees, raising a separate set of issues relating to the internal governance of the board.65 While not all nonprofits—even of the same size or in the same industry—have the same structure, common standing committees include

63. See also supra Part I.C.
65. See also infra Part I.D.
the executive committee, the audit committee, the nominating committee, the governance/program committee, the finance and investment committee, the development/fund-raising committee, the compensation committee, and (for membership organizations) the membership committee. Ad hoc committees might include a chief executive search committee, a special litigation committee, and a committee to consider a merger or sale of substantially all the assets of the organization.

A recent Urban Institute survey of nonprofit governance practices found, among other things, that “[i]t was only among nonprofits with over $40 million that a majority of organizations had an audit committee”; indeed, only fifty-eight percent of this class had an audit committee. Such a finding does not mean, however, that the board is not performing audit committee functions. More troubling is the study’s finding that nineteen percent of large nonprofits had management serving on the audit committee. Worse, “[40] percent of those that include paid staff on the audit committee said it would be somewhat or very difficult to comply with a law prohibiting all staff from serving on the audit committee, and 21 percent said it would be very difficult.” But it should not take a law to require this practice: How can an audit committee do its proper job of supervising management if management sits on the committee?

b. Board Functions and How Board Members Learn Their Craft

The ALI Nonprofit Principles project has a significant educational component. In an attempt to describe the functions of the typical charity governing board, section 320(b) of Tentative Draft No. 1 states that, subject to law and the organizational documents, the governing board’s functions include (but are not limited to):

(1) monitoring implementation of the charity’s purposes, and modifying those purposes as necessary and appropriate in accordance with §§ 230 and 240;
(2) adopting bylaw provisions that address governance issues, and amending the bylaws as necessary and appropriate;
(3) constituting the governing board and filling the chief executive position, and monitoring the board’s and the chief executive’s performance of their legal and organizational responsibilities;
(4) holding periodic meetings of the board (and membership, if any);
(5) setting and reviewing policies, particularly those addressing matters reserved to the board by law or the organizational

67. Id. app. at 7.
68. Id. at 2–3.
documents, and providing direction to and oversight of management;

(6) [overseeing] the charity’s fiscal integrity and performance by adopting the budget, setting investment and spending policies, seeking appropriate resources, and exercising oversight over the charity’s assets, both investment and programmatic;

(7) overseeing appropriate communication with the charity’s constituencies and the public; and

(8) [overseeing the establishment of] appropriate procedures for internal controls, including financial controls, legal compliance, and information flow to the board.69

Nonprofit trusteeship is a highly institutionalized activity, although the form the institution takes varies with the society that produced it.70 The number of U.S. nonprofit organizations has exploded—in 1940 there were about 12,000 exempt organizations,71 but by 2005 there were over 1.7 million on the Internal Revenue Service Business Master File (which does not include most churches).72 All of these organizations must staff their boards, amounting nationwide to millions of positions on the boards of

69. Principles of the Law of Nonprofit Orgs. § 320(b) (Tentative Draft No. 1, 2007). The bracketed material reflects corrections that will be made in the next draft.

70. See Peter Dobkin Hall, Inventing the Nonprofit Sector 138 (1992).

71. Id. at 136–37.


This number can understate as well as overstate the number of U.S. charities. Congress exempts churches and small public charities (generally gross receipts of less than $5000) from having to register in order to obtain recognition of tax exemption under Internal Revenue Code § 501(c)(3), and exempts churches and small public charities (generally gross receipts of less than $25,000) from having to file the annual Form 990. The IRS estimates that for 2006, a total of 648,600 returns will be filed by 501(c)(3) organizations (407,400 Forms 990; 151,300 Forms 990-EZ, available to organizations with income and assets below modest thresholds; and 89,900 Forms 990-PF, filed by private foundations). See Principles of the Law of Nonprofit Orgs., intro., reporter’s note 3 (Tentative Draft No. 1, 2007).

The number of exempt organizations could drop precipitously as the IRS adjusts its Business Master File to reflect a new requirement—effective for years beginning after 2006—that small organizations file an annual notice of their continued existence (and minimal other information). Failure to file either the appropriate Form 990 or this notice for three consecutive years will result in revocation of exemption. The new statute additionally requires notification when an exempt organization terminates its existence. See I.R.C. §§ 6033, 6652, 7428 (2001). This process will clarify whether the many “missing” Forms 990 and 990-EZ are attributable to small size or to cessation of activities (or ignorance of filing obligations).
nonprofit organizations. As Peter Dobkin Hall observed, "[T]he dramatically increased number of nonprofits has created an enormous demand for competent trustees—a demand that far exceeds the population of those with either trustee experience or an understanding of traditional trusteeship values."73

How do nonprofit directors learn what to do? While there is no single route to board membership, to some degree service on lesser boards is a stepping stone for more important (more visible) boards.74 In effect, the smaller nonprofits serve as the farm system for developing directorial talent. In addition, corporate grant making and other external pressures have led nonprofits to adopt more businesslike practices; the arrival of business executives on nonprofit boards further the importation of business norms.

Unfortunately, one cannot automatically conclude that large and established nonprofits have boards that focus on governance. Membership on the boards of some cultural and other high status, donation reliant organizations depends on generous monetary contributions—notoriously, some even have a known "price list."75 It is even more likely that in small or less connected nonprofit organizations, new board members know little about what they are supposed to do. With the recent emphasis on governance and the proliferation of information on the Internet, new and prospective board members can find abundant advice. Among the best practices urged in both the business and nonprofit sectors is that new and continuing board members receive orientation and training—not just in fiduciaries’ legal obligations but also in their governance responsibilities, such as appreciating the appropriate roles of the board and the staff, the importance of asking questions and offering constructive criticism, and contributing to policy and strategic development.76 But the push for peer regulation has also been criticized.77

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73. Hall, supra note 70, at 137.
74. See id. at 140–41.
A recent comprehensive survey, by the Urban Institute’s Francie Ostrower, found,

Only a minority of boards were very active when it came to most of the activities we asked about, including fundraising (29 percent), monitoring the organization’s programs and services (32 percent), monitoring the board’s own performance (17 percent), planning for the future (44 percent), community relations (27 percent), and educating the public about the organization and its mission (23 percent).  

The Panel on the Nonprofit Sector, a group assembled by the charity trade association Independent Sector, appointed an Advisory Committee on Self-Regulation to help develop recommendations on this subject. In early 2007, the panel posted the committee’s revised draft set of thirty-one principles for effective practice. These draft principles are grouped into five categories: (1) facilitating legal compliance and public disclosure, (2) effective governance, (3) strong financial oversight, (4) responsible fundraising practices, and (5) two staff principles regarding risk management practices and adoption of a code of ethics. The panel is soliciting public comment on this draft, and expects to issue its final report in fall 2007.

A recent (although pre–Sarbanes-Oxley) study of the actual practice of service on boards of New York City social-service nonprofits confirmed the benefits of board training and experience:

Activity levels are consistently higher across all three categories [meeting attendance, hours worked, service on committees] for board members who also receive orientation and training. In terms of tenure, we continue to find higher activity levels among board members with longer tenures. All activities are significantly higher for board members with more than two years of experience. . . . Attendance rates peak for the middle tenure group. As board members move beyond ten years of experience, their attendance declines some—although not to the point of the newest
members. However, participation in committees does not decline, and in fact, total time on board work increases.\textsuperscript{81}

c. Conflict of Interest Transactions

Nonprofit governance overall might be improved through the development of a cadre of “professional” directors (often retired executives), who can take their expertise from organization to organization, as is increasingly true of nonprofit executives.\textsuperscript{82} Some even suggest paying nonprofit board members for their time and talent.\textsuperscript{83} However, most charity board members serve without compensation—other than expenses—although institutional trustees of charitable trusts are normally paid for their services, and board members of many foundations are compensated.\textsuperscript{84} Ostrower’s survey concluded, “We generally found no indication that compensating trustees promotes higher levels of board engagement. Boards that compensate were not more or less likely to be actively engaged in financial oversight, setting policy, planning, monitoring programs, or evaluating the CEO/executive director,” and “[c]ompensation was negatively associated with levels of board activity in fundraising, community relations, and educating the public about the organization and its mission...” However, compensation was positively associated with

\textsuperscript{81} Alan G. Hevesi & Ira Millstein, Nonprofit Governance in New York City 46 (2002), available at http://www.comptroller.nyc.gov/bureaus/omn/Nonprofit\%20Governance\%20In\%20New\%20York\%20City.pdf. The report added, “Advocacy, personal giving, and planning all continue to increase after the tenth year.” Id. at 47.

\textsuperscript{82} This term traces back to Joseph Barr, who defines “professional director” to be “a man...who spends all his time in the discharge of his responsibilities as a director of various publicly held corporations.” Joseph W. Barr, From the Boardroom: The Role of the Professional Director, Harv. Bus. Rev., May–June 1976, at 18, 18. This definition excludes those employed as chief executives of their own firms, with possibly reciprocal board service. Compare Barr’s view with the concept of “professional outside director” as used by Ronald Gilson and Reinier Kraakman, who proposed that institutional investors collectively should have the right to seats on the boards of corporations whose stock they own; the professional directors would have “portfolios” of, say, six directorships. See Ronald J. Gilson & Reinier Kraakman, Reinventing the Outside Director: An Agenda for Institutional Investors, 43 Stan. L. Rev. 863, 883–92 (1991). But see Cox, supra note 49 (criticizing the professional outside director theory).


attendance at board meetings, and this relationship held even after controls for other variables."85 Moreover, she observed,

We did not find evidence that compensating trustees help[s] nonprofits attract board members with particular expertise. Boards that compensate were actually less likely to have members with professional backgrounds or expertise in management, law, or accounting, and no more or less likely to have members with expertise in the organization's field of activity. Furthermore, compensation was not associated with achieving greater racial or ethnic diversity.86

Query whether compensating governing board members would erode the current corporate standard for breach of the duty of care from gross negligence87 to simple negligence. After all, simple negligence is the legal standard that applies to lawyers, doctors, and other service professionals—and, indeed, to corporate agents generally88—as well as, traditionally, to trustees of private and charitable trusts.

Concerns generally about financial dealings between charities and their insiders—directors, officers, and other key persons—arise more commonly over compensation for executives, and over transactions for goods and services—other than board services—with members of the governing body. (Importantly, the subset of charities dubbed "private foundations" by federal tax law presents compliance issues only with respect to the payment of compensation, because all other transactions with insiders are prohibited.)89 Ostrower's survey found conflict of interest transactions to be extensive, growing with charity size:

Overall, 21 percent of nonprofits reported buying or renting goods, services, or property from a board member or affiliated company during the previous two years. Among nonprofits with more than $10 million in annual expenses, however, the figure climbs to more than 41 percent. Note, however, that among those nonprofits that say they did not engage in transactions with board members or affiliated companies fully 75 percent also say they do not require board members to disclose their

85. Ostrower, supra note 78, at 11.
86. Id.
87. See infra Part I.F.
88. Deborah DeMott, the reporter for the ALI's Restatement (Third) of Agency, recently noted, "An actively debated question is whether the extensive body of Delaware caselaw applicable to directors applies to officers as well." Deborah A. DeMott, Inside the Corporate Veil: The Character and Consequences of Executives' Duties 16 (Duke Law Sch. Legal Stud., Working Paper No. 112, 2006). She explained,

It may seem incongruous that agents situated higher in a corporation's hierarchy would be subject to a lower standard of care (gross negligence) that [sic] the standard applicable to ordinary agents and employees. The incongruity stems from two factors. First, the more elevated an agent's position within a hierarchy, the higher the expectations for the quality of the agent's performance. Second (and relatedly), the higher the agent's position, the greater the detrimental impact that may follow from the agent's failure to act with care. Id. at 17.
financial interests in entities doing business with the organization, and thus, respondents may have been unaware of transactions that do exist.\textsuperscript{90}

Specifically, this study found,

According to respondent reports, among nonprofits engaged in financial transactions, most obtained goods at market value (74 percent), but a majority (51 percent) did report that they obtained goods below market cost. Under 2 percent reported paying above market cost. Keep in mind, too, that these are self-reports, and thus, if anything, the figures are likely to underreport transactions resulting in obtaining goods at above market value or at market value and overreport transactions resulting in obtaining goods below market cost.\textsuperscript{91}

Moreover,

smaller nonprofits were considerably more likely than larger ones to obtain goods and services from board members at below market cost: 58 percent of nonprofits with under $100,000 in expenses obtained goods or services at below market cost from a board member, but the percentage drops to a low of 24 percent among nonprofits with over $40 million in expenses. The percentage of nonprofits that received goods or services at market value, in contrast, was over 70 percent among nonprofits of every size.\textsuperscript{92}

Finally, forty-five percent of those charities engaged in business transactions with board members reported that “it would be at least somewhat difficult were they prohibited from purchasing or renting goods from board members, but only 17 percent said it would be very difficult.”\textsuperscript{93}

D. Group Authority, Individual Responsibility

1. What the Law Requires

a. Group Responsibility: Board and Committees

The governing board (and each board committee) makes decisions as a group. Unlike a cotrustee of a charitable trust (whose settlor does not constitute the cotrustees as a board), a single member of a multimember nonprofit corporate board, without board authorization, has no power to act for the organization.\textsuperscript{94}

\textsuperscript{90} Ostrower, \textit{supra} note 78, at 8.
\textsuperscript{91} \textit{Id.}
\textsuperscript{92} \textit{Id.}
\textsuperscript{93} \textit{Id.}
\textsuperscript{94} See, e.g., Baldwin v. Canfield, 1 N.W. 261, 270 (Minn. 1879) (“The separate action, individually, of the persons comprising such governing body, is not the action of the constituted body of men clothed with corporate powers.”). As for cotrustees functioning as a board, see Principles of the Law of Nonprofit Orgs. § 320 cmt. b(1) (Tentative Draft No. 1, 2007).
There is little law that translates the individual fiduciary duties into group responsibilities. Some commentators put weight on the duty of loyalty, expressed in the statutes as the director's duty to act in ways he or she reasonably believes to be in the best interests of the corporation. More helpfully, trust law explicitly requires cotrustees to cooperate with each other in the exercise of their duty of care. The draft ALI Nonprofit Principles endorse, for all types of charities, the trust law's imposition of an obligation of cooperation on co-fiduciaries.

At the same time, commentary in the Restatement (Third) of Trusts provides that a cotrustee's "duty to participate in administering the trust does not require an equal level of effort or activity by each co-trustee." Accordingly, that comment continues, cotrustees may decide "(short of constituting delegation) to allow one or more of the cotrustees to carry more of the burden in regard to various matters, for example, by initiating, analyzing, reporting, and making recommendations for reasonably informed action by all of the trustees." However, trustees may not "divide['] the trusteeship or its functions in a manner that is not authorized by the terms of the trust." Similarly, the draft ALI Nonprofit Principles comment, "[I]t is impermissible for a board member of a corporate charity to delegate the responsibilities to be informed and to participate in deliberation." A great deal of board work occurs in committees. Nonprofit corporation statutes typically prohibit a committee of the board from taking four specific actions: (1) authorizing distributions; (2) approving (or proposing to members) action that must be approved by members, such as dissolution, merger, or the sale, pledge or transfer of all or substantially all of the corporation's assets; (3) electing, appointing or removing directors, or filling vacancies on the board or any board committee; and (4) adopting,
amending, or repealing the articles or bylaws. Otherwise, what decisions committees may make can be set forth in the organizational documents and in the board policies (including committee resolutions and charters).\textsuperscript{104} The full board always can reject a decision of a committee, subject to any rights of third parties.\textsuperscript{105} Even when committees exercise board power, the noncommittee board members must still exercise their fiduciary duties.\textsuperscript{106} While delegation to committees allows directors to focus on key areas, the board retains oversight obligations in addition to its responsibility for making decisions reserved to the board by law, the organizational documents, or board policy.

As described in the 2007 draft ALI Nonprofit Principles, regardless of an individual’s motive for joining the board, included in every charity board member’s duty of care is the obligation to participate appropriately in governance. This generally requires each board member to review the material distributed to the board, attend meetings, ask questions, participate in deliberations, and cast informed votes. While an individual board member may reasonably rely on the efforts of those to whom delegation has been properly made, in order to rely on reports, the member must actually review them, whether by reading them or attending a presentation of them.

\subsection*{b. Who Is Really on the Board?}

State statutes impose a minimum governing board size on nonprofit corporations, but no state imposes a maximum size. Notably, section 8.03 of the Revised Model Nonprofit Corporation Act requires a minimum of three directors, but about a dozen states—including Delaware—recognize a single-director nonprofit corporation.\textsuperscript{107} A nonprofit corporation may incorporate in a jurisdiction that permits the desired minimum board size, and then register to do business in another state or states of operation.\textsuperscript{108}

Statutes provide few criteria for board membership, requiring, usually, only that the occupant must be an individual and of a specified minimum age. Additional reasonable criteria for board membership may be included in the organizational documents. A charity may condition board membership on such ideological characteristics as membership in the organization or adherence to a certain philosophy, and on such performance

\begin{itemize}
  \item \textsuperscript{104} See, e.g., \textit{In re Walt Disney Co. Derivative Litig.}, 906 A.2d 27 (Del. 2006). One issue in \textit{Disney} related to whether only the full board, rather than just the compensation committee, could set the financial terms of the contract with incoming president Michael Ovitz. Compensation can be a sensitive topic for many exempt organizations, particularly charities, and the visibility of the Form 990 suggests that the full board at least should be aware of the compensation it pays to directors, officers, and top executives before the public.
  \item \textsuperscript{105} The one exception is for decisions made by a special litigation committee, because such a body determines whether to permit a derivative suit to be brought against the board.
  \item \textsuperscript{106} See Revised Model Nonprofit Corp. Act § 8.25(f) (1987) ("The creation of, delegation of authority to, or action by a committee does not alone constitute compliance by a director with the standards of conduct described in section 8.30.").
  \item \textsuperscript{107} See Del. Code Ann. tit. 8, § 141(b) (2007).
  \item \textsuperscript{108} See Revised Model Nonprofit Corp. Act § 15.01 (1987).
\end{itemize}
characteristics as experience in a particular industry, satisfactory performance as a board member, and attendance at a certain number or percentage of meetings. In addition, a charity might properly require each board member to make (or raise) a minimum annual financial contribution. The organization may also consider the desirability of including representatives of its various stakeholders, and the value of diversity in board membership.

State statutes not infrequently provide for certain designated public officials or others to hold ex officio or other status-based (e.g., student) positions on the boards of public utilities, public agencies (including boards of regents for state systems of higher education), and licensing and other regulatory or quasi-regulatory bodies. The consequence of the designation "ex officio" is that the identity of the board member changes as the holder of the position changes or as the status of the holder otherwise changes.

Statutorily mandated nonprofit board positions for governmental officials are often designated as nonvoting. General nonprofit corporation statutes, however, rarely recognize the possibility of nonvoting directors.\(^{109}\) (By contrast, as discussed in Part I.E, a nonprofit may have nonvoting members of the organization.) Many state statutes do provide that a board committee may include non-board members if they have no vote;\(^ {110}\) and a few state statutes provide that certain key committees (e.g., the executive committee) may contain only board members.\(^{111}\) The legal responsibilities and liability of a nonvoting board member have not been addressed in the case law; it would be helpful for nonprofit corporation law to declare affirmatively that the term "director" means only those with voting power.

The 2007 draft of the Principles of Nonprofit Organizations concludes, “Essentially, ‘if you’re on the board, you’re on the hook.”\(^{112}\) Some states permit the founder of a nonprofit corporation to include a provision in the articles of incorporation requiring the assent of the founder or another specified person or body to all or some corporate decisions, or the vesting

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\(^{109}\) For an example of one that does, see the New York Not-for-Profit Corporation Law, which provides, "The certificate of incorporation or the by-laws may provide that any one or more officers shall be ex-officio members of the board, with voting rights unless specified otherwise." N.Y. Not-for-Profit Corp. Law § 713(d) (McKinney 2002). By contrast, Texas’s revised nonprofit corporation statute contains the opposite presumption. Texas Business Organizations Code Annotated section 22.210(c) reads, “An ex officio member is not entitled to vote unless the certificate of formation or bylaws authorize the member to vote. An ex officio member of the board who is not entitled to vote does not have the duties or liabilities of a director provided by this chapter.” Tex. Bus. Orgs. Code Ann. § 22.210(c) (Vernon 2006).

\(^{110}\) See, e.g., Wis. Stat. § 611.56(1) (2006) (“Any committee under this section may include one or more nonvoting members who are not directors.”).

\(^{111}\) Interestingly, the IRS’s regulations under Internal Revenue Code § 4958—which taxes certain insiders on “excess benefit transactions” with exempt charities—defines the category of covered persons to include, among others, “any individual serving on the governing body of the organization who is entitled to vote on any matter over which the governing body has authority.” Treas. Reg. § 53.4958-3(c)(1) (2006).

of authority over certain issues in a specified person or body. Such a "sterilization option" might be desirable for some membership or religious organizations in order to retain control over certain issues by the membership or hierarchy.\textsuperscript{113}

For example, section 8.01(c) of the Revised Model Nonprofit Corporation Act provides,

The articles may authorize a person or persons to exercise some or all of the powers which would otherwise be exercised by a board. To the extent so authorized any such person or persons shall have the duties and responsibilities of the directors, and the directors shall be relieved to that extent from such duties and responsibilities.\textsuperscript{114}

Section 8.12 of the 2006 proposed revision to the Model Act expands on this concept by allowing the bylaws—not just the articles—to create such a designated body. Specifically, this proposed provision reads, in its entirety, as follows:

(a) Some, but less than all, of the powers, authority or functions of the board of directors of a nonprofit corporation under this [act] may be vested by the articles of incorporation or bylaws in a designated body.

(b) The provisions of this chapter and other provisions of law on the rights, duties and liabilities of the board of directors or directors individually also apply to any designated body of a nonprofit corporation and to the members of a designated body individually. The provisions of this chapter and other provisions of law on the manner of acting of the board of directors also apply to any designated body in the absence of an applicable rule in the articles of incorporation, bylaws or internal operating rules of the designated body,

(c) To the extent the powers, authority, or functions of the board of directors have been vested in a designated body, the directors are relieved from their duties and liabilities with respect to those powers, authority, and functions.\textsuperscript{115}

In the absence of commentary in the Exposure Draft, however, significant open questions remain. What does it mean to say "[s]ome, but less than all, of the powers" of the board can be assigned to a designated body? Assuming the board has the power to amend the bylaws or even the articles without member approval (or if there are no members), and the board itself establishes such a body, can the board thus divest itself of legal


\textsuperscript{114} Revised Model Nonprofit Corp. Act § 8.01(c) (1987).

responsibility and liability for some matters? What are the powers and liabilities of the board and the designated body when both bodies claim authority over an issue—or both disclaim it?

2. What Occurs in Practice

a. Group Decision Making

A variety of techniques have been developed in the business world to encourage boards to overcome the natural tendencies toward “group think” and deference to the better-informed inside directors or those with perceived expertise. These techniques include appointing a lead independent director (when the CEO is the board chair), having meetings of the independent board members separate from the inside directors, designating a board member to act as a devil’s advocate, and, when called for, undertaking a forensic audit. More worrisome for many charities, not all board members come with the same expectations of performing their individual duties.

b. Identifying “the Board” and the “Members” of a Committee

It can be surprisingly difficult to ascertain the composition of the governing board of many nonprofit organizations because of the proliferation of honorary and special titles. The draft black letter of the ALI Nonprofit Principles emphasizes, “The governing board must ensure that those persons who are responsible for the affairs of the charity are clearly identified.”116 Comment a(1) adds,

[E]very charity must be able to identify that person or group of persons endowed with the responsibilities assigned in this Section to the governing board... so that all fiduciaries may appreciate their legal duties, and so that regulators, the charity’s constituents (including members, if any), and the general public know whom to hold accountable.117

This information has now become easier to detect from tax filings.118

Much of the recent management literature on nonprofit board composition addresses the diversity of board membership in terms of whether the organization’s various stakeholders have a voice, rather than—as is the focus here—on whether each board member conceives of his or

116. Principles of the Law of Nonprofit Orgs. § 320(a) (Tentative Draft No. 1, 2007) (quoting the second sentence of § 320(a)).
117. Id. § 320 cmt. a(1).
her role as encompassing an obligation to attend to governance (as distinct from fund-raising or other contributions).  

The ability of a charity to recruit good board members obviously depends on what is expected of them—after all, passion alone will not suffice to discharge the legal obligations described above.  

Marion Fremont-Smith observes,

It is not uncommon to elect individuals to serve as directors because of certain unique contributions they are able to make by virtue of their particular expertise, standing in the community, or as potential donors. In many instances it is understood that these individuals will not be expected to attend meetings or give the affairs of the charity the degree of attention expected of other board members.

She refers to proposals “to redefine the duties of directors to permit what might be considered a special class that would not be held to the standards required of others.” However, she believes, “A better solution would be to provide these individuals with an honorary title or, if the corporation has members, elect them to that position, rather than diluting the overall standards appropriate for directors.”

Michael Klausner and Jonathan Small recently proposed that the law recognize a bifurcated board, made up of “governing board members” and “nongoverning board members.” To these authors, “[a]ll directors should not be asked or expected to govern,” and this expectation “stems from a misplaced analogy with for-profit boards.” These authors comment,

In contrast to their counterparts on for-profit boards, directors of nonprofit organizations are called upon to perform several functions. Some directors give or raise funds; others provide special expertise; others maintain ties to an important community; others are there because their stature serves as a signal that the organization does good work. And some—perhaps just a few—govern. All of these functions are important, and the reality is that there is typically a division of labor on a board, a

119. See, e.g., Ostrower & Stone, supra note 53 (surveying studies of gender, race, ethnicity, age, class, and occupation, and calling for more research on how the actual activities of different types of board members differ).
120. See Ostrower, supra note 78, at 16 (“The degree of difficulty experienced by the nonprofit in recruiting new members was negatively associated with levels of board engagement in every role. This is highly significant because 70 percent of nonprofits say it is difficult to find board members and 20 percent say it is very difficult.”).
122. Id.
123. Id.
125. Id. at 43.
division that reflects the varied interests and abilities of those who choose to join a board. 126

These authors explain, "The objective of the Bifurcated Board structure is to make the governance role clear to the board members who assume governance responsibility and to the public, while also continuing to use the board for fundraising and other nongovernance functions." 127 They emphasize that the directors could "choose to govern one year and not govern another, depending on their interest and availability." 128

The 2007 draft of the Principles of Nonprofit Organizations, in contrast to proposals for a designated body or bifurcated board, endorse as better policy the view that all board members should bear responsibility for governance. 129 The ALI draft comments,

In this age of high expectations for governance, the challenge to the charity is to bring all board members into the governance effort, or to find alternative ways to recruit supporters who provide financial and other aid but are not interested in committing time and energy to governance. These alternatives offer legal clarity without inviting after-the-fact claims of "everyone understood that my role was to be limited"—and avoid, at the extreme, the operation of organizations headed by boards that cede too much authority to management. This is not to say, however, that all board members must participate to the same degree in all aspects of governance. If appropriate, . . . a charity may generally assign various responsibilities to board committees, including an executive committee. In such a case, board members not serving on the particular committee are relieved of their fiduciary duties to the charity other than their responsibility to participate in oversight and for matters specifically reserved to the board by law, the organizational documents, or board policy. 130

126. Id. at 44.
127. Id. at 47.
128. Id.
129. Cf. Principles of Corp. Governance: Analysis and Recommendations § 7.19 cmt. d (1992) (prohibiting "chart amendments that restrict the scope of the duty of care, or permit directors to specialize over only a limited area of corporate affairs").
130. See Principles of the Law of Nonprofit Orgs. § 320 cmt. b(2) (Tentative Draft No. 1, 2007) (citations omitted); see also id. § 315 cmt. b(3), c, § 325 cmt. b. The American Bar Association Coordinating Committee on Nonprofit Governance recommends that the organization find ways other than board service to involve donors or fund-raisers in the organization:

In the wake of current recommendations for smaller, more effective "working" boards, some nonprofits may need to review their assumptions about the appropriateness of having large or prospective donors/fundraisers serve on their boards. If monetary contribution or fundraising is a primary reason for certain board positions, are there other structures, such as an advisory board or fundraising committees[,] that could fulfill such purpose without the increased time and potential liability demands of board service? Are all board members willing and able to make the necessary commitment to serve as active overseers of corporate operations, including through active committee involvement?

To avoid the problems of an overly large board, one technique, when permitted by law, is to use a small board supplemented by non-board committee members. This spreads the work, brings in a variety of perspectives, and recruits potential board members. Nonprofit organizations commonly bring in outsiders to help with committee work.\textsuperscript{131} The American Bar Association’s \textit{Guidebook for Directors of Nonprofit Corporations} comments, “[E]ven a committee of total outsiders, named to perform some specific function, can be formed at the discretion of the board of directors, except that in most states, the board may not delegate any board-level power to such non-director committees.”\textsuperscript{132} Note that while the Revised Model Nonprofit Corporation Act is silent on the subject of advisory bodies, the 2006 draft proposed revision expands section 8.25, dealing with board committees, to clarify the legality of advisory committees. New subsection (h) would read, “A nonprofit corporation may create or authorize the creation of one or more advisory committees whose members need not be directors.”\textsuperscript{133}

Separately, it is common for a nonprofit’s chief executive to serve as a member of the board, albeit often without a vote.\textsuperscript{134} If the vote is the legal indicium of what distinguishes a “real” board member from an honorary or advisory member, the law might diverge from all parties’ expectations, and surprise, if not offend, the many executive directors that serve on their boards without voting authority. On the other hand, Francie Ostrower’s survey found it more likely that the executive director would have a vote if the board includes members from the business community, and that

\begin{quote}
[h]aving the CEO/executive director as a voting board member was \textit{negatively} associated with having an outside audit, a conflict of interest policy, a document retention policy, and a whistleblower policy. . . .
\end{quote}

\begin{quote}
\textit{O}ur study suggests that conflating executive director and board positions in this way detracts from the board carrying out its stewardship
\end{quote}

\textsuperscript{131} See Jeffrey L. Callen, April Klein & Daniel Tinkelman, \textit{Board Composition, Committees, and Organizational Efficiency: The Case of Nonprofits}, 32 Nonprofit & Voluntary Q. 493, 503 (2004) (finding that, “[d]epending on the committee, up to 64% of the respondents had at least one non-board member serving on committees”); BoardSource, Nonprofit Governance Index 2004: Executive Summary 8 (2005), http://www.boardsource.org/dl.asp?document_id=424 (noting that 69% of respondents had non-board members serving on committees).


\textsuperscript{133} See Proposed Model Nonprofit Corp. Act, Third Ed. § 8.25(h) (Exposure Draft 2006), http://meetings.abanet.org/webupload/commlupload/CL580000/sitesofinterest_files/MNCAexp osuredraft.doc; see also infra notes 149–51 and accompanying text (discussing the use of a “strong” executive committee).

responsibilities, and that nonprofits should think carefully before adopting this corporate practice. 135

c. Board Size and Composition and the Use of Board Committees

The business world provides an interesting comparison on issues of board size and composition. According to a leading industry study, the average board size of Standard & Poor’s 500 companies “leveled off to 10.7 four years ago and remains there today. This is a small enough size to work efficiently as a group but large enough to staff needed committees. Practically speaking, it seems unlikely that boards can grow much smaller.” 136 The report notes a five-year trend toward smaller boards, with 81% having twelve or fewer directors. 137 The report additionally found, “On 39% of S&P 500 company boards, the CEO is the only non-independent director, an increase from 27% in 2001”; and that the “CEO and chairman roles are separated at one-third of companies, a trend that has increased from 29% last year and 26% in 2001.” 138 Very small boards typically exist in the business world only in closely held corporations. 139

Business corporations rarely have the very large boards often found in arts and cultural organizations, higher education, and other types of charities. Boards of commercial-type charities are most likely to resemble business boards in size and operation. 140 In preliminary analysis, the National Center for Charitable Statistics (a project of the Center on Nonprofits and Philanthropy at the Urban Institute) found that in the period from 1998 to 2000 public charities had a mean board size of just under eleven (although that study excluded organizations with board sizes exceeding seventy). 141

Ostrower’s survey examined board size and composition. Among many other findings, she observed that a

facet of board composition that varies considerably with size is the inclusion of members who are relatives of other board members, a

135. Ostrower, supra note 78, at 5–6.
137. Id.
138. Id. at 19.
139. See supra Part I.B.
141. Specifically, the National Center for Charitable Statistics’ data showed that fewer than 7% reported one or two board members; 29% reported three to five board members; 26% reported six to ten board members; 24% reported eleven to twenty board members; and 13% reported more than twenty board members. Nat’l Ctr. for Charitable Statistics, What Is the Size of the Average Board of Directors? (2002), http://nccsdataweb.urban.org/faq/detail.php?linkID=175&category=8&xrefID=2578.
characteristic more common in small organizations and in cultural organizations. Fully 26 percent of boards of nonprofits with under $100,000 in expenses have members who are related to one another, as do 19 percent of boards of nonprofits with $100,000 to $500,000. The percentage drops to 15 percent for the next two size groups and down to 10 percent for nonprofits with $10 million to $40 million and 11 percent for those with over $40 million.\textsuperscript{142}

She added, "Even after taking size into account, boards of cultural organizations are also more likely to include relatives, a finding consistent with the greater likelihood of donors to culture to be couples rather than individuals and the propensity of cultural boards to maintain family connections."\textsuperscript{143} She separately found, "An emphasis on friendship or acquaintanceship with current board members had a negative association with activity in every board role except fundraising (where it had no impact)."\textsuperscript{144}

Committee composition can be more revealing than composition of the board as a whole. One study of the board and committee composition of large U.S. charities observed, "[T]he motive for selecting a person to the board need not be the same as the reason for selecting that person to serve on a particular committee."\textsuperscript{145} This study found that major donors make up varying percentages of key committees: fundraising (31% of committee members are major donors), nominating (22.4%), executive committee (21.2%), audit committee (14%), and program committee (14.8%). By contrast, board members with professional skills serve primarily on the audit committee (64.9%), investment committee (62.9%), and finance committee (52.1%), and are least represented on the fundraising committee (34.8%) and nominating committee (31.4%).\textsuperscript{146} These authors conclude that their findings "do not support the hypothesis that major donors gain disproportionate membership on monitoring committees. In fact, major donors appear to be underrepresented on monitoring committees (e.g., audit) by comparison to their representation on the board."\textsuperscript{147}

A committee and the rules governing it may be established by the bylaws, a board resolution, a committee charter, or some combination of these. In any case, the documents should specify not only what the committee is to do, but also how it is to keep the board informed of its activities. Committees exercising board powers (e.g., the executive committee) should keep minutes of their meetings and report regularly to the board. As the Business Roundtable explained,

Regardless of whether the board grants plenary power to its committees with respect to particular issues or prefers to take recommendations from

\textsuperscript{142} Ostrower, \textit{supra} note 78, at 20–21.
\textsuperscript{143} \textit{Id.} at 21.
\textsuperscript{144} \textit{Id.} at 16.
\textsuperscript{145} Callen, Klein & Tinkelman, \textit{supra} note 131, at 503.
\textsuperscript{146} \textit{Id.} at 503–04.
\textsuperscript{147} \textit{Id.} at 516.
its committees, committees should keep the full board informed of their activities. Corporations benefit greatly from the collective wisdom of the entire board acting as a deliberative body, and the interaction between committees and the full board should reflect this principle.\textsuperscript{148}

The draft ALI Nonprofit Principles comment that a charity with an unavoidably large board can improve governance by adopting a “strong” executive committee.\textsuperscript{149} The ALI draft explains the trade-offs of using an executive committee:

In an organization with a large board, an executive committee is more nimble, being able to work more closely with management and to act on behalf of the charity when it is not practical to assemble the full board for action. However, like the other committees, an executive committee may not usurp the board, and the governing board may reverse (or ratify) the executive committee’s action. Moreover, the organization should proceed carefully to ensure that the executive committee does not have too much power. Some issues are so central to the charity, or so potentially controversial, that they should be decided by the full board following presentation by the executive (or other) committee of its recommended action.\textsuperscript{150}

The ALI commentary advises,

A clear definition of this relationship is important to prevent the executive committee from usurping the power of the board and to reduce the possibility of power struggles over which matters may properly be handled by the executive committee. In the absence of such a formal delegation, the charity with a large board likely will fall into such a structure informally—indeed, its governance process would be overwhelmed if every one of its board members actually participated actively in governance—but the working group would be less likely to keep the board fully informed and the allocation of legal responsibility would be less clear, increasing the risk to the less participatory board members.\textsuperscript{151}

The ABA’s \textit{Guidebook for Directors of Nonprofit Corporations} recommends,

\begin{itemize}
\item[\textsuperscript{149}] Principles of the Law of Nonprofit Orgs. § 320 cmt. g(3) (Tentative Draft No. 1, 2007). The draft recommends,

A charity with a large board that wants to use a strong executive committee . . . should set forth in its organizational documents an explicit provision authorizing the delegation of the board’s functions and obligations to an executive committee. This will clarify that the non-executive committee members’ duty of care is limited to oversight of the executive committee and to decisionmaking on those matters specifically reserved to the board by law, the organizational documents, or board policy.

\textit{Id.} § 325 cmt. b(4) (citation omitted).
\item[\textsuperscript{150}] \textit{Id.} § 325 cmt. b(2) (citation omitted).
\item[\textsuperscript{151}] \textit{Id.} § 320 cmt. g(3).
\end{itemize}
If the executive committee exercises a substantial amount of the power of the board, the board as a whole should periodically evaluate whether the board is meeting its fiduciary obligations through such delegations, and whether the board effectively oversees and has the opportunity to provide input regarding executive committee decisions.\textsuperscript{152}

The \textit{Guidebook} adds that a large board that delegates significant power to an executive committee “should also periodically evaluate whether the corporation would benefit from having a smaller board that meets more frequently.”\textsuperscript{153}

The ALI Nonprofit Principles draft also addresses the problems of a charity having too small a board: “At the other extreme, because all charities, regardless of size, must be organized and operated for charitable rather than private purposes, a minimum number of three unrelated individuals is usually necessary for charity governance that protects the public interest.”\textsuperscript{154} Best practices might require a board larger than three.\textsuperscript{155}

E. \textit{Are Charity Members Shareholder-Substitutes?}

1. What the Law Requires

Modern U.S. state statutes merely permit—but no longer require, as many once did—nonprofit organizations to have members.\textsuperscript{156} Member control is common in the “mutual benefit” nonprofit, such as a labor organization, social club, or business league.\textsuperscript{157} Most charities and social

\begin{itemize}
\item \textsuperscript{152} ABA, \textit{Guidebook for Nonprofit Directors}, \textit{supra} note 132, at 52.
\item \textsuperscript{153} \textit{Id.}
\item \textsuperscript{154} Principles of the Law of Nonprofit Orgs. § 320 cmt. g(3) (Tentative Draft No. 1, 2007). Comment g(3) adds, The American Law Institute has previously recommended that “small publicly held corporations and large publicly held corporations that are majority-owned by a single person, a family group, or a control group . . . should have at least three directors who are free of significant relationships with the corporation’s senior executives. The number three is chosen . . . in the belief that it is the number of directors necessary to attain a critical mass on the board.” Even family foundations, which might function more like donor-advised funds than the typical charity, should consider the benefits of opening up board deliberation and oversight to an outside perspective.
\item \textsuperscript{155} \textit{Id.} (citation omitted).
\item \textsuperscript{156} See BBB Wise Giving Alliance, Standards for Charity Accountability, \textit{supra} note 76 (calling for a board of at least five voting members).
\end{itemize}
welfare organizations, by contrast, have no members, or have members only in the ceremonial sense, offering affinity but not authority. Unless the articles or bylaws provide for another selection mechanism, a nonprofit corporation without members has a self-perpetuating board of directors.

Statutes often simply substitute the word “members” for “shareholders” where the corresponding business-corporation statute would give oversight rights to shareholders. Because the term “member” in nonprofit corporate statutes is defined as those with rights to elect the board of directors, in a nonprofit lacking members, no stakeholder of the organization other than the board has any say in such extraordinary decisions as a merger or liquidation. (As a separate matter, the nonprofit might be required to notify or obtain the approval of the state attorney general.) Some statutes permit members to initiate a derivative suit if a minimum number or percentage of members join together to do so.\(^{158}\)

Commentary in the Revised Model Nonprofit Corporation Act explains how membership in a nonprofit differs from traditional stock ownership:

Issuance of a membership, unlike the sale of stock, does not necessarily involve the sale of something of value. Memberships in public benefit and religious corporations have no economic value, but reflect a contribution or a commitment to participate in or support the organization and its objectives. Memberships in mutual benefit corporations may or may not have an economic value depending on the nature of the organization.\(^{159}\)

Members of a nonprofit organization (unlike members of the board) need not be individuals. One important use of membership—although beyond the scope of this essay—is in creating control of a group of affiliated nonprofit corporations. Thus, a “subsidiary” nonprofit would have a sole

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See generally The European Foundation, supra note 1.

158. See James J. Fishman, Improving Charitable Accountability, 62 Md. L. Rev. 218, 257 & n.288 (2003) (describing, among other statutes, Revised Model Nonprofit Corporation Act section 6.30(a), extending standing to “five percent or more of the voting power or by fifty members, whichever is less” to file a derivative suit, as well as cases coming down on both sides of the standing issue).

159. Revised Model Nonprofit Corp. Act § 6.02 cmt. (1987). Henry Hansmann coined the term “nondistribution constraint” as the key legal feature of the nonprofit organization:

A nonprofit organization is, in essence, an organization that is barred from distributing its net earnings, if any, to individuals who exercise control over it, such as members, officers, directors, or trustees. By “net earnings” I mean here pure profits—that is, earnings in excess of the amount needed to pay for services rendered to their organization; in general, a nonprofit is free to pay reasonable compensation to any person for labor or capital that he provides, whether or not that person exercises some control over the organization. It should be noted that a nonprofit organization is not barred from earning a profit . . . . It is only the distribution of the profits that is prohibited.

corporate (voting) member that acts as the “parent.” 160  Separately, for tax reasons relating to the treatment of lobbying and political activity, charities can be created by or affiliate with other types of nonprofits (such as unions and trade associations).

2. What Occurs in Practice

In the business corporation, the shareholders own the stock; workers own their labor; suppliers own their supplies; and lessors (and, in some economic sense, the lenders) own the factory and equipment. But it is generally only to the shareholders that the board of directors must account. After all, shareholders “are the only voluntary constituency whose relation with the corporation does not come up for periodic renewal”; and shareholders “are also unique in that their investments are not associated with particular assets.” 161  Henry Hansmann and Reinier Kraakman view the “standard shareholder-oriented model” of the large-scale business corporation as the social ideal, in contrast to models oriented to the state, to stakeholders (usually labor), or to managers. 162  But given that memberships in nonprofits generally lack monetary value and are nontransferable (except for certain mutual-benefit organizations), is the implicit analogy in nonprofit corporation law between shareholders and members apt? And what are we to make of the silence of nonprofit

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162. Hansmann & Kraakman, supra note 30, at 441. In the 1990s, American legal scholarship focusing on the business sector raised questions of corporate responsibility—whether corporations owe obligations beyond the wealth maximization of shareholders, to reach the welfare of workers, suppliers, creditors, and the local community. See Principles of Corp. Governance: Analysis and Recommendations (1992). State legislatures expressed these concerns in “corporate constituency statutes” that permit (or even, in one state, require) the board to make business decisions taking these other interests into account. See Eric W. Orts, Beyond Shareholders: Interpreting Corporate Constituency Statutes, 61 Geo. Wash. L. Rev. 14, 16, 73 (1992). Skeptics see corporate constituency laws as thinly disguised antitakeover statutes, enacted at the behest of incumbent managers of threatened corporations. That view finds support in the fact that these corporate constituency statutes fail to grant standing in court to the newly protected classes. Id. at 83.

Some theorists challenge the view that shareholders have legal rights because the board is their agent. Notably, Margaret Blair and Lynn Stout comment,

Shareholders enjoy special legal rights not because they have some unique claim on directors, but because they often are in the best position to represent the interests of the coalition that comprises the firm. Thus, when directors breach their fiduciary duties and seek to profit personally at the firm’s expense, shareholders sometimes can take legal action on the firm’s behalf. As a general rule, however, the benefits of such derivative actions inure not just to shareholders, but to all stakeholders. Similarly, shareholders’ limited voting rights may operate to benefit other stakeholders in the firm.

corporation statutes with respect to the majority of charitable

corporations—those having no members at all?

The approach of endowing even shareholders with legal oversight has its
critics. While the shareholders of a business corporation elect the members
of the board of directors—and can replace members of the board simply for
misfeasance, or indeed for no reason at all—and while shareholders vote on
certain extraordinary transactions, such as a merger, in the modern
corporation the shareholders actually perform very little monitoring. It is
really only the smaller model of joint enterprise that fits the statutory
paradigm (in the United States at least) of stockholders who control the
board of directors who then oversee management by the officers. In the
larger corporations, any notion of shareholder voice has been discarded,
except for controlling or large minority interests. When the shareholder
loses confidence in management, she can sell the stock (the “Wall Street
walk”). Meanwhile, the stock market signals the value of the corporation,
and of its management. “In the ‘market for corporate control,’ a buyer
might engage in a takeover in order to toss out the bad managers.”

Nor do members of nonprofits—at least of charities—always perform
much oversight; mutual-benefit organizations (such as labor unions,
professional associations, and clubs) are most likely to have active
memberships. Most important, in the absence of specific legislation (such
as applies to labor unions), the terms of membership, including any voting
rights and the manner of voting, are left to each nonprofit to determine.
Members might be disenfranchised or simply uninterested in exercising
oversight.

Aside from the difficulty of compelling the exercise of vigilant oversight,
members might not be the right constituency (if any single one is) on whom
to impose legal duties for overseeing the nonprofit board. Members of a
charity—and even members of some mutual-benefit organizations—rarely
make a financial investment similar to that of capital-supplying
shareholders. Moreover, membership tends to be (although it need not be)
“one man, one vote.” Of course, members often are ideologically and
emotionally invested in the organization, but so are other stakeholders of
the organization.

Over the last few decades, economists, sociologists, and management
specialists have come to appreciate the effects on internal governance of a
nonprofit’s multiple stakeholders. The issue is complicated by two typical
problems: the nonprofit’s diffusion of mission and dependence on key


164. Avner Ben-Ner would improve nonprofit accountability by requiring a nonprofit to
have (active) members. Avner Ben-Ner, Who Benefits from the Nonprofit Sector? Reforming
Law and Public Policy Towards Nonprofit Organizations, 104 Yale L.J. 731, 735–36
(1994).

165. See generally Dana Brakman Reiser, Nonprofit Takeovers: Regulating the Market
for Mission Control, 2006 BYU L. Rev. 1181.

166. See Brody, supra note 17, at 482–88.
resources. Even for the typical charity, which lacks voting members, the board is hardly untethered. Relationships—some voluntary, some contractual, some political (in the broad sense)—exist within and between organizations, and between nonprofit organizations and business, government, and the public.\textsuperscript{167} Regardless of whether they have voting rights, nonprofit members have a range of “voice” and “exit” choices; they can “seek change from within, withhold financial support, cease to associate with the group, or form a rival group of their own.”\textsuperscript{168} This discussion suggests that, at least for charities, the law should proceed cautiously in granting members preferential rights, such as standing to challenge fiduciary performance in court.\textsuperscript{169}

F. What Really Happens to a Wayward Charity Fiduciary?

1. What the Law Requires

Finally, we reach what some observers lament as the core hypocrisy of the nonprofit governance legal regime: that the standard of care is precatory only, because few parties can complain about fiduciary wrongdoing, and, even when the attorney general or other person with standing does bring suit, courts will not impose meaningful sanctions.

The poster child for this concern is George Pepperdine. In \textit{George Pepperdine Foundation v. Pepperdine},\textsuperscript{170} a California appellate court declared that “[r]eason, justice, equity and law stand aghast at the judgment proposed by the . . . complaint” of a foundation against its founder and other board members for causing investment losses of $3 million over eleven years.\textsuperscript{171} As the opinion summarized the complaint, George Pepperdine completely dominated and controlled the foundation, and the board “held few and infrequent meetings at which a quorum was seldom present, and at such meetings nothing was done except to vote approval of the inter-meeting transactions of President Pepperdine who was also treasurer and general factotum; in other words, the corporation was George Pepperdine’s other self.”\textsuperscript{172} Over the period from 1939 through 1948, the foundation’s investments performed so poorly that the foundation became insolvent.\textsuperscript{173} The court at length expressed its disgust with the plaintiff foundation’s position, remarking, in part,

\begin{quote}
Assuming that the alleged losses were due to the alleged egregious blunders of the board under the leadership of President Pepperdine, and to
\end{quote}

\textsuperscript{169} See infra Part I.F.
\textsuperscript{171} \textit{Id.} at 605.
\textsuperscript{172} \textit{Id.} at 602–03.
\textsuperscript{173} \textit{Id.} at 603.
have been the result of his negligence and of the lack of zealous interest on the part of the others, why should he be now required to restore to his corporation what he once gave from his bounty and which was lost solely by reason of his ignorant or careless reckoning? Although a director of such a corporation is held to the highest degree of honor and integrity, he is not personally liable for mistake of judgment.174

The court concluded, “If any of such misfortunes encompassed him and deprived him of his erstwhile powers, should he and his patriotic associates now be plundered of their personal possessions to fill the never-to-be-gratified maw of charity?”175 While the California Supreme Court later established the authority of a nonprofit organization to sue its directors,176 the “Pepperdine attitude causes one of the larger difficulties in achieving effective supervision over charities.”177

As for addressing breach of fiduciary duty, it is commonly believed that only the attorney general has standing to take action, but this is not true. In the first instance, the governing board itself has the obligation to ensure that trustees or directors (as well as officers and senior executives) perform their fiduciary duties. In general, breaches of the duty of loyalty present less ambiguous cases for action than breaches of the duty of care, and the remedies appropriately vary.178

In some cases, even an individual board member must take action. What the suspecting board member must do will vary with the circumstances. Draft commentary in the ALI Nonprofit Principles recognizes that, “[i]n the absence of an express assignment of responsibility by the board (such as by committee membership), an individual board member has no obligation to monitor co-fiduciaries, officers, and employees, and does not have the

174. Id. at 604.
175. Id.
178. See Principles of the Law of Nonprofit Orgs. §§ 350, 360 (Tentative Draft No. 1, 2007). As described in the commentary,
If necessary to protect the interests of the charity, the governing board should remove for cause a board member (or officer or senior executive) who breaches his or her duties. Notably, while dissent is often healthy . . . a fiduciary’s behavior can be so hostile that it impedes the proper governance of a charity . . . . Of course, the charity must abide by any limitations specified by law or in the organizational documents, such as a provision that only an organization’s members may remove a director they elected, so resort to court might be necessary.

Moreover, the board must consider enforcement action when necessary to safeguard the rights of the organization, including, when appropriate, bringing suit for damages or injunctive relief against wayward fiduciaries. As might be expected, in most of these cases, the defendant fiduciaries are actually former board members, officers, or executives, but this is not necessarily the case. A board that vigorously enforces fiduciary duties, rather than covers up breaches, both demonstrates the charity’s worthiness of public support and enhances the reputation of the sector.

Id. § 350 cmt. a (citations omitted).
power (and often the resources) to conduct an investigation of suspected wrongdoing. Accordingly,

[t]he burden to take reasonable and appropriate action ordinarily obligates the board member merely to bring his or her concerns to the attention of the board or to the appropriate internal body or person charged with initial oversight for the particular wrongdoing . . . unless the process itself is corrupted. Ultimately, the board member will usually have done enough if the charity itself takes action.

However, for charities with very small boards or with boards lacking independence, resignation might not be enough. Consider the “sinking ship” scenario, when frustrated board members are tempted to quit rather than fight one or more domineering directors. The draft comment concludes that in appropriate cases, a board member must notify the attorney general or even seek court relief.

In rare cases, the law gives a private party standing to sue, but usually on the grounds of being a person with a special interest to enforce well-defined rights. Common law does not traditionally recognize the general right of third parties to sue to enforce fiduciary duties owed to the charity, other than, in appropriate cases, to enforce the terms of a restricted gift or charitable trust. Compare the broad proposal to give mandatory intervention rights to the founder of a European Foundation. Aside from the small percentage of charities that are private foundations, a similar proposal would have limited effect in the United States. Most U.S. publicly

179. Id. § 350 cmt. b(4).
180. Id.
181. Id. This draft ALI position derives from an influential decision of the New Jersey Supreme Court, which declared in a case involving a business corporation, “Directors may not shut their eyes to corporate misconduct and then claim that because they did not see the misconduct, they did not have a duty to look. The sentinel asleep at his post contributes nothing to the enterprise he is charged to protect.” Francis v. United Jersey Bank, 432 A.2d 814, 822 (N.J. 1981).
183. See Evelyn Brody, From the Dead Hand to the Living Dead: The Conundrum of Charitable-Donor Standing, 41 Ga. L. Rev. 1183 (2007). The Uniform Trust Code provides that the “settlor of a charitable trust, among others, may maintain a proceeding to enforce the trust.” Unif. Trust Code § 405(c), 7C U.L.A. 486 (2000). The Uniform Trust Code, as of February 20, 2007, has been adopted in nineteen jurisdictions. This statute does not apply to a corporate charity, except as it may hold gifts in trust.
184. Article 4.3 (Rights of the Founder) of the European Foundation proposal set forth in The European Foundation provides,

The Founder of a European Foundation and also any subsequent donor of a significant contribution have the right to intervene with the State supervisory authority if the Board of Directors and/or the Supervisory Board fail to comply with their responsibilities; the State supervisory authority must produce a substantive statement on this intervention within 60 days.

The European Foundation, supra note 1, at 121.

Commentary explains that subsequent donors “only have the right to intervene if they have reason to complain that the Board of Directors and/or the Supervisory Board are not complying with their responsibilities as regards that person’s gift.” Id. at 122.
supported charities are funded primarily by fees for services and government grants and contracts, rather than by contributions (much less by a contribution from a single or small number of donors).\textsuperscript{185}

Even if a suit involving breach of the duty of care should reach the merits, plaintiffs will find that they cannot easily successfully challenge board member conduct in court. Most important, the business judgment rule shields decisions made in good faith.\textsuperscript{186} Moreover, the board is obviously not expected to exercise oversight of each individual management action.\textsuperscript{187} True, recent Delaware jurisprudence emerging from

\begin{footnotesize}
\begin{enumerate}
\item \textsuperscript{185} See I.R.S. Data Release, Charities and Other Tax-Exempt Organizations, 2002, in Statistics of Income Bulletin, Fall 2005, at 263, 263, 264 fig.B.
\item \textsuperscript{187} In the Principles of Corporate Governance, the ALI acknowledged the difficulty of distinguishing between “a conscious decision or inexcusable inattentiveness.” Principles of Corp. Governance: Analysis and Recommendations § 4.01(c) cmt. c (1992). Bayless Manning complained, “[A]stonishingly, . . . given the realities of the way boards operate, the business judgment rule would not operate at all in respect of fully ninety percent of what directors are actually engaged in.” Bayless Manning, The Business Judgment Rule and the Director's Duty of Attention: Time for Reality, 39 Bus. Law. 1477, 1494 (1984). Manning takes “as axiomatic that a director should not be held liable for having failed in his duty of attention unless his conduct departs significantly from normal expectations of proper conduct.” Id. at 1480. To Manning, the central problem for a director is that “the universe of all actions not taken is always far greater than the roster of actions taken”; because agenda setting is the most important thing a board does, the distinction between commission and omission of specific acts is meaningless and unhelpful. Id. at 1485–86. Manning concluded, The courts will somehow find a way to alter the interpretation of the business judgment rule in such a way as to make it produce commonsense results in the case of reasonably diligent citizens who have been in good faith generally attentive to their duties as directors over a period of time. Id. at 1495. Indeed, as the Delaware Chancery Court subsequently ruled in In re Caremark International, a case involving potential board liability for failing to learn of criminal activity, Generally where a claim of directorial liability for corporate loss is predicated upon ignorance of liability creating activities within the corporation, . . . only a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exits [sic]—will establish the lack of good faith that is a necessary condition to liability. Such a test of liability—lack of good faith as evidenced by sustained or systematic failure of a director to exercise reasonable oversight—is quite high. But, a demanding test of liability in the oversight context is probably beneficial to corporate shareholders as a class, as it is in the board decision context, since it makes board service by qualified persons more likely, while continuing to act as a stimulus to good faith performance of duty by such directors. In re Caremark Int'l, 698 A.2d 959, 971 (Del. Ch. 1996). As modified to emphasize intentionality, the Delaware Supreme Court adopted the Caremark standard in 2006: We hold that Caremark articulates the necessary conditions predicate for director oversight liability: (a) the directors utterly failed to implement any reporting or information system or controls; or (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their
\end{enumerate}
\end{footnotesize}
suits against directors of publicly traded corporations has been expanding the concept of good faith, the absence of which renders unavailable a waiver or exculpation of traditional fiduciary duties. However, the burden still falls on the plaintiff to prove causation and damages from the director’s breach. The burden of proof falls on the defendant only for self-dealing when the transaction does not meet a procedural safe harbor, and then only as to the elements of whether the transaction was fair and in the charity’s best interest. 188

Finally, in those rare cases when the fiduciary is found to violate the duty of care, lenient enforcement or light punishment nearly always follows. Twenty-one state statutes (including Delaware’s) permit a nonprofit corporation to adopt a charter amendment shielding directors from liability for breaches of the duty of care 189 (and all well-advised nonprofit corporations would do so); courts can absolve charity fiduciaries of monetary liability even in the absence of a charter shield. Many legislatures have adopted other protections for volunteer nonprofit directors. 190

2. What Occurs in Practice

Michael Hone, the reporter of both the current California nonprofit corporation statute and the Revised Model Nonprofit Corporation Act, observed that the law allows volunteer (uncompensated) directors, “in some cases in fact, to almost be asleep at the gate”:

It is my impression, from talking with state Attorney Generals [sic], that it is almost impossible to win cases involving only inattentive management. Where the directors are pillars of the community or spending hours of their time, they are not good emotional defendants. Therefore, the [Revised Model Nonprofit Corporation] Act has adopted a duty of care which imposes liability only in particularly egregious cases. If one could show years of inattention, then there would be liability. But if one had just a single lapse, a terrible judgment, the business judgment rule would protect directors. . . . The trust standard would hold the directors personally liable for mere negligence. . . . It was the subcommittee’s attention. In either case, imposition of liability requires a showing that the directors knew that they were not discharging their fiduciary obligations. Where directors fail to act in the face of a known duty to act, thereby demonstrating a conscious disregard for their responsibilities, they breach their duty of loyalty by failing to discharge that fiduciary obligation in good faith.

188. See supra Part I.C.
189. See Fremont-Smith, supra note 121, app. at 514–17 tbl.3.
opinion that if that were the standard adopted by the Act, very few sensible people would serve on the boards of nonprofit organizations.\footnote{191}{Michael C. Hone, Aristotle and Lyndon Baines Johnson: Thirteen Ways of Looking at Blackbirds and Nonprofit Corporations: The American Bar Association's Revised Model Nonprofit Corporation Act, 39 Case W. Res. L. Rev. 751, 771 (1989).}


Despite this state of the law, financial protection remains a particular concern for many current and prospective board members. As a threshold matter, monetary protection is not generally available for intentional breaches of the duty of loyalty. For breaches of the duty of care, however, monetary protection is the norm—either under a charter provision or by court decision—in keeping with the policy articulated in the ALI’s Principles of Corporate Governance that the financial injury to the organization (and hence potentially to the fiduciaries) can be prohibitively disproportionate to the personal benefits (financial and otherwise) of board service.\footnote{193}{Of course, the likelihood of monetary sanctions is little greater on the for-profit side of the fence. See In re Walt Disney Co. Derivative Litig., 906 A.2d 27 (Del. 2006). Note that personal liability for the outside directors in the WorldCom and Enron cases resulted from settlements.}

As a result of the legal impediments to bringing suit and to imposing monetary liability on individual fiduciaries, nonprofit director and officer insurance policies are generally inexpensive.

At the same time, at least for charities, the absence of shareholders weakens the rationale for permitting an overly generous monetary liability shield. The 2006 draft revision of the Model Nonprofit Corporation Act excepts from a charter liability shield only “(i) the amount of a financial benefit received by a director or member of a designated body to which the person is not entitled; (ii) an intentional infliction of harm on the corporation or the members; (iii) a violation of section 8.33 [relating to distributions]; or (iv) an intentional violation of criminal law.”\footnote{194}{Proposed Model Nonprofit Corp. Act § 2.02(b)(8) (3d ed. Exposure Draft 2006), http://meetings.abanet.org/webupload/commupload/CL580000/sitesofinterest_files/MNCAe_xposedraft.doc.}

By slight contrast, the 2007 draft ALI Nonprofit Principles additionally take the position that “[p]ublic policy requires that those who govern charities should be vulnerable to monetary sanctions for [intentional] breaches of the duty of loyalty beyond self-dealing and deliberate infliction of harm and for failing to conduct themselves in good faith.”\footnote{195}{Principles of the Law of Nonprofit Orgs. § 370 cmt. b (Tentative Draft No. 1, 2007). Brackets reflect a clarification that will be made in the next draft.} Under the draft Nonprofit Principles, failure to act in good faith extends to intentional abdication of the duty of care, including conscious abdication of oversight...
With the focus on board members' personal monetary exposure, it can be easy to overlook the many available nonmonetary equitable remedies (such as injunctions or removal) to address fiduciary wrongdoing.\textsuperscript{197}

II. CONCLUSION: HOW CAN PRACTICE BE IMPROVED?

This essay’s recognition of six “puzzling gaps” between law and practice is not meant to suggest that the law should be modified to move closer to current practices. While good nonprofit governance is the goal, compulsory law is not the best route for improving behavior.

Commentators disagree about how to create an incentive and punishment structure that will improve governing board performance. Most broadly, advocates for increasing monetary penalties as the appropriate means of inducing fiduciaries to take their jobs seriously face equally fervent assertions that the risk of financial liability would drive away well-meaning volunteers. Given the absence of financial reward for most board members—and the difficulty of measuring fiduciary behavior—I fall into the latter camp. Nonprofits are more likely to be better run when the regulatory focus endeavors to ensure that fiduciaries are informed of their responsibilities, and when nonprofits are willing to pay for the staff and outside advisers they need to help protect against poor decision making and failures of internal control.

The ALI’s 1992 Principles of Corporate Governance express the policy that the potential damages for breach of duty of care—unlike for self-dealing—is far disproportionate to the financial benefits enjoyed by the wrongdoer. Similarly, the 2007 draft ALI Nonprofit Principles take the position that increasing the threat of monetary liability for breach of fiduciary duties is unlikely to affect fiduciary behavior in a positive way. Instead, the draft recommends making clear that while all board members are responsible for governance, monetary sanctions for poor board member behavior will be rare. Of course, the monetary shield would not apply in cases of intentional breach of the duty of loyalty, or breach of the duty of care not in good faith (including intentional abdication).\textsuperscript{198} Otherwise, the draft urges, appropriate nonmonetary sanctions should be liberally applied, with the dual aims of making board service more attractive and of alerting fiduciaries that charities are entitled to a meaningful level of governance.

While I support a greater level of activism by charity regulators and the courts in crafting nonfinancial remedies to wayward fiduciary behavior, I appreciate that the enforcement has to be appropriate to the role of the state

\textsuperscript{196} Id.
\textsuperscript{197} See infra Part II.
with respect to the nonprofit sector.\textsuperscript{199} Specifically, I hope that certain recent enforcement actions do not portend a trend toward public parochialism and paternalism.\textsuperscript{200} Appropriate enforcement could lead to increased settlements and injunctions mandating governing board and management training, and adoption of best practices policies and procedures; restructuring of board and removal of fiduciaries when necessary; and even the closing down of charities and the transferring of assets from charities that will not adopt and follow appropriate safeguards to those charities that will. After all, when a charity has substantial assets or responsibility for a program, society is ill served by allowing control to remain with those who refuse to exercise minimal care.


\textsuperscript{200} See Brody, \textit{supra} note 20.