

The Fiduciary Duties of Nonprofit Directors and Officers: Paradoxes, Problems, and Proposed Reforms

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I. INTRODUCTION: PARADOXES AND PROBLEMS

A. Paradoxes

Consideration of the fiduciary duties of directors and officers of nonprofit institutions¹ necessitates grappling with a series of problematic paradoxes. Nonprofit directors and officers generally operate under the same legal standards under state law in terms of managerial obligations and the duties of loyalty and care as their for-profit peers. However, in contrast to the for-profit world, the law plays little role, other than aspirational, in assuring accountability in the nonprofit sector. Moreover, the roles of directors of nonprofit institutions are more demanding and complex than those of their for-profit peers,² but almost all evidence suggests that nonprofit directors provide less oversight, less effective participation in decision-making, and in general, less effective governance than their peers in comparable for-profit corporations.³ Perhaps the central paradox of nonprofit corporate governance, particularly for friends and admirers of the nonprofit sector like me, is the fact that the nation's nonprofit institutions are the recipients of so much public and private largess—in terms of gifts, grants, tax benefits, volunteer efforts, and other subsidies—and yet are subjected to so few accountability constraints.

There would be no reason for concern about these paradoxes, particularly about the relative absence of accountability constraints, if one could assume that a personal sense of responsibility, pride, decency, peer pressures, and similar factors were making the nonprofit governance system work effectively. But there is much evidence, largely anecdotal, to the contrary. A recent piece in the Harvard Business Review began: "Effective governance by the board of a nonprofit organization is a rare and unnatural act."⁴ Similarly, Professor James J. Fishman concluded:

1. This Article generally focuses on the duties of directors and officers of secular nonprofit corporations classified as public charities and established under Section 501(c)(3) of the Internal Revenue Code. Although many of the governance points made in this article apply to religious corporations, private foundations, and other Section 501(c) nonprofit institutions, special factors such as First Amendment protections and private foundation legislation may alter the analysis in particular circumstances. See JAMES J. FISHMAN & STEPHEN SCHWARZ, CASES AND MATERIALS ON NONPROFIT ORGANIZATIONS 58-69 (1995) [HEREINAFTER FISHMAN & SCHWARZ].

2. William G. Bowen, for example, recently observed:

In my view, it is especially hard to be an effective director of a nonprofit organization. The very mission of the enterprise can be difficult to define with precision and subject to intense debate. It is often seen differently by various influential participants and supporters. Relevant data and analyses are frequently either unavailable or, if available, tricky to interpret. Performance often defies easy assessment and lack-luster leadership can go unnoticed, or at least uncorrected, for considerable periods of time. Resources are almost always scarce, and problems often appear intractable. Creative solutions can be elusive and, if identified, hard to put into effect—in part because of the lack of ready access to the kind of "buy-sell" mechanisms provided by markets.

William G. Bowen, *Inside the Boardroom: A Reprise*, in NONPROFIT GOVERNANCE 9 (VICTOR FUTTER & GEORGE W. OVERTON eds., 1997); see also discussion *infra* Part II.A and B.

3. See discussion *infra* notes 4-7 and accompanying text.

4. Barbara E. Taylor, et al., *The New Work of the Nonprofit Board*, HARV. BUS. REV., Sept.-Oct. 1996 at 36. Daniel L. Kurtz, a former head of the New York Attorney General's Charities Bureau, reported: "Probing questions by charity board members have been viewed as simply bad manners." FISHMAN & SCHWARZ, *supra* note 1, at 186.

Because nonprofits tend to have many directors who are on the board for "window dressing" only, a common phenomenon of nonprofit boards is directors who do not direct. The "figurehead" directors assume non-involved roles on the board, rarely attending meetings, and certainly never involving themselves in oversight responsibilities. They are corrosive to nonprofit corporations in that they allow employees or fellow directors to dominate the organization.⁵

Although serious empirical evidence is not available, it seems entirely likely that ineffective nonprofit corporate governance has had a significant negative impact on the capacity of nonprofit corporations to carry out their missions.⁶

Of even greater concern are recent well-publicized scandals in the duty of loyalty area.⁷ Improper self-dealing and other duty of loyalty violations threaten to undermine the trust and goodwill necessary for the nonprofit sector to function successfully. The following review of three recent serious governance failures, by different types of nonprofit corporations, illustrates the cost to the nonprofit community of the absence of accountability constraints.

B. Problems: United Way, Adelphi, and Nonprofit Conversion Transactions Illustrate Reasons for Concern

In December 1991, officers of the United Way of America (UWA) learned that two reporters from *The Washington Post* were investigating allegations that then-UWA President William Aramony was misusing funds and resources to enhance his personal lifestyle.⁸ According to the Executive Summary of a report later prepared for the Board of Governors of UWA: "[I]t was alleged that Mr. Aramony used UWA funds, both directly and through the use of organizations which had been spun off from UWA operations, to rent limousines, to take transatlantic flights on the Concorde, and to reward friends and family members with jobs, board memberships, and consulting contracts."⁹ Aramony, who had been chief staff officer¹⁰ or president of UWA from 1970 until his resignation

5. James J. Fishman, *Standards of Conduct for Directors of Nonprofit Corporations*, 7 PACE L. REV. 389, 397 (1987). See, e.g., *Stern v. Lucy Webb Hayes Nat'l Training Sch. for Deaconesses and Missionaries*, 367 F. Supp. 536 (D.D.C. 1973) (finding "total abdication" and failure to provide even the most cursory supervision by defendant directors).

6. See *infra* Part II.B; cf. Ira M. Millstein & Paul W. MacAvoy, *The Active Board of Directors and Improved Performance of the Large Publicly-Traded Corporation*, Yale School of Management (Working Paper 49 1997) (concluding that for-profit corporations "with active and independent boards appear to have performed much better in the 1990s than those with passive boards").

7. See, e.g., FISHMAN & SCHWARZ (Supp. 1997), *supra* note 1, at 9-17 (dealing with the *Adelphi* case discussed *infra* Part I.B.); Deborah A. DeMott, *Self-Dealing Transactions in Nonprofit Corporations*, 59 BROOK. L. REV. 131, 133 (1993) (discussing incidents of self-dealing by directors of United Way and the San Diego National Sports Training Foundation); *Developments in the Law—Nonprofit Corporations*, 105 HARV. L. REV. 1578, 1591 n.5 (1992).

8. *The Report to the Board of Governors of United Way of America, excerpted in THE PHILANTHROPY MONTHLY* (Dec. 1991 and Jan.-Feb. 1992) [hereinafter *The Report*] (submitted by the law firm of Verner, Lipfert, Bernhard, McPherson and Hand on April 2, 1992).

9. Executive Summary of *The Report*, *supra* note 8, at 1.

10. *The Report*, *supra* note 8, at 10.

in February 1992, was ultimately indicted, convicted,¹¹ and most of his conviction was affirmed on appeal.¹²

His conduct was reprehensible, but the most significant question from both a corporate governance perspective and a public policy perspective, is: Where was the Board? During Aramony's tenure, UWA's Board had more than 30 members. Although the Board had representatives from labor and the nonprofit sector, it was comprised "almost exclusively of individuals holding (or having held) prestigious positions at some of America's largest corporations."¹³

The Report indicates the following about the passivity of UWA's Board: (i) the Board met semi-annually and an Executive Committee of the Board also met twice each year,¹⁴ both receiving little material information; (ii) although the Board received inadequate information and facially flawed rationales with respect to the creation of spin-off corporations, the Board or the Executive Committee always granted Aramony's requests for separately incorporating UWA functions;¹⁵ (iii) after the spin-offs were incorporated, despite apparent interlocking relationships, the UWA Board lost control and supervision over the spin-offs.¹⁶ Consequently, the spin-offs provided compensation perquisites to some individuals and engaged in questionable business transactions which might not have been authorized if the UWA Board had scrutinized them;¹⁷ (iv) annual audits failed to disclose numerous abuses of the UWA accounting system, including: avoiding control procedures, using restricted funds for purposes other than those stipulated, paying questionable fees, and financing transactions with the spin-off corporations;¹⁸ and (v) the Board had no compensation committee, it received at best only vague briefings on proposals concerning benefit policies,¹⁹ and it played almost no role in evaluating officers or setting their salaries.²⁰

It is hardly conceivable that in the early 1990's the senior corporate executives who comprised the bulk of the UWA Board would have permitted their for-profit boards to operate in this fashion.²¹ Moreover, the failure to effectively oversee the operation of

11. See Karen W. Arenson, *Former United Way Chief Guilty in Theft of More Than \$600,000*, N.Y. TIMES, Apr. 4, 1995, at A1.

12. See *United States v. Aramony*, 88 F.3d 1369 (4th Cir. 1996) (holding that evidence of a defendant's sexual misconduct was admissible to show his motive in defrauding the nonprofit organization).

13. *The Report*, *supra* note 8, at 50.

14. *Id.*

15. *Id.* at 12.

16. *Id.* at 13.

17. *Id.*

18. *The Report*, *supra* note 8, at 40. This apparently occurred partly because the Board did not know that Aramony had sharply limited the scope of UWA's audits.

19. *Id.* at 44.

20. *Id.* at 41. ("Officer salaries would be unilaterally set by Mr. Aramony after the Board approved a total amount of officers' salaries.")

21. See, e.g., Millstein & MacAvoy, *supra* note 6, at 1-13 (discussing the modern, active for-profit board); Harvey J. Goldschmid, *Harmonization of Corporate Law in Federal Systems: A United States Perspective*, in HARMONIZATION OF LEGISLATION IN FEDERAL SYSTEMS 161 (Ingolf Pernice, ed., 1996); E. Norman Veasey, *The Director and the Dynamic Corporation Law With Special Emphasis on Oversight and Disclosure*, Keynote Address at the 17th Annual Ray Garrett Jr. Corporate and Securities Law Institute (Apr. 24, 1997) (transcript on file with the author). Chief Justice Veasey of Delaware concluded: "The law of fiduciary duty is not static. It is dynamic. Courts may take into account modern trends and adjust jurisprudence accord-

UWA cannot be rationalized on the basis of the corporation's economic insignificance. In the early 1990s, UWA was a national membership organization with approximately 1,400 United Way local members, had a budget of roughly \$30 million, and in 1990, raised \$3.11 billion in charitable funds under the United Way system which funded 44,000 agencies nationwide.²² On December 28, 1995, the Attorney General of the State of New York signed a settlement with UWA that did not sanction any individuals, but mandated various corporate governance reforms.²³

Adelphi University's president, Peter Diamandopoulos, shared common ground with UWA's Aramony in being a dominant full-time executive. He was appointed in 1985. In subsequent years, according to Professors Fishman and Schwarz:

Diamandopoulos lost the support of all campus constituencies except the trustees, most of whom he appointed. A decisive moment in Diamandopoulos's administration came in the fall of 1995, when a report in the Chronicle of Higher Education revealed that he was the nation's second highest paid college president. A Committee to Save Adelphi was formed and brought allegations to the New York Board of Regents, accusing the governing board and president of misappropriation of funds, conflicts of interest, and lavish expenditures by the president.²⁴

Both Aramony and Diamandopoulos were executive types well known in the for-profit sector. Dean Courtney Brown, of Columbia's Graduate School of Business, who spent over two decades serving on some of the nation's most important for-profit boards, concluded: "[A] single major blunder of judgement can damage an enterprise seriously. It would be interesting to know the extent to which write-offs ranging from \$100 million to \$500 million that have been recorded in recent years ... stemmed from the dominant influence of one decision maker."²⁵ Victor H. Palmieri, who had a flourishing career turning floundering for-profit corporations around (beginning with Penn Central), described a "failed-company syndrome" as involving a "corporate despot," who "brooks no argument either by his forceful personality or by just being an S.O.B., or some combination of those...."²⁶ Palmieri stressed the need for independent oversight of full-time managers.²⁷

ingly—whether it be: ... [e]xpecting modern compliance programs, [e]xpecting an active—not passive board, [r]especting independence and hard work of nonmanagement directors...." *Id.*

22. See *The Report*, *supra* note 8, at 7.

23. Assurance of Discontinuance Pursuant to Executive Law Section 63(15), In the Matter of the Investigation by Dennis C. Vacco, Attorney General of the State of New York, of United Way of America, Inc. (December 28, 1995) [hereinafter UWA Settlement] (on file with the author). Most of the stipulated reforms, e.g., additional board meetings, oversight committees, and information dissemination, covering about 14 pages, had already been put in place by UWA's new management and Board.

24. FISHMAN & SCHWARZ (Supp. 1997), *supra* note 1, at 9; see also William H. Honan, *Campus in Turmoil: A Special Report; Adelphi, a Little University with Big Ideas*, N.Y. TIMES, Feb. 5, 1997, at B1 (providing history and overview of circumstances that culminated in the Adelphi case).

25. D. COURTNEY BROWN, PUTTING THE CORPORATE BOARD TO WORK 16 (1976).

26. Victor H. Palmieri, *Shooting Stars and Corporate Flameouts*, Address at the Annual Meeting of the American College of Investment Counsel (Sept. 1983).

27. *Id.*

By the 1990s, a combination of factors made for-profit corporate boards more active, and mitigated the dangers presented by the corporate despot.²⁸ In a recent piece, in an analogous area (dealing with permissive state laws that too often permitted for-profit despots to flourish), I pointed to and analyzed the following "mitigating circumstances":

1. The federal securities laws have filled some of the gap created by permissive state laws

2. Effective global competition has also helped fill some of the gap

3. New decisions by Delaware courts have alleviated some of the problem

4. Among the other factors ... that have mitigated potential harm caused by permissive state law during recent years are the following: (i) greater interest in corporate governance and increased activity by institutional investors; (ii) corporate governance rules promulgated (often with SEC prodding) by important quasi-private institutions like the New York Stock Exchange (*e.g.*, requiring independent audit committees for listed corporations); (iii) peer pressures among outside directors—often stimulated by more acute financial press coverage in recent years—leading to more effective governance and more experimentation with governance innovations (*e.g.*, separate meetings of outside directors); and (iv) hostile takeover attempts (which have been a mixed blessing).²⁹

It should be carefully noted that few of these for-profit mitigating circumstances would apply to a corporate despot now operating in the nonprofit sector.

In terms of patterns, what distinguishes the *Adelphi* and UWA situations, in addition to the absence of criminality in the former, is that the outside directors of UWA may have neglected their duties, but they acted in good faith and without disabling conflicts of interest. In the *Adelphi* case, the New York Board of Regents³⁰ found several instances of improper self-dealing by outside directors. In February 1997, the Regents removed eighteen of the nineteen trustees for failure to carry out their duties of care and loyalty.³¹

My final category of serious governance failure was considered at a 1996 conference sponsored by the National Center on Philanthropy and the Law. The conference dealt with the legal and public policy issues raised by health care conversions, such as acquisitions of nonprofit corporations by for-profit corporations.³² My contribution to that conference focused on the absence of accountability constraints—which resulted in scandalously inadequate prices and other loyalty abuses—and commented as follows:

Nonprofit conversions suffer when compared to for-profit acquisitions because of the nature of nonprofit directorships, the nonexistence or inadequacy of disclosure requirements, the limits on standing to sue and other legal safe-

28. See discussion *supra* note 21 and accompanying text.

29. Goldschmid, *supra* note 21, 166-68.

30. The Board of Regents is an independent body, appointed by New York's legislature, which has the "power to remove [educational] trustees for neglect of duty, an action which has been exercised only four times in 80 years." FISHMAN & SCHWARZ (Supp. 1997), *supra* note 1, at 9.

31. *Id.* at 9-17.

32. See THE NATIONAL CENTER ON PHILANTHROPY AND THE LAW, CONVERSION TRANSACTIONS: CHANGING BETWEEN NONPROFIT AND FOR-PROFIT FORM (1996) [hereinafter CONVERSION TRANSACTIONS].

guards, and the general difficulty of valuation in the nonprofit conversion context. In making acquisitions, for-profit corporations like Columbia/HCA Healthcare Corp. have been negotiating with nonprofit directors who: (i) may have little or no acquisition experience and, unlike many for-profit directors, were selected for reasons wholly unrelated to their ability to obtain fair value from a purchaser; (ii) usually have limited time to devote to their institutions and are unpaid; (iii) sometimes have serious conflicts of interest; and (iv) usually are hesitant to spend nonprofit dollars on investment bankers, accountants, lawyers, and others associated with for-profit acquisitions. Even more important, in an acquisition of any size in the for-profit sector, extensive disclosure to the SEC, and, in effect, to the public is required. Except for a relatively few instances (e.g., special legislation in California and effective use of leverage of the type described by Messrs. Boisture and Varley), no disclosure is required in the acquisition of a nonprofit corporation. Even where disclosure is mandated, it appears to involve the production of documents to understaffed state charity regulators, and not the detailed disclosures in accordance with carefully conceived disclosure schedules—subject to a spectrum of effective remedies—required under our federal securities laws.

Moreover, no protection analogous to the shareholder vote of approval, required in a for-profit acquisition, is available in the nonprofit context. In general, the absence of private rights of action and of class and derivative actions (when compared to the for-profit sector) seriously undermine the effectiveness of fiduciary doctrines.³³

Today, given the well-publicized travails of Columbia/HCA and new legislation in several states,³⁴ nonprofit hospitals are less vulnerable to unfair conversion offers. However, basic governance problems remain in the conversion transaction area for hospitals, other health care institutions, and nonprofit corporations in general.

The fundamental question posed by these three illustrations, as well as the many others that could be cited involving similar patterns,³⁵ is: What legal reforms, if any, would make the situation better? The “if any” qualification is stated seriously. Harsh new fiduciary requirements, or uncontrolled exposure to litigation, for nonprofit directors and officers would almost certainly have counterproductive effects. As is true of for-profit directors and officers, professionals, and almost all others in our society, the accountability of nonprofit directors and officers and the effective functioning of their institutions are legitimate public policy concerns. But there must be concomitant concern about the need to encourage individuals with vision, ability, resources, and expertise to serve the nonprofit sector. Fairness to those who are willing to serve as nonprofit directors and officers is clearly an essential value.

33. Harvey J. Goldschmid, *Nonprofit Conversion Transactions: Existing Fiduciary Duties and Necessary Reforms*, in *CONVERSION TRANSACTIONS*, *supra* note 32, at C1-3.

34. See James F. Owens, *States Regulate Non-Profit Hospital Conversions*, NAT'L. L.J., Sept. 8, 1997, at B10.

35. See, e.g., discussion *supra* note 7; David G. Samuels, *Obligations of Fiduciaries of Charitable Foundations*, N.Y.L.J., Feb. 5, 1997, at 1; Roy M. Adams, et al., *A Nonprofit Director's Roadmap for Survival*, TRUST & ESTATES, Mar. 1996, at 42.

For the most part, the governance standards of nonprofit corporations are controlled by state law.³⁶ Professor DeMott recently described nonprofit corporations as "corporate 'Cinderellas,' as the 'neglected stepchildren of modern organization laws,' relegated to the hand-me-downs of their half-siblings, for-profit business organizations."³⁷ However, the for-profit "hand-me-downs" fit and look pretty well in the nonprofit context. Cinderella only needs a few significant doctrinal modifications in the sensitive transaction (e.g., conversion transactions) and loyalty areas, in addition to cautious experimentation with less restrictive standing rules, to be sparkling, properly dressed, and ready for the ball. Section III discusses these reforms, as well as the need for enhanced educational efforts, governmental monitoring, and enforcement capacities.

II. CURRENT MANAGERIAL, CARE, AND LOYALTY STANDARDS

Although there are dissenters for one reason or another,³⁸ Professor DeMott correctly recognizes that, in general, as a recent *Guidebook for Directors of NonProfit Corporations* explains: "The Duties of Care and Loyalty are the common terms to describe the standards which guide all actions a director [or officer] takes. These standards are derived from a century of litigation principally involving business corporations and are equally applicable to nonprofit corporations."³⁹

In discussing managerial standards and the duties of care and loyalty in the for-profit context, this Article cites heavily and relies on the American Law Institute's *Principles of Corporate Governance* (ALI Principles), which were adopted in 1992.⁴⁰ As they are cited and quoted herein, except where expressly indicated otherwise, the ALI Principles are consistent with the law in almost all jurisdictions, and would almost certainly be as applicable to directors and officers of nonprofit corporations as they are to directors and officers of for-profit corporations.⁴¹

36. See *infra* note 101 for a discussion regarding the role of federal law in nonprofit corporate governance, as reflected in Internal Revenue Code provisions.

37. DEBORAH A. DEMOTT, SHAREHOLDER DERIVATIVE ACTIONS §2:04, at 22 (1994).

38. Some have argued that directors and officers of nonprofit corporations do or should have higher fiduciary responsibilities, usually in the loyalty area, than their for-profit peers. See, e.g., DeMott, *supra* note 7, at 137-38; Henry B. Hansmann, *Reforming Nonprofit Corporation Law*, 129 U. PA. L. REV. 497, 567-72 (1981) ("An attractive alternative to the currently prevailing doctrine would be a flat prohibition against all self-dealing transactions."). Other commentators have argued for lower standards, usually in the care area, for nonprofit fiduciaries. See, e.g., David W. Barrett, *A Call for More Lenient Director Liability Standards for Small, Charitable Nonprofit Corporations*, 71 IND. L.J. 967 (1996) (arguing that because nonprofit board members are uncompensated volunteers, they should not be subject to the same standards that apply to directors of for-profit corporations).

39. AMERICAN BAR ASSOCIATION, SECTION OF BUSINESS LAW, *GUIDEBOOK FOR DIRECTORS OF NONPROFIT CORPORATIONS* 21 (George W. Overton ed., 1993) [hereinafter *NONPROFIT GUIDEBOOK*].

40. See generally 1-2 AMERICAN LAW INSTITUTE, *PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS* (1994) [hereinafter *ALI PRINCIPLES*].

41. I was the Reporter for Part IV of the ALI Principles dealing with "Duty of Care and the Business Judgment Rule." In general, the quotations from the ALI Principles will not indicate the deletion of bracketed material citing to definitions.

A. *Current Managerial Standards: A Potential Trap for the Unwary*

New York's Not-for-Profit Corporation Law (N-PCL) majestically commands that "a corporation shall be managed by its board of directors."⁴² Section 8.01 of the Revised Model Nonprofit Corporation Act states that "all corporate powers shall be exercised by or under the authority of, and the affairs of the corporation managed under the direction of, its board."⁴³ Both of these formulations parrot traditional language in the statutes governing for-profit corporations. What is unclear, however, is what nonprofit boards are actually supposed to do.

The generality of the statutory provisions may create false comfort (i.e., traps for the unwary) in many nonprofit directors who assume that a little governance activity and a lot of fund-raising will suffice. The generality also may raise unrealistic expectations in state charity regulators or judges, who may take the word "managed" literally. The ALI Principles analyzed these same statutory commands in a for-profit context and concluded with respect to officers:

The management of the business of a publicly held corporation should be conducted by or under the supervision of such principal senior executives as are designated by the board of directors, and by those other officers and employees to whom the management function is delegated by the board or those executives....⁴⁴

Section 3.02 of the ALI Principles then narrows the literal command of the statutory provisions for directors and specifically provides:

The board of directors of a publicly held corporation should perform the following functions:

- (1) Select, regularly evaluate, fix the compensation of, and, where appropriate, replace the principal senior executives;
- (2) Oversee the conduct of the corporation's business to evaluate whether the business is being properly managed;
- (3) Review and, where appropriate, approve the corporation's financial objectives and major corporate plans and actions;
- (4) Review and, where appropriate, approve major changes in, and determinations of other major questions of choice respecting, the appropriate auditing and accounting principles and practices to be used in the preparation of the corporation's financial statements;
- (5) Perform such other functions as are prescribed by law, or assigned to the board under a standard of the corporation.⁴⁵

How many boards of large nonprofit corporations function today in a way that would meet these standards? The ALI's formulation should be marginally modified in

42. N.Y. NOT-FOR-PROFIT CORP. LAW § 701 (McKinney 1997).

43. REV. MODEL NONPROFIT CORP. ACT § 8.01 (1987).

44. 1 ALI PRINCIPLES, *supra* note 40, §3.01 at 82; *see also* NONPROFIT GUIDEBOOK, *supra* note 39, at 24 ("Even under statutes providing that the business and affairs of a corporation shall be 'managed' by the board of directors, it is recognized that actual operation is a function of 'management,' that is, the officers and agents of the corporation.").

45. 1 ALI PRINCIPLES, *supra* note 40, at 86.

the nonprofit context, for example, to take specific account of a nonprofit's mission, but in general, the ALI's approach preserves flexibility. More importantly, it encourages accountability and activity, far more activity than is generally seen in nonprofit boardrooms. A board could take on other tasks, but the stipulations in section 3.02, as modified for nonprofit corporations, is all that would be legally required. Similar formulations were recently proposed for nonprofit boards by William G. Bowen and for for-profit boards by The Business Roundtable and National Association of Corporate Directors.⁴⁶

It is generally recognized that a failure to carry out the functions specified in section 3.02 of the ALI Principles (and similar formulations for nonprofits) would make directors—of nonprofit or for-profit corporations—vulnerable under duty of care standards.⁴⁷ What appears to be a general lack of information regarding a board's obligations in the nonprofit community strongly suggests the need for enhanced educational efforts.⁴⁸

As important as are increased governance activity and accountability by nonprofit boards, one can't help but worry about the "trap for the unwary" aspects of the current situation. Only our highly restrictive standing rules, which need modification,⁴⁹ and the forbearance and egregious understaffing of our state charity regulators stand between nonprofit directors of large institutions and an unfortunate morass of expensive and embarrassing litigation.⁵⁰

46. See WILLIAM G. BOWEN, *INSIDE THE BOARDROOM: GOVERNANCE BY DIRECTORS AND TRUSTEES* 18-20 (1994); THE BUSINESS ROUNDTABLE, *STATEMENT ON CORPORATE GOVERNANCE* (Sept. 1997); NATIONAL ASS'N OF CORPORATE DIRECTORS, *BLUE RIBBON COMM'N REPORT ON DIRECTOR PROFESSIONALISM* (1996).

47. See 1 ALI PRINCIPLES, *supra* note 40, at 134-98.

48. See *infra* Part III.A.

49. But see generally Rob Atkinson, *Unsettled Standing: Who (Else) Should Enforce the Duties of Charitable Fiduciaries?*, 23 J. CORP. L. 655 (1998) (this issue).

50. The UWA settlement with New York's Attorney General included the following provisions:

The duties of the Board to manage and oversee the affairs of UWA shall include:

- a. establishing and overseeing the implementation of the organization's major policies and procedures;
- b. overseeing the management of UWA's finances, including reviewing and approving yearly budgets, periodically reviewing financial projections, and establishing and implementing fiscal controls sufficient to assure that UWA's resources are expended only for its corporate purposes;
- c. defining, modifying or clarifying UWA's mission, after any necessary consultation with UWA's members;
- d. taking all steps necessary to ensure that UWA is being managed consistent with its mission and that its assets are being expended prudently and only for its corporate purposes;
- e. setting compensation for, defining duties of, and monitoring and evaluating the performance of the chief executive officer and senior executive staff;
- f. having UWA's Audit Committee receive and review reports on the activities of legal counsel and outside accountants;
- g. establishing procedures to ensure that each director conscientiously performs his or her duties;
- h. monitoring of Board directives to staff, committees, paid professionals and/or officers to ensure implementation;
- i. holding UWA's General Counsel and other staff accountable for ensuring corporate compliance with federal and state laws and UWA's corporate by-laws.

UWA Settlement, *supra* note 23, at 6-7.

B. Duty of Care and the Business Judgment Rule

Consistent with the law in most states, Section 717 of New York's N-PCL states: "Directors and officers shall discharge the duties of their respective positions in good faith and with that degree of diligence, care and skill which ordinarily prudent men would exercise under similar circumstances in like positions."⁵¹ Section 8.30 of the Revised Model Nonprofit Corporation Act contains a similar formulation that appears to provide the same substantive content.⁵² Again, these formulations parrot for-profit statutes.⁵³

Daniel L. Kurtz has accurately described the distinction between the duty of care and the duty of loyalty in the following terms:

The duty of care concerns the director's competence in performing directorial functions and typically requires him to use the care that an ordinarily prudent person would exercise in a like position and under similar circumstances. The duty of loyalty requires the director's faithful pursuit of the interests of the organization he serves rather than the financial or other interests of the director or of another person or organization. And the duty of obedience requires that a director act with fidelity, within the bounds of the law generally, to the organization's "mission," as expressed in its charter and by-laws.⁵⁴

Although Kurtz's distinction between a duty of obedience and a duty of care is analytically justifiable, the analytical approach of this Article, consistent with for-profit caselaw, is to treat obedience to the bounds of the law and to the organization's mission as special functions of directors and officers to which general duty of care standards apply.⁵⁵

The obligation of nonprofit directors and officers with respect to the corporation's mission creates a more difficult and complex decision-making process for them than for their for-profit peers. For-profit directors and officers are principally concerned about long-term profit maximization.⁵⁶ While nonprofit directors and officers keep economic matters in mind, they are principally concerned about the effective performance of the nonprofits's mission. It would be entirely in accordance with their duty of care and business judgment responsibilities, for example, for the directors of a nonprofit hospital to accept a low bid from one of several suitors because the chosen bidder would provide a far higher level of public benefit or service to the community. In most instances, a for-profit board would not have—and should not have—such freedom.

Duty of care standards in the for-profit sector have received extensive judicial and commentator attention during the past two decades, and these sources should provide substantial guidance to the nonprofit community.⁵⁷ Briefly summarized, the ordinarily

51. N.Y. NOT-FOR-PROFIT CORP. LAW § 717 (McKinney 1997).

52. REV. MODEL NONPROFIT CORP. ACT § 8.30 (1988) (noting that the Act provides the same standard of conduct for directors as does New York law).

53. See 1 ALI PRINCIPLES, *supra* note 40, at 144-61.

54. DANIEL L. KURTZ, BOARD LIABILITY: GUIDE FOR NONPROFIT DIRECTORS 21 (1988).

55. See 1 ALI PRINCIPLES, *supra* note 40, at 134-88 (using the approach advocated in this text).

56. See *id.* § 2.01 at 55-70.

57. See, e.g., *Hanson Trust PLC v. ML SCM Acquisition, Inc.*, 781 F.2d 264, 274-75 (2d Cir. 1986) (stating it is settled law that directors must be "reasonably diligent" in obtaining information necessary to

prudent person language in statutory provisions and common-law cases is intended to convey the image of a generalist who has the capacity to perform the functions discussed in Part II.A. In general, to perform the functions of a director or officer no special expertise in any field is required. "There are instances, however, when special skills or expertise may be a prerequisite for appointment to a particular corporate office (e.g., controller or general counsel). In those instances, the officer undertaking the position will be held to the duty of care of an ordinarily prudent person in such a position."⁵⁸

The terms "similar circumstances" and "like position" provide flexibility by permitting factors like the nature of the nonprofit, its size and complexity, the magnitude of any problems, and the individual role of a director or officer to be taken into account in judging whether the director or officer has acted with reasonable care.⁵⁹ It is now well settled that duty of care standards require "reasonable inquiry" in appropriate circumstances.⁶⁰

For the guidance of the nonprofit community, three basic duty of care issues must now be addressed. The first deals with the sense that current duty of care standards, in the words of Professors Fishman and Schwarz, are "quite low."⁶¹ The second relates to the "affirmative obligation of directors to be reasonably concerned with the existence and effectiveness of procedures, programs, and other techniques ... to assist the board in overseeing the corporation's business."⁶² The third addresses the role of the business judgment rule.

1. The Myth of "Quite Low" Standards

The reasonable care articulations of duty of care standards are certainly not quite low in literal terms. Moreover, during the past two decades in the for-profit sector, state courts have been applying duty of care standards in a demanding way. The Supreme Court of New Jersey, for example, imposed a standard of ordinary care on directors and indicated that "dummy, figurehead and accommodation directors are anachronisms with no place in New Jersey law."⁶³ It required that directors "exercise reasonable supervision and control over the policies and practices of a corporation. The institutional integrity of a corporation depends upon the proper discharge by directors of those duties."⁶⁴ Inconsistent with most states, Delaware uses a gross negligence standard, rather than a reasonable care formulation,⁶⁵ though its Supreme Court has applied the reasonable care

make a decision); *Francis v. United Jersey Bank*, 432 A.2d 814 (N.J. 1981) (stating that corporate directors are required to keep informed about activities of the corporation); 1 ALI PRINCIPLES, *supra* note 40, at 134-88 (extensively discussing, with citations to relevant authorities, a director's duty of care to the corporation).

58. 1 ALI PRINCIPLES, *supra* note 40, at 148.

59. *Id.* at 151-52.

60. *See, e.g., id.* at 161-64; REV. MODEL NONPROFIT CORP. ACT: OFFICIAL TEXT WITH OFFICIAL COMMENTS 214 (1988) ("In appropriate circumstances the duty of care requires reasonable inquiry.").

61. FISHMAN & SCHWARZ, *supra* note 1, at 186.

62. 1 ALI PRINCIPLES, *supra* note 40, at 165.

63. *Francis v. United Jersey Bank*, 432 A.2d 814, 824 (N.J. 1981).

64. *Id.*

65. *See* 1 ALI PRINCIPLES, *supra* note 40, at 153-58.

standard with considerable rigor during the past decade.⁶⁶ Chief Justice Veasey recently described active independent directors as necessary "to make the system work."⁶⁷

In both the for-profit and nonprofit sectors, duty of care standards should not be applied harshly or unrealistically. The application of these standards should involve subtle, fair-minded evaluations of specific facts and circumstances. "Directors and officers obviously should not be required to insure that every potential corporate problem is anticipated or that every instance of wrongdoing (e.g., looting by an employee) is prevented."⁶⁸ It is critical to note that the absence of enforcement (because of forbearance by state charity regulators, understaffing, and highly restricted standing), not the "lowness" of care standards, makes care standards largely aspirational in the nonprofit context. Indeed, if enforcement opportunities are enhanced, nonprofit law may have to build in some of the mitigating provisions found in the for-profit sector.⁶⁹

2. Programs, Procedures, and Other Techniques to Assist the Board

The complexity and scale of many modern nonprofit corporations compel directors and officers to rely heavily on other directors and officers, employees, professionals, and other persons. Such reasonable reliance is entirely appropriate.⁷⁰ But given this complexity and scale, increasing emphasis is being placed on the board's "affirmative obligation" to be "reasonably concerned with the existence and effectiveness of procedures, programs, and techniques ... to assist the board in overseeing the corporation's business."⁷¹ Chancellor Allen of Delaware recently indicated that a director's duty of care obligations includes "a duty to attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists."⁷² Chief Justice Veasey of Delaware recently opined that "the oversight responsibility is a dynamic one" and that today information and compliance programs are expected.⁷³

The message for nonprofit directors and officers is obvious. Although information and compliance programs must be tailored to the needs of individual institutions, a reasonable concern about those needs is now legally required.

3. The Role of the Business Judgment Rule

The business judgment rule is a judicial gloss on duty of care standards that sharply reduces exposure to liability for erroneous judgments. Although formulations of the

66. See, e.g., *Cede v. Technicolor, Inc.*, 634 A.2d 345 (Del. 1993) (stating that the board must not be grossly negligent in failing to exercise due care); *Smith v. Van Gorkum*, 488 A.2d 858 (Del. 1985) (holding that director liability under the business judgment rule is predicated upon concepts of gross negligence).

67. E. Norman Veasey, *The Defining Tension in Corporate Governance in America*, 52 BUS. LAW. 393 (1997); see also Veasey, *supra* note 21, at 17.

68. 1 ALI PRINCIPLES, *supra* note 40, at 134.

69. See, e.g., 2 ALI PRINCIPLES, *supra* note 40, § 7.19 at 239-60 (permitting shareholders to limit the monetary liability of directors and officers, except in specific extreme circumstances).

70. See 1 ALI PRINCIPLES, *supra* note 40, §§ 4.02-.03 at 188-204.

71. *Id.* at 165.

72. *In Re Caremark International Inc. Derivative Litigation*, 698 A.2d 959, 970 (Del. Ch. 1996) (indicating that a failure to oversee the implementation of an effective corporate information and reporting system could render a director liable for losses caused by non-compliance with applicable standards).

73. Veasey, *supra* note 21, at 11, 17.

business judgment rule vary, basically the rule requires that decisions be made: (i) in good faith and without a conflict of interest; (ii) on a reasonably informed basis; and (iii) with a rational belief (connoting broad discretion and wide latitude) that the business judgment is in the best interests of the corporation.⁷⁴

The rationale for the business judgment rule is that it encourages rational risk taking and innovation, limits litigation and unfair exposure, encourages service by quality directors, and limits judicial intrusiveness.⁷⁵ This applies as much to nonprofit directors and officers as to their for-profit peers. There is wisdom in protecting nonprofit directors from hindsight reviews of their unsuccessful decisions and encouraging them to change the configuration of their nonprofit enterprises (e.g., expand a nonprofit museum, produce a new educational or health care product, and accept or reject a conversion proposal). It is sound public policy to accept the risk that *informed* decisions by nonprofit directors, undertaken *honestly*, without conflict of interest, and *rationaly believed* to be in the best interests of the nonprofit, may not be vindicated by subsequent success.

Although there is relatively little caselaw, a number of courts have applied the business judgment rule to the decisions of nonprofit directors.⁷⁶ The Appellate Division of New York in *Scheuer Family Foundation Inc. v. 61 Associates* assumed the applicability of the business judgment rule, but found it unnecessary to resolve the issue because conflicts of interest were involved.⁷⁷ The Official Comment to Section 8.30 of the Revised Model Nonprofit Corporation Act states that while "the application of the business judgment rule to directors of nonprofit corporations is not firmly established by the caselaw, its use is consistent with section 8.30."⁷⁸

The assumption is erroneous, however, that the business judgment rule provides directors with an overly protective free ride from liability. Shielding nonprofit directors

74. See 1 ALI PRINCIPLES, *supra* note 40, at 172-88; *cf.* KURTZ, *supra* note 54, at 49 (providing guidance about the legal principles that govern the duties of directors of nonprofit organizations).

75. See 1 ALI PRINCIPLES, *supra* note 40, at 135.

76. See, e.g., *Beard v. Achenbach Memorial Hosp. Ass'n.*, 170 F.2d 859, 862 (10th Cir. 1948) (requiring "bad faith, fraudulent breaches of trust, or gross or willful negligence" to recover from a nonprofit corporation); *John v. John*, 450 N.W.2d 795 (Wis. Ct. App. 1989) (finding non-profit directors' fraudulent conduct unprotected by the business judgment rule); *Yarnall Warehouse & Transfer, Inc. v. Three Ivory Bros. Moving Co.*, 226 So. 2d 887, 890 (Fla. Dist. Ct. App. 1969) (refusing to question the business judgment of non-profit director).

77. 179 A.D.2d 65 (1992); *cf.* *Levandusky v. One Fifth Ave. Apt. Corp.*, 75 N.Y.2d 530, 537 (1990) (applying a standard of review analogous to the business judgment rule to cooperative and condominium board decisions). In the *Adelphi* case, New York's Board of Regents concluded:

In setting the compensation of their officers, not-for-profit trustees also have the benefit of the "business judgment rule," which bars a substantive review of the merits of their decisions, as long as they have acted in good faith, with due care and in the absence of self-dealing. Where these circumstances exist, trustees are not liable for mere errors in judgment and cannot be second-guessed through application of hindsight. Although the trustees have not cited any case law in which a New York court has specifically applied the business judgment rule to trustees of education corporations, presumptively the rule would apply to an education corporation just as to any other not-for-profit corporation.

FISHMAN & SCHWARZ, *supra* note 1, 1997 Supp. at 32.

78. REV. MODEL NONPROFIT CORP. ACT, *supra* note 43, at 216; see also NONPROFIT GUIDEBOOK, *supra* note 39, at 27.

from liability using the business judgment rule requires the following: a conscious exercise of judgment, good faith coupled with a lack of interest, and an informed decision.

a. Prerequisite of a Conscious Exercise of Judgment

To be protected under the business judgment rule a decision must be consciously made and judgment must, in fact, have been exercised. The ALI Principles states: "There is, however, no reason to provide special protection where no business decision-making is to be found. If, for example, ... a director received but did not read basic financial information ... and thus allowed his corporation to be looted," business judgment protection would be manifestly undesirable.⁷⁹

b. Prerequisites of Good Faith and No Interest

It is well settled that good faith and disinterested decision-making are prerequisites to entry into the business judgment rule's safe harbor.⁸⁰ Take, for example, a conversion transaction involving a leveraged buyout by the nonprofit's directors and officers. The demanding standards of duty of loyalty caselaw,⁸¹ not the business judgment rule, would be applicable.

c. Prerequisite of an Informed Decision

The ALI Principles explain:

Among the factors that may have to be taken into account in judging a director's reasonable belief as to what was "appropriate under the circumstances" are: (i) the importance of the business judgment to be made; (ii) the time available for obtaining information; (iii) the costs related to obtaining information; (iv) the director's confidence in those who explored a matter and those making presentations; and (v) the state of the corporation's business at the time and the nature of competing demands for the board's attention.⁸²

Basic to an understanding of the reasonably informed component of the business judgment rule is recognition that it requires reasonable inquiry in appropriate circumstances.⁸³

79. See 1 ALI PRINCIPLES, *supra* note 40, at 175.

80. *Id.* at 174-76.

81. See discussion *infra* Part II.C.

82. 1 ALI PRINCIPLES, *supra* note 40, at 178.

83. See *id.* at 161-64, 179; see, e.g., *Hoye v. Meek*, 795 F.2d 893, 896 (10th Cir. 1986) (holding that it is the director's duty to make necessary inquiries when suspicions are, or should be, aroused); *Hanson Trust PLC v. ML SCM Acquisition, Inc.*, 781 F.2d 264, 275 (2d Cir. 1986) (indicating that the director's lack of information and slowness of decision-making suggested a breach of the duty of due care); *Barnes v. Andrews*, 298 F. 614, 615-16 (S.D.N.Y. 1924) (holding that director failed to keep himself informed in "some detail"); *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985) ("the directors were duty bound to make reasonable inquiry"); *Devlin v. Moore*, 130 P.35, 45 (Ore. 1913) (noting that if nothing arouses suspicion that something is wrong, "ordinary attention ... is sufficient. If, on the other hand, directors know, or by the exercise of ordinary care should have known, any facts which would awaken suspicion and put a prudent man on his guard ... want of that care makes them responsible.").

Finally, it should be carefully noted that the most important recent case dealing with the business judgment rule in Delaware, *Cede v. Technicolor, Inc.*, held that the informed component of the business judgment rule "requires a director, before voting on a proposed plan of merger or sale, to inform himself and his fellow directors of all material information that is reasonably available to them."⁸⁴ In *Technicolor*, the Supreme Court of Delaware suggested that directors make a "prudent search for alternatives."⁸⁵ The Supreme Court implied that to be properly informed, directors should provide for a "pre- or post-agreement market check mechanism" as an alternative to a formal auction.⁸⁶ This theme should be carried further, expressly requiring either a formal auction or a "market test" in all nonprofit conversion transactions.⁸⁷

d. The "Rationally Believes" Requirement

"The rationally believes test is the basis of the legal insulation provided by the 'business judgment rule.'"⁸⁸ It affords directors and officers wide latitude when making decisions that meet the other prerequisites of the rule. But, as the ALI explained, there are objective outer limits to the protection this test affords:

There is no reason to insulate an objectively irrational business decision—one so removed from the realm of reason that it should not be sustained—solely on the basis that it was made in subjective good faith. The weight of authority and wise public policy favor barring from the safe harbor of [the business judgment rule] directors and officers who do not believe, or do not *rationaly* believe, that their business judgments are in the best interests of the corporation.⁸⁹

C. Duty of Loyalty

As previously indicated, the legal obligations of directors and officers have traditionally been divided into the categories of duty of care and duty of loyalty. Allegations of neglect, mismanagement, and improper (but disinterested) decision-making are dealt with under the duty of care and the business judgment rule. Fraud, self-dealing, misappropriation of corporate opportunities, improper diversions of corporate assets, and similar matters involving conflicts between a director's or officer's interest and the corporation's welfare are considered under duty of loyalty statutes and caselaw.

As was true in the duty of care area, duty of loyalty standards in the for-profit sector have received extensive judicial and commentary attention during recent decades. The ALI Principles, for example, cover almost 200 pages in the loyalty area.⁹⁰ These sources provide important guidance for the nonprofit community; there is no reason to repeat their analyses here.

84. 634 A.2d 345, 367 (Del. 1993).

85. *Id.* at 369.

86. *Id.* at 369, n. 37.

87. *See infra* Part III.

88. *See* 1 ALI PRINCIPLES, *supra* note 40, at 179-85.

89. *Id.* at 181.

90. *Id.* at 199-382 (denominated "Duty of Fair Dealing").

For present purposes, the important issue worth considering is: should loyalty standards be the same in the nonprofit and for-profit sectors? The New York Board of Regents' *Adelphi* case provides an excellent vehicle for considering this issue in the area of interested director transactions. Adelphi University purchased insurance through a brokerage firm owned by trustee Procope, the "material terms of which neither Procope nor Diamandopoulos ever disclosed to the board. Those terms include the issuance of broker of record letters and ... [Procope's] receipt of fees since 1987 in the approximate amount of \$1,227,949."⁹¹ Under evolving but relatively well-settled loyalty standards, the failure to disclose constitutes a breach of the duty of loyalty.⁹²

What if the directors or officers had made proper disclosure? Unless disinterested directors approved the transaction, state law would apply a fairness test, the law's most demanding test, with the burden of proof on those defending the interested transaction.⁹³ Similarly, even with proper disclosure, if a dominant group of directors and officers wished to buy a nonprofit corporation in a conversion transaction, a fairness test would apply. Section 5.15 of the ALI Principles provides the following rule of law: "If directors or principal senior executives of a corporation are interested in a transaction in control ... then those directors or principal senior executives have the burden of proving that the transaction was fair to the shareholders of the corporation...."⁹⁴ State cases use tests like "entire fairness," "intrinsic fairness," and "inherent fairness" in these situations.⁹⁵ In general, what these terms mean is that the directors and officers will have to carry a heavy burden of showing that the acquisition process and price were fair to the corporation (*i.e.*, the best price reasonably available was received).

In my view, no basis exists for challenging these approaches. Professor Hansmann recommends "a flat prohibition against all self-dealing transactions involving controlling persons in nonprofit organizations."⁹⁶ However, this proposal is too inflexible and would prove both impractical and counterproductive, particularly in the nonprofit sector. As Professors Fishman and Schwarz explain:

Wouldn't a total prohibition against any conflicts of interest by nonprofits be too severe, by carrying in its swath useful interested transactions that nonprofits, particularly smaller ones, need to survive? An absolute ban ignores the reality of much of the charitable sector.... Interested transactions are efficient. The transaction costs are low. Interested directors may be able to lend money or provide services or do business with a nonprofit at a lower rate because they

91. FISHMAN & SCHWARZ (Supp. 1997), *supra* note 1, at 12.

92. The New York Board of Regents, in fact, found such a breach. *Id.* at 13; *see, e.g.*, Boston Children's Heart Found., Inc. v. Nadal-Ginard, 73 F.3d 429 (1st Cir. 1996) (finding that a director's failure to disclose salary to other directors evidenced a lack of good faith, and was a breach of fiduciary duty); 1 ALI PRINCIPLES, *supra* note 40, at 209-18 (illustrating how a director's failure to disclose his/her transaction with the corporation will breach the duty of fair dealing).

93. *See* 1 ALI PRINCIPLES, *supra* note 40, at 209-34.

94. *Id.* at 359.

95. *See, e.g., id.* at 325-72; Paramount Communications Inc. v. QVC Network, 637 A.2d 34, 42 n.9 (Del. 1994) ("Where actual self-interest is present and affects a majority of the directors approving a transaction, a court will apply even more exacting scrutiny to determine whether the transaction is entirely fair to the stockholders.").

96. Henry B. Hansmann, *Reforming Nonprofit Corporation Law*, 129 U. PA. L. REV. 497, 569 (1981).

know the organization best.... A nonprofit would often lose advantageous opportunities otherwise available to it if it were completely barred from entering into any transactions with any of its directors or any entity in which the directors have an interest.... Finally, as nonprofit organizations become more complex and professionally run, there may be greater need for individuals who happen to be interested directors. A nonprofit needs patron directors more than the patron directors need the nonprofit.⁹⁷

The difficult issue in the nonprofit context comes if, after proper disclosure, a facially disinterested group of directors approves an interested director transaction or a conversion transaction proposed by a minority of the directors on the board. If for-profit precedents are used, most states would apparently apply the business judgment rule—and its highly deferential rationally believes test—to judicial review of these transactions.⁹⁸ Professor DeMott, on the other hand, proposes that such self-dealing transactions “be voidable unless the transaction’s proponents can affirmatively establish its fairness to the corporation at the time of the transaction.”⁹⁹

There is considerable strength in Professor DeMott’s position. My concerns about deferential judicial review include the following: (i) the tendency of nonprofit directors to defer to each other in an environment “not characterized by skepticism and analytical rigor;”¹⁰⁰ (ii) the absence in the nonprofit sector of “extensive [SEC] disclosure requirements, enforcement machinery and private litigation;”¹⁰¹ and (iii) the fact that nonprofit institutions generally lack voting rights, appraisal rights, and other protections available in the for-profit sector that would lessen the dangers, at least with respect to certain significant transactions.¹⁰²

For these reasons, even where proper disclosure has been made and disinterested director approval is found, more rigorous judicial scrutiny than the business judgment rule affords should be available in the nonprofit context. The ALI Principles use an intermediate standard of judicial review—more rigorous and intrusive than the business judgment rule’s rationally believes test—for interested director and officer transactions in the

97. FISHMAN & SCHWARZ, *supra* note 1, at 221.

98. See WILLIAM L. CARY & MELVIN A. EISENBERG, CASES AND MATERIALS ON CORPORATIONS 637-84 (7th ed. 1995).

99. DEMOTT, *supra* note 7, at 143.

100. *Id.* at 140; see discussion *supra* Part I.

101. *Id.* at 139. Professor DeMott concluded that “apart from private foundations, the risk of attracting the wrath of the Internal Revenue Service does not operate as a deterrent to self-dealing that is comparable to the impact of the disclosure requirements” of the federal securities laws for for-profit public corporations. *Id.* at 139. Peter Swords has recently demonstrated that the IRS requires a great deal of disclosure related to the duty of loyalty area. See PETER SWORDS, FORM 990 AS A TOOL FOR NONPROFIT ACCOUNTABILITY (Oct. 30, 1997). In the past, however, the IRS’s enforcement efforts have been seriously hampered by the severity (and focus) of inurement penalties and a lack of resources. It remains to be seen whether the new intermediate sanctions legislation, 26 U.S.C. § 4958 (1996), which gives the IRS the power to tax and penalize excess benefit transactions, will have a significant impact in the loyalty area. See Douglas M. Mancino, *New “Intermediate Sanctions” May Cause Public Charities to Change the Way They Do Business*, 85 J. TAX’N 368 (1996). In general, both the loyalty responsibilities of the IRS and the special provisions under state law relating to the investment of funds are beyond the scope of this Article. See FISHMAN & SCHWARZ, *supra* note 1, at 229-37.

102. See Goldschmid,, *supra* note 33, at C1-16.

for-profit contest.¹⁰³ It is clear that at a minimum such a test should be applied in the nonprofit context. Either a fairness test or an intermediate test would be consistent with the following observations by the Supreme Court of Delaware:

Because of the special duty of the fiduciaries of a charitable corporation to protect and advance its charitable purpose, the court's review of an independent committee's approval would be more searching for a charitable corporation than for a for-profit corporation. If disinterested directors approved a transaction that posed a clear threat to the charitable purpose or assets of the corporation, their approval would be an *ultra vires* act and therefore not legally binding. Thus, even when an independent committee approved a transaction, the Attorney General would still have some leeway to challenge it. The extent to which the standard or review applicable to an independent committee's approval would differ from the standard of entire fairness applicable to the decisions of interested directors is a question that is not now before us. At very least, the burden of proof would rest upon the Attorney General rather than the directors in such a case.¹⁰⁴

In *Oberly*, the Supreme Court concluded:

Although principles of corporate law generally govern the activities of such a [charitable] corporation, its fiduciaries have a special duty to advance its charitable goals and protect its assets. However, a charitable corporation is not barred from engaging in transactions in which its directors have an interest, as long as such transactions are intrinsically fair or are approved by a committee of independent directors.¹⁰⁵

For similar reasons, I suspect that most courts would accept my suggestion from the National Center's 1996 conference that they give special emphasis—enhanced scrutiny—to allegations of conflict of interest in conversion transactions. Subtle conflicts or “taints” to the process, which might be considered marginal in the for-profit context, should be resolved in favor of duty of loyalty (not business judgment) treatment in the nonprofit conversion context.¹⁰⁶ This approach to interested transactions—with respect to the standard for judicial review and the identification of conflicts—should apply in almost all duty of loyalty areas involving nonprofit directors and officers.

III. PROPOSED REFORMS

A. Self-Help: More Precise Specification of Functions, Guidelines, and Enhanced Educational Efforts

The nonprofit community may be able to stimulate considerable governance reform by self-help steps, thereby avoiding unnecessary governmental mandates. During the past two decades, the for-profit sector has participated in a continuous series of governance discussions and dialogues, producing important practice recommendations, guidelines,

103. See 1 ALI PRINCIPLES, *supra* note 40, § 5.02 at 209-34.

104. *Oberly v. Kirby*, 592 A.2d 445 (Del. 1991) (*sitting en banc*).

105. *Id.* at 472-73.

106. Goldschmid, *supra* note 33, at C15-16.

and reports, which have had a substantial impact on how for-profit corporations function.¹⁰⁷ The nonprofit sector needs a similar process.

One area that should be addressed relates to the functions of the nonprofit board. A whimsical commentator suggested that most of the "problems that befall ... groups stem from the fact that boards have over the years, translated their [mandate] with as much variety as husbands and wives interpret their vows to love, honor and obey."¹⁰⁸ Of course, there is insight in the suggestion that the enormous diversity of nonprofit institutions—in mission, size, economic consequences, and complexity—precludes too many bright-line strictures. But, as was true in the for-profit context, there are core functions of the board (which are legally required under the "shall be managed" statutory commands¹⁰⁹ and duty of care standards) and numerous non-mandatory governance options and techniques that could profit from reasoned elaboration and refinement.¹¹⁰

Similarly, enhanced educational opportunities and guidelines of various types would be of considerable help to nonprofit directors and officers. Although guidelines now exist in specific sectors of the nonprofit community, the updating and refinement of existing guidelines, the development of new guidelines, and the tailoring of guidelines to the needs of particular nonprofit institutions are all needed. Especially in the broad duty of loyalty area, tailored guidelines which include process specifications (*e.g.*, the audit committee or general counsel must review...) and conduct specifications (which can be more restrictive than current loyalty law) should be available for the directors and officers of many institutions.

Among the other self-help steps that could enhance the quality of nonprofit corporate governance are the development of guidelines for internal audit procedures, information systems, law compliance programs, board committees, and similar matters that would assist the board in overseeing, and the officers in managing, the nonprofit institution.¹¹¹ An interesting self-help suggestion to the nonprofit community, made in an unpublished paper by a recent graduate of Columbia Law School and reportedly used by the Mellon Foundation, is that foundations use "restrictive gifts to address some of the [governance] weakness" found in nonprofit institutions.¹¹²

B. Duty of Loyalty Modifications

As discussed in Part II.C, this Article recommends two important modifications of duty of loyalty law as it would be applied in a for-profit context. First, when there has been proper disclosure with respect to an interested transaction, or another matter implicating the duty of loyalty, followed by disinterested approval, the highly deferential ra-

107. See generally, *e.g.*, Millstein & MacAvoy, *supra* note 6, at 1-13; Goldschmid, *supra* note 21; Veasey, *supra* note 21 (discussing principles of corporate governance under Delaware law); BOWEN, *supra* note 46; THE BUSINESS ROUNDTABLE, *supra* note 46; NATIONAL ASS'N OF CORPORATE DIRECTORS, *supra* note 46.

108. FISHMAN & SCHWARZ, *supra* note 1, at 152 (quoting Melissa Middleton, *Nonprofit Boards of Directors Beyond the Governance Function*, in THE NONPROFIT SECTOR: A RESEARCH HANDBOOK 141 (1987)).

109. See *supra* Part II.A.

110. A most useful starting place for analysis is BOWEN, *supra* note 46.

111. See *supra* Part II.B.2 (indicating the need for compliance programs and procedures).

112. Jed I. Bergman, *The Ties that Bind? Using Restricted Gifts as a Nonprofit Governance Tool* 28 (May 1997) (unpublished manuscript on file with the Columbia Law School).

tionally believes test of the business judgment rule should not be the standard for judicial review.¹¹³ A fairness test, or at a minimum the ALI's intermediate test, should provide the applicable standard of review.¹¹⁴ Similarly, reviewing courts should give enhanced scrutiny to allegations of conflict of interest or dominating influence in the nonprofit context. Business and financial relationships, familial relationships, and "taints" to the process, for example, which might be considered of marginal concern in the for-profit context, should be resolved in favor of review under loyalty standards rather than the business judgment rule when nonprofit institutions are involved.¹¹⁵

C. Special Rules for Conversion Transactions and Similar Sensitive Transactions

At the National Center's 1996 conference, I urged that a "new mandatory disclosure system" be established for conversion transactions, to which I would now add, similar sensitive transactions.¹¹⁶ The recommendation includes applying the business judgment rule to all of the key decisions in a conversion transaction when conflicts of interest are *not* present. For example, the recommendation would apply the business judgment rule to the following: (i) the decision whether to enter into an agreement; (ii) a review of the fairness of the price and terms of the agreement; (iii) a decision by the board of a nonprofit hospital, for example, not to maximize the profit from a conversion transaction, but rather to protect a community's essential health services;¹¹⁷ and (iv) the decision about where, within the nonprofit community, to put the funds received in a conversion transaction.¹¹⁸ However, four modifications are needed in the traditional analysis that would be applied to conflict-free mergers and acquisitions (similar to conversion transactions) in the for-profit sector. In addition to the enhanced scrutiny for conflicts discussed above, I suggested in 1996 that:

1. The retention of disinterested outside experts should in almost all instances be required in significant conversion transactions.
2. Because of the difficulty of valuing nonprofit enterprises ... new legislation, new regulations by state charity regulators, and court decisions should impose a "market test" requirement before any conversion transaction can be consummated. The "market test" should provide for: (i) public disclosure of the

113. See *supra* text accompanying notes 103-105. An example of other matters implicating the duty of loyalty is board approval of a director or officer taking a nonprofit's corporate opportunity.

114. *Id.*

115. See *supra* text accompanying note 106.

116. Goldschmid, *supra* note 33, at C12-14.

117. There is no reason why a decision with respect to any trade-off between maximum price and community needs by a nonprofit's board should not be protected by the standards of the business judgment rule—assuming the decision is properly informed and conflict-free. The word business in the business judgment rule sometimes causes confusion in the nonprofit context. The business judgment rule should simply be thought of as a protective, highly deferential review standard for the judgmental component of a decision. See *supra* Section II.B (providing policy reasons). It may be noted that even in the for-profit context, the business judgment rule is applied to many non-profit-maximizing decisions (e.g., whether to take account of ethical considerations and forgo profits, how many dollars to devote to humanitarian and philanthropic purposes even when profits will be lowered in the long term, and whether to put a specific law compliance program into effect). See 1 ALI PRINCIPLES, *supra* note 40, at 55-70, 154, 173-74.

118. Goldschmid, *supra* note 33, at C14-15.

proposed transaction; (ii) the provision of relevant information (subject to appropriate confidentiality safeguards) to responsible persons interested in making a competing offer; and (iii) adequate time for competing offers to be made.¹¹⁹ A fair formal auction would, of course, meet the "market test" requirement....

[3. Similar to the approach on conflicts,] enhanced scrutiny ... should be used with respect to the placement of the proceeds of a conversion transaction into a new nonprofit foundation and with respect to any joint venture undertaken by the nonprofit entity (or its successor) and a for-profit purchaser.¹²⁰

D. Enforcement and Process Reforms

Society should increase the capacity of state charity regulators and the IRS to monitor the nonprofit sector and litigate where necessary. Because it is entirely unlikely that perennially understaffed state charity regulators will ever be able to handle their monitoring and enforcement functions alone, state legislatures and courts should approve the use of relator actions.¹²¹ A relator is generally a person authorized by a state attorney general to sue in the "name of the people when that right to sue resides solely in the attorney general."¹²² In California, for example, the "attorney general controls the action at all times, and can at any stage of the proceeding withdraw, discontinue, or dismiss the action or assume the proceeding's management."¹²³ Costs and attorney's fees can be awarded to successful relators for benefits they confer.

As indicated earlier, more room should cautiously be opened for donor, member, and beneficiary derivative actions.¹²⁴ Except in the most unusual circumstances, it is the nonprofit corporation rather than a class or individual that should be the recipient of any monetary recovery. Less stringent standing rules would undoubtedly open the nonprofit sector to the danger of weak (but lawyer driven) or spiteful litigation. However, statutory provisions or court decisions providing that legal costs and fees will be awarded against plaintiffs and their lawyers if an action is unreasonably brought or litigated could moderate some of the danger.

Plaintiffs would not, of course, receive attorney's fees at the end of a litigation unless they were successful and conferred substantial benefit. As is true in all class and derivative actions, but particularly true in cases involving nonprofit corporations, courts and state charity regulators should play an active role in reviewing the fairness of settlements and the appropriateness of any award of attorney's fees. One would not expect courts to be overly generous to plaintiffs' lawyers in litigation against nonprofit corpora-

119. Other provisions (e.g., dealing with lock-up concerns and break-up fees), which would both facilitate the "market test" and provide appropriate safeguards, could usefully be added to new legislation or regulations.

120. Goldschmid, *supra* note 33, at C15-16.

121. See generally James J. Fishman, *Checkpoints on the Conversion Highway: Some Trouble Spots in the Conversion of Nonprofit Health Care Organizations to For-Profit Status*, 23 J. CORP. L. 701 (1998) (this issue).

122. See FISHMAN & SCHWARZ, *supra* note 1, at 248.

123. *Id.*

124. See *supra* Part II. But see Rob Atkinson, *Unsettled Standing: Who (Else) Should Enforce the Duties of Charitable Fiduciaries?*, 23 J. CORP. L. 655 (1998) (this issue).

tions since any fee awarded would diminish the resources available to a public charity. In affirmative terms, less restrictive standing rules could provide significant self-protective incentives for more active nonprofit governance and could create the deterrence necessary to make substantive fiduciary standards effective.

For those willing to consider broader standing, the conversion transaction area is a particularly attractive one for experimentation. Nonprofit conversions are likely to be one-shot, decisive transactions in the life of the nonprofit entity. Plaintiffs' lawyers who come at these transactions with backgrounds in corporate and securities law could bring talent, expertise, and resources to any litigation; the limited number of such transactions would preclude enhanced standing resulting in a flood of litigation.

IV. CONCLUSION

This Article began with a paradox: nonprofit directors and officers generally operate under the same state fiduciary standards as their for-profit peers, but, in contrast to the for-profit world, fiduciary law plays little role in assuring accountability in the nonprofit sector. The explanation for the paradox should now be apparent. Highly restrictive standing rules and a lack of governmental enforcement have made duty of care and duty of loyalty standards almost wholly aspirational in the nonprofit sector. Although this Article proposes a number of significant modifications in state fiduciary standards as they would apply to nonprofit directors and officers, by and large current for-profit standards work well in the nonprofit context.

The explanation for what I termed the "central paradox of nonprofit corporate governance"—the fact that nonprofit institutions receive so much in public and private largess, but are subject to so few accountability constraints—probably lies in some mix of history, naiveté, accident, inertia, fear of counterproductive effects, overemphasis on the nonprofit sector's "independence," and a good faith belief in the unvarying decency and honesty of these serving the nonprofit community. But as a friend and admirer of the nonprofit sector I ask: Can we continue to justify or afford—and will the public continue to tolerate—the relative ineffectiveness of nonprofit corporate governance and the virtual absence of accountability constraints? My answer is reflected in the proposals for reform in Part III.