1-1-1987

Standards of Conduct for Directors of Nonprofit Corporations

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This article is dedicated to Robert B. Fleming, former Dean and soon to be Professor of Law Emeritus of the Pace University School of Law, whose encouragement and friendship I have so valued.

I. Introduction

The law of nonprofit corporations has developed with neither consistency nor coherence. It has evolved from an uneasy mix of trust, contract, and corporate principles, the effect of which may be difficult to predict in a particular situation.[1] The conflicting origins of nonprofit corporation law are most keenly felt when defining the duties of care and loyalty of directors of nonprofit corporations.[2] Basically, the directors' duty of care de-

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1. Cary & Bright, *The "Income" of Endowment Funds*, 69 COLUM. L. REV. 396, 402 (1969) (quoting Boylan, *Endowment Funds — Collision of Corporate and Trust Standards*, 18 BUS. LAW. 807, 807 (1963)).

2. A substantial body of literature has developed discussing the appropriate standards of conduct for trustees and directors of nonprofit organizations. *See* Albert, *The Legal Liabilities of Trustees, Directors and Officers of a Non-Profit Cultural Institution — Preparing For and Dealing with Financial Difficulties and Dissolution*, in NON-PROFIT CULTURAL ORGANIZATIONS 103 (1979); DuBoff, *Duties and Liabilities of Trustees*, in NON-PROFIT CULTURAL ORGANIZATIONS 61 (1979); Committee on Charitable Trusts, *Duties of Charitable Trust Trustees and Charitable Corporation Directors*, 2 REAL PROP. PROB. & TR. J. 545 (1967) [hereinafter *Duties of Charitable Trust Trustees*]; Eyster, *Responsibilities of Directors and Trustees of Not for Profit Organizations*, 4 ART & L. 13 (1978); Gerstenblith, *The Fiduciary Duties of Museum Trustees*, 8 ART & L. 175 (1983); Hackler, *Hospital Trustees' Fiduciary Responsibilities: An Emerging Tripartite Distinction*, 15 WASHBURN L.J. 422 (1976); Hansmann, *Reforming Nonprofit Corporation Law*, 129 U. PA. L. REV. 497, 567-74 (1981); Karst, *The Efficiency of the Charitable Dollar: An Unfulfilled State Responsibility*, 73 HARV. L. REV. 433 (1960); Marsh, *Governance of Non-Profit Organizations: An Appropriate Standard of Conduct for Trustees and Directors of Museums and Other Cultural Institutions*, 85 DICK. L. REV. 607 (1981); Merryman, *Are Museum Trustees and the Law Out of Step*, ART NEWS, Nov. 1975, at 24-27; Oleck, *Proprietary Mentality and the New Non-Profit Corporation Laws*, 20 CLEV. ST. L. REV. 145 (1971); Weil, *Breaches of Trust, Remedies, and Standards in the American Private Art Museum*, in BEAUTY AND THE BEASTS: ON MUSEUMS, ART, THE LAW AND THE MARKET 160 (S. Weil ed. 1983); Note, *Dissolution of Public Charity Corporations: Preventing Improper Distribution of Assets*, 59 TEX. L. REV. 1429 (1981); Note, *The Fiduciary Duties of Loyalty and Care Associated with Directors and Trustees of Charitable Organizations*, 64 VA. L. REV. 449 (1978).

mands that board members not only invest a certain amount of time and effort, but also exercise skill and judgment in the operation of the organization. The directors' duty of loyalty requires that directors both place the interests of shareholders ahead of their own and supervise transactions when there is a conflict of interest.[3] In recent years, the standards of behavior for directors of charitable corporations have developed from the rigid and inflexible rules drawn from the law of charitable trusts which impose harsh liability to the more lenient but less predictable guidelines of corporate law.[4]

This Article analyzes the standards of care and loyalty that should apply to directors[5] of nonprofit corporations. It suggests that the movement toward corporate law principles neither reflects the differences in the types of nonprofit corporations[6] nor provides a coherent rationale for the conduct regulated.[7] The "trust law"-"corporate law" distinction has often centered upon the label to be applied rather than on an analysis of the principles involved. Too often the selection of the label has determined the result. At other times, the label has been used as a

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3. Scott, *Corporation Law and the American Law Institute Corporate Governance Project*, 35 STAN. L. REV. 927, 927-28 (1983).

4. Stern v. Lucy Webb Hayes Nat'l Training School for Deaconesses & Missionaries, 381 F. Supp. 1003, 1013 (D.D.C. 1974) [hereinafter referred to in the text as *Sibley Hospital*].

5. This article uses the term "director" interchangeably with that of "trustee" as do some statutes. For instance, New York educational corporations are managed by "trustees." N.Y. EDUC. LAW § 216 (McKinney 1972). The New York Not-for-Profit Law which governs the standard of conduct of educational trustees refers to "directors." *See* N.Y. NOT-FOR-PROFIT CORP. LAW § 717 (McKinney 1970 & Supp. 1987). The standards of conduct for both are the same.

6. *See* Hansmann, *supra* note 2, at 580-99.

7. In most states all conduct relating to self-dealing is treated in only one or two sections of the nonprofit statute regardless of the nature of the action or the kind of organization. *See* N.Y. NOT-FOR-PROFIT CORP. LAW § 715 (McKinney 1970). The self-dealing statutes tend to be procedural in nature in that they outline the steps necessary to validate interested transactions. Other sections of states' nonprofit statutes deal with substantive self-dealing issues such as the prohibition or authorization of loans to officers and directors or proscriptions against organizations turned private foundations under the Internal Revenue Code. For a discussion of these statutes, see *infra* notes 253-71 and accompanying text. California, however, has different requirements concerning self-dealing depending upon the type of corporation. *See* CAL. CORP. CODE § 5233(b)(2) (public benefit corporations); § 8322(b) (mutual benefit corporations); § 9243(b)(2)(B) (religious corporations) (West Supp. 1987). *See infra* note 251.

For a definition of self-dealing, see *infra* note 253 and accompanying text.

convenient rationalization of a socially desirable conclusion.[8] This Article will attempt to develop a framework for applying a particular standard — corporate, trust, or other. The author contends that corporate law standards of directors' conduct are too low in certain situations. Instead, he maintains that there should be shifting standards, the application of which depends upon the type of nonprofit corporation and the nature of a director's conduct and interest in a particular transaction. This Article concludes that if high standards of conduct are clearly articulated, they will be adhered to by most directors and thereby lessen the problem of fiduciaries abusing their power or ignoring their responsibilities. High standards widely communicated to the nonprofit sector will provide the most cost-efficient monitoring of directors' behavior.

II. The Duty of Care

Discussions surrounding the concept of duty of care are filled with generalizations and moralistic phrases which offer little or no guidance as to what should be expected from board members. Directors are fiduciaries, but this word tells us little as it is so imprecise.[9] Its very definition is nebulous and uncertain. The meaning of fiduciary responsibility is amorphous as well.[10] There have been few attempts to describe what a fiduciary is or what he should do.[11] Because of the nature of a director's work, it is difficult to prescribe with precision his fiduciary responsibilities in a particular situation. Fiduciaries are decisionmakers and as

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8. W. Cary & C. Bright, The Law and the Lore of Endowment Funds 15 (1969).

9. In Justice Frankfurter's oft-quoted words:

> But to say that a man is a fiduciary only begins analysis; it gives direction to further inquiry. To whom is he a fiduciary? What obligations does he owe as a fiduciary? In what respects has he failed to discharge these obligations? And what are the consequences of his deviation from duty?

SEC v. Chenery Corp., 318 U.S. 80, 85-86 (1943).

10. Kaplan, *Fiduciary Responsibility in the Management of the Corporation*, 31 Bus. Law. 883, 886 (1976).

11. *Cf.* ABA Comm. on Corporate Laws, *Corporate Director's Guidebook*, 33 Bus. Law. 1591 (1978) (an example of an attempt to describe a director's fiduciary responsibilities); W. Knepper, Liability of Corporate Officers and Directors 1 (3d ed. 1978 & Supp. 1985). For an excellent illustration of how boards really work, see Manning, *The Business Judgment Rule and the Director's Duty of Attention: Time for Reality*, 39 Bus. Law. 1477 (1984).

such cannot be subjected to detailed standards or guidelines. Their work requires an educated judgment about uncertain problematical issues.[12] The vague generalities enunciating the standards of conduct provide outside boundaries for board behavior. At the same time they allow directors the freedom to make decisions.[13]

A. *How Nonprofit Boards Function*

A board of directors acts as a group. Although the dynamics of board interaction influence how a director exercises his responsibilities, the liabilities for violations of the duty of care focus upon a director's individual conduct. The nature of board decisionmaking is as varied as the kinds of nonprofit corporations. It may differ from that reflected in legal models which offer standards of conduct. When a board makes a decision, information often is incomplete. Factors may be unpredictable and uncontrollable.[14] There may be neither sufficient time nor the structure of operation for careful investigation and elaborate documentation before the making of the decision. Board members often make decisions on the basis of gut feelings or experiences. Although the statutory rules for the duty of care presuppose a formalized method of decisionmaking for board activity, the actual functioning of boards differs greatly from this statutory supposition.

Bayless Manning[15] has observed that the corporate board's most important judgment is the content of its agenda — its decision as to what it will attend to and how it will allocate the limited resources available to it.[16] Manning's insight applies equally to nonprofit corporations. However, judgments about the content of the board's focus are not formally made. Usually the

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12. Anderson, *Conflicts of Interest: Efficiency, Fairness and Corporate Structure*, 25 UCLA L. Rev. 738, 757 (1978).

13. Frankel, *Corporate Directors' Duty of Care: The American Law Institute's Project on Corporate Governance*, 52 Geo. Wash. L. Rev. 705, 708 (1984).

14. *See* Kennedy, *The Standard of Responsibility for Directors*, 52 Geo. Wash. L. Rev. 624, 634 (1984).

15. Bayless Manning, former Professor of Law at Yale Law School and Dean and Professor of Law at Stanford University Law School, currently practices law with Paul, Weiss, Rifkind, Wharton & Garrison in New York City.

16. Manning, *supra* note 11, at 1484.

management, rather than the board, sets the agenda. Thus, the board becomes reactive rather than initiatory.

Service on a nonprofit corporate board, as with its business counterpart, is a part-time activity.[17] For nonprofit directors, except in a period of crisis, the time commitment may be less than for the business corporate director. Because of the *pro bono publico* nature of most nonprofit board service, compensation is far less likely than in the business corporation. If remuneration is offered, it is only a token compared to the responsibilities performed. Nonprofit organizations have become increasingly complex and diverse in their activities. The number of matters that a board of directors might address could be extraordinarily large.[18]

Most corporate business does not come before the board and is not attended to by the board. The more complex the organization, the less likely that a board will become involved in a particular decision.[19] Thus, only a small percentage of a board's attention is preoccupied by decisions that would trigger the duty of care requirements.[20] Formal decisions by a board, which are protected by the best judgment rule, are but a small part of board activity.[21] Much of the time spent by board members deals with ongoing housekeeping functions which require neither deliberation nor formal decision. Thus, the time allocated for board meetings is spent making routine approvals, listening to reports from management, and attending to procedural matters. Relatively little time may be spent deliberating major decisions. Most board action is effectuated by consensus. A prime function of the board can be to serve as a check or veto on management.[22]

Despite the diversity in nonprofit board environments and the infinite ways to reach decisions, there are some minimal re-

17. A survey of outside directors of publicly held companies showed that the average director devoted a total of 123 hours per year to his board and committee work including travel — averaging less than three hours per week or 1.5 working days per month. KORN FERRY INTERNATIONAL BOARD OF DIRECTORS, TENTH ANNUAL STUDY 9 (1983), *cited in* Manning, *supra* note 11, at 1481 n.7.

18. *See* Kennedy, *supra* note 14, at 633.

19. Manning, *supra* note 11, at 1481, 1482.

20. *See id.* at 1482 (the vast bulk of corporate business does not and cannot come before the board, and therefore cannot be attended to by the directors).

21. *See* Kennedy, *supra* note 14, at 630.

22. *See* Manning, *supra* note 11, at 1488.

sponsibilities and levels of attention required of all boards. A first duty is to install a management in which the board has confidence.[23] A board needs an internal information system to judge the progress of the organization and the abilities of its management.[24] The internal information system is particularly important in the nonprofit sector, because there are few market forces to monitor performance. Therefore, prime responsibilities of the board are to press for the installation of such systems and to address problems that might arise. If an agenda item requires a decision, the board has an obligation to be informed about the matter. If there is reasonable belief that a particular matter will have a great impact on the corporation, the board has an obligation to inquire into the matter *and* to follow up such inquiry or decision by monitoring the progress of the matter.

In the nonprofit area, the budget is a prime board concern. If a new program or project is introduced, there is a substantial likelihood that it will impact on the corporation's financial health or even affect its exempt status. The board has an affirmative ongoing responsibility to monitor the project. If a board has been diligent, then it comports with the best judgment rule and will have met its duty of care.

B. *The Figurehead Director*

Board members of nonprofit corporations are chosen for a variety of reasons, many of which have little to do with their responsiblities as directors. Nonprofit board members have differing skills and backgrounds. Directors are sought for special skills or achievement; support of, or relationship to, the management; social or political connections; name recognition which provides the organization with added credibility particularly useful for fund raising efforts; status as beneficiaries of the organization's activities; or deep pockets — generous financial support.[25] Other board members resemble their business corpo-

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23. *Id.* at 1484.

24. *Id.*

25. *See* GLUECK, POWER AND ESTHETICS: THE TRUSTEE ART IN AMERICA 78-83 (1971), *reprinted in* 2 J. MERRYMAN & A. ELSEN, LAW, ETHICS AND THE VISUAL ARTS 7-60, 7-63 (1979). For the problems that can arise from a diverse board, see Kisselgoff, *Art and Money in a Ballet Conflict*, N.Y. Times, May 22, 1985, at C17, col. 1.

rate analogues[26] in that they are knowledgeable about the particular area in which the corporation is involved. These board members transfer corporate directorial skills and techniques to the nonprofit board.

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. Yet, such directors can be personally liable for losses resulting from nonmanagement and nonparticipation.[27]

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26. Nonprofit board members can be classified into at least three broad and somewhat overlapping categories based upon directors' affiliations or the function they fill on the board: monitoring, executive and instrumental. Baysinger & Butler, *Revolution Versus Evolution in Corporation Law: The ALI's Project and the Independent Director,* 52 GEO. WASH. L. REV. 557, 568 (1984). Monitoring directors are independent, outside directors who are not employed by the nonprofit and have no strong economic or psychological relationship to the organization. They are considered best able to make disinterested decisions on behalf of the organization and also in the nonprofit context, on behalf of the organization's patrons and beneficiaries, the public. *Id.* (citing SEC STAFF REPORT COMM'N ON CORPORATE ACCOUNTABILITY, 96TH CONG., 2D SESS. 29 (Comm. Print 1980)). One jurisdiction, California, has statutorily required that no more than 49% of the persons serving on the board of a public benefit corporation can be "interested"; that is, a full or part-time employee, independent contact or any relative of such person. CAL. CORP. CODE § 5227 (West Supp. 1987). Outside directors in the nonprofit context would include individuals selected for their reputation in the community, specialists or experts in the area of the nonprofit's activities, designated directors, members of the public or beneficiaries of the organization's activities, and donors. Some nonprofits, for example, the Metropolitan Museum of Art, receive a substantial proportion of their operating budget from government sources, and designate a certain number of seats on the board to be filled by elected officials or their delegates. *See* THE METROPOLITAN MUSEUM OF ART, INFORMATION FOR TRUSTEES 4-5 (1978). Inside directors are current and former employees of the organization, and relatives of such persons. Baysinger & Butler, *supra* at 569-70. A third broad category, the instrumental component, consists of individuals with a special expertise who serve a functional purpose on the board. *Id.* at 569. On the nonprofit board such individuals might include legal counsel, accountants, consultants, fundraising professionals, or public relations professionals. The dynamics of board interaction and the ways nonprofit boards actually operate differ no matter what typology of composition.

27. *Cf.* Francis v. United Jersey Bank, 87 N.J. 15, 34, 432 A.2d 814, 823 (1981); *Cf.* PRINCIPLES OF CORPORATE GOVERNANCE: RESTATEMENT AND RECOMMENDATIONS § 4.01, Ill. 1 (Tent. Draft No. 1, 1982).

Many nonprofits, particularly smaller ones, will always need prominent, recognized individuals to serve on their boards. These people attract charitable contributions and provide immediate legitimacy and recognition to the organization. A genuine concern has been that more rigorous standards for directors' conduct will discourage competent people from serving on boards.[28] In fact though, courts rarely find nonprofit directors liable. When they do, the penalties are not severe, usually requiring merely restitution of loss. Nonetheless, fears of liability and the increasing difficulty of obtaining directors' and officers' liability insurance have served as a deterrent to board service. There has been some reaction to these fears.[29] Yet, the public's right to expect that public monies or tax benefits will be used properly must be weighed against the specter of directors' flight from boards. This is a sensitive balance to achieve. Adequate standards of conduct, widely communicated to directors and officers, should be a form of insurance to directors and to the public.

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28. *See* Reidy, *Study Details Problems Facing Directors of Nonprofit Concerns*, N.Y.L.J., July 25, 1979, at 1, col. 3; Marsh, *Governance of Non-Profit Organizations: An Appropriate Standard of Conduct for Trustees and Directors of Museums and Other Cultural Institutions*, 85 DICK. L. REV. 607, 627 (1981).

29. Recent business corporate cases which have found liability for a director's breach of the duty of care, e.g. Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985), and imposed severe liabilities have led some jurisdictions to change their corporate statutes to improve the affordability and availability of directors' and officers' insurance to lessen the duty of care, and to permit advanced authorization of indemnification of legal expenses. *See* DEL. CODE ANN. tit. 8, § 145(c) (1974) and N.Y. BUS. CORP. LAW § 722 (McKinney Supp. 1987). These changes in indemnification primarily affect business corporations. For a thorough discussion of the protections afforded directors of nonprofit corporations by indemnification and insurance, see Kurtz, *The Duties and Liabilities of Officers and Directors, Including a Review of Indemnification and Insurance*, in NONPROFIT ORGANIZATIONS 263, 283-98 (D. Kurtz & J. Small eds. 1986) [hereinafter D. Kurtz & J. Small]. For a discussion of statutory efforts to encourage directors' service by lowering the duty of care, see *supra* note 28.

In the nonprofit sector there may be a greater willingness to allow indemnification because directors are serving without compensation. Cross v. Midtown Club, Inc., 33 Conn. Supp. 150, 157, 365 A.2d 1227, 1231-32 (1976).

While the chances of a court finding a due care violation by nonprofit directors is *de minimis*, one should recall Professor Coffee's comment that "even if the risk of due-care liability were no greater than that of being struck by a lightning bolt, one must observe that prudent men do not wander out needlessly in a thunderstorm; some are in fact terrified by lightning." Coffee, *Litigation and Corporate Governance: An Essay on Steering Between Scylla and Charybdis*, 52 GEO. WASH. L. REV. 789, 796 (1984).

C. *The Corporate Standard of Care*

The corporate duty of care requires the director of a business corporation to perform his responsibilities in good faith, in a manner that he reasonably believes to be in the best interests of the corporation, and with the care that an ordinarily prudent person reasonably would be expected to exercise in a like position and under similar circumstances.[30] The corporate director is not an insurer, nor is he liable for errors of judgment or mistake as long as he acts with reasonable diligence, care, and skill. To establish liability, a loss must be caused by the director's failure to exercise care.[31] The duty of care requires the director or officer to make reasonable inquiry in appropriate circumstances.[32] He can rely upon others and delegate if the reliance is in good faith, unless he knows or should know that such reliance is unwarranted.[33]

The components of the corporate duty of care are so general that they provide little specific guidance to a director of a business or nonprofit corporation. However, at the minimum, a nonprofit director has an obligation: 1) to ensure that there are pro-

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30. Selheimer v. Manganese Corp. of America, 423 Pa. 563, 224 A.2d 634 (1966); CAL. CORP. CODE § 309(a) (West 1977); N.Y. BUS. CORP. LAW § 717 (McKinney 1986); PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 4.01(a) (Tent. Draft No. 3, 1984) [hereinafter Draft No. 3]; PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 4.01(a) (Tent. Draft No. 4, 1985) [hereinafter Draft No. 4]; 3A W. FLETCHER, CYCLOPEDIA OF CORPORATIONS § 1029 (rev. perm. ed. 1986).

31. This Article uses the duty of care principles outlined in the American Law Institute's Corporate Governance Project. *See* Drafts No. 3 and 4, *supra* note 30, §§ 4.01-4.03. Despite the brouhaha surrounding the project, the duty of care recommendations reflect the current law in the majority of states. The project has been generally opposed by the business community. *See* Andrews, *Rigid Rules Will Not Make Good Boards*, HARV. BUS. REV., Nov.-Dec. 1982, at 34; Andrews, *Corporate Governance Eludes the Legal Mind*, 37 U. MIAMI L. REV. 295 (1982-83); BUSINESS ROUNDTABLE, STATEMENT OF THE BUSINESS ROUNDTABLE ON THE AMERICAN LAW INSTITUTE'S PROPOSED "PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS" (1983); Letts, *Corporate Governance: A Different Slant*, 35 BUS. LAW. 1505 (1980); Smith, *Corporate Governance: A Director's View*, 37 U. MIAMI L. REV. 273 (1982-83). *See Symposium: American Law Institute's Corporate Governance Project*, 52 GEO. WASH. L. REV. 495 (1984) (volume 52, issues 4 & 5, are dedicated entirely to this symposium).

32. Draft No. 3, *supra* note 29, § 4.01(b); Draft No. 4, *supra* note 30, § 4.01(a)(1).

33. Draft No. 4, *supra* note 29, §§ 4.01(a)(2) & 4.01(b); *see* CAL. CORP. CODE §§ 5231(b), 7231(b), 9241(b) (West. Supp. 1987); N.Y. NOT-FOR-PROFIT CORP. LAW § 717(b) (McKinney 1970 & Supp. 1987). The director can delegate but cannot abdicate his responsibilities. Milton Frank Allen Pub., Inc. v. Georgia Ass'n Petroleum Retailers, Inc., 224 Ga. 518, 526-28, 162 S.E.2d 724, 729-30 (1968), *cert. denied*, 393 U.S. 1025 (1969).

cedures in place which are adequate to keep the director informed as to material matters relating to the organization's exempt[34] purposes; 2) to ensure that a financial reporting system is in place and operating in a manner that is appropriate for the organization;[35] 3) to be attentive to the flow of information to the board of directors and to matters presented for consideration or decision; 4) to inquire about and to endeavor to cause the organization to take appropriate measures with respect to matters which the director knows or has reason to know are likely to have a significant impact on the organization; and 5) to be informed with respect to the matter being acted upon,[36] including approval or disapproval of a transaction.

The corporate duty of care involves attention and informed decisionmaking as well as affirmative responsibilities such as: inquiry in specific situations, the establishment of information systems and procedures, and the ongoing monitoring of financial and other significant matters.

Under the corporate standard, if a nonprofit director makes a wrong decision, but has no self-interest in the transaction and has a rational basis for believing that the judgment is in the best interests of the corporation, he has not violated his duty of care according to the best judgment rule.[37] This rule accords corporate directors and officers legal insulation from hindsight reviews of unsuccessful decisions. However, this "safe harbor" presupposes a reasonable inquiry, a deliberative process, and an informed decision. Even if the director has disregarded the above components of the duty of care standard, he will not be held liable unless the breach of duty was the proximate cause of the

34. An organization's "exempt" purposes are those which make it a nonprofit as opposed to a profit-making entity, and qualify the organization for exemption from federal, state, and local taxation. I.R.C. § 501(c)(3) (1987).

35. Manning, *supra* note 11, at 1499.

36. Kennedy, *supra* note 14, at 646-52 (the author offers a suggested redraft of § 4.01 of the Corporate Governance proposals giving the duty of care more specificity).

37. Adopted from Draft No. 4, *supra* note 30, § 4.01(d). The business judgment rule "immunizes management from liability in corporate transaction undertaken within both power of corporation and authority of management where there is reasonable basis to indicate that transaction was made in good faith." BLACK'S LAW DICTIONARY 105 (abr. 5th ed. 1983). The best judgment rule is basically the same as the business judgment rule but the former is more appropriate for nonprofits which, by definition, are not in business.

damage suffered by the corporation.[38]

A plaintiff has a difficult burden when attempting to prove a breach of a director's duty of care. The standard is flexible. It contains the objective element of "the reasonably prudent person," and subjective factors such as the background of the director, his special skills or experience, and the facts and circumstances surrounding the charitable organization including its activities and size.[39] Since the standard of care is so general, it should not be a surprise that it is difficult to apply because it provides so little guidance for the director.

Although in both the corporate and the nonprofit areas, courts rather than legislatures have played the central role in shaping the law regarding the duty of care of corporate directors, there are few cases. Even rarer are cases involving a breach of the directors' duty of care which do not involve misdealing or misuse of corporate property.[40] In relation to the business corporate standards of due care, Professor Bishop stated that "[t]he search for cases in which directors of industrial corporations have been held liable in derivative suits for negligence uncomplicated by self-dealing is a search for a very small number of needles in a very large haystack."[41] In the nonprofit area, there are so few reported decisions that the search is for the haystack, let alone the needle. The legal rules regarding standards of conduct do not fully take into account the nature of the nonprofit sector or the functioning of nonprofit boards.[42]

D. *The Trust Standard of Care*

In contrast to the corporate director, a trustee is under a duty to exercise such reasonable care and skill as a man of ordinary prudence would employ in dealing with his own property.[43]

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38. Draft No. 4, *supra* note 30, § 4.01(d).

39. Draft No. 3, *supra* note 30, § 4.01(a) comments c-e.

40. Phillips, *Managerial Misuse of Property: The Synthesizing Thread in Corporate Doctrine*, 32 RUTGERS L. REV. 184, 203 (1979).

41. Bishop, *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078, 1099 (1968). *But see* Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985).

42. *See, e.g.*, Draft No. 4, *supra* note 30, § 4.01(a); CAL. CORP. CODE § 5231 (West 1980); N.Y. NOT-FOR-PROFIT CORP. LAW § 717 (McKinney 1970 & Supp. 1987).

43. Francis v. United Jersey Bank, 87 N.J. 15, 26-27, 432 A.2d 814, 819, 825-26

This "prudent man" standard applies to the charitable trust.[44] The charitable trustee is liable for mere negligence in the performance of his duties in acting or failing to act. Traditionally, charitable trustees could not delegate the administration of their trust duty to others. They were severely circumscribed as to investments which could be made. A significant difference between the trustee and the corporate director is that historically the primary role of the trustee was to preserve the trust, to be cautious, and to avoid risk,[45] whereas the role of a director of a business corporation was, and still is, to take risks to ensure that earnings continue and grow in the future. The role of a director of a nonprofit corporation encompasses elements of both the trustee and corporate director models.

While the legal responsibilities of directors of nonprofit organizations have evolved from the more rigid trust principles, when dealing with matters of internal management and delegation of responsibilities, nonprofit directors have always enjoyed greater flexibility than trustees of a charitable trust.[46] In administrative areas involving corporate housekeeping, day-to-day operations, counseling, litigation, and the investment and use of funds, nonprofit corporations have long relied on the more permissive corporate standard. Such reliance has been supported by statutory developments concerning directors' and officers'

(1981) (total abdication of director's responsibility).

44. RESTATEMENT (SECOND) OF TRUSTS § 374 (1959) [hereinafter RESTATEMENT]; 2 A. SCOTT, THE LAW OF TRUSTS § 174 (3d ed. 1967). The standard may not offer too great an insight into human behavior, for as Lord Northington remarked, "No man can require, or with reason expect a trustee to manage his [trust] property with the same care and discretion that he would his own." Harden v. Parsons, 1 Eden 145, 148, 28 Eng. Rep. 639, 641 (1758). For an outline of legal differences between the charitable trust and nonprofit corporation, see Clark, *Charitable Giving and Receiving*, in D. Kurtz & J. Small, *supra* note 29, at 327, 367-70.

45. Accepted guidelines for the use of trust investment funds have been employed both in England and the United States over several centuries. They were expressed in the concept that principal and income must always be kept separate and distinct and in the precept that in investing one must consider not only the probable income but also the safety of the principal. Note, *The Uniform Management of Institutional Funds Act — A Commentary*, 8 REAL PROP. PROB. & TR. J. 405 (1973). In recent years the havoc played by inflation upon charitable organizations and the complexity of modern portfolio management have led to a relaxation of traditional trust rules. *See* Cary & Bright, *The Delegation of Investment Responsibility for Endowment Funds*, 74 COLUM. L. REV. 207 (1974).

46. W. CARY & C. BRIGHT, *supra* note 8, at 33.

responsibilities.[47]

E. *Circumstances Triggering an Examination of the Duty of Care*

The generalized standard of care is less important than the determination of the types of circumstances in which it will be applied and to whom the fiduciary will be compared when judging his performance. In this area, the duty of care has borrowed the ordinary prudent person standard from tort law concepts of negligence. There is a contrast between the corporate standard of care which focuses upon the care that the ordinary prudent person would reasonably be expected to exercise in a like position and the higher standard of the charitable trust which requires that the director exercise the care with which an ordinary person would deal with his own property. The corporate standard measures the care that a reasonably prudent director would exercise. In the rare situation when a breach of the duty of care has been found, either the courts have applied a gross negligence standard[48] or the facts have indicated a complete abdication of any directorial performance.

F. *Applying the Standard of Care*

1. Sibley Hospital

From the few reported cases it is difficult to discern whether a trust or corporate standard has been applied to nonprofit corporations. Courts and juries formulate their own measuring rods on a case-by-case basis.[49] Several of the older decisions apply the trust standard to the nonprofit director's duty of care.[50] In re-

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47. *See* CAL. CORP. CODE §§ 5231-5235 (West 1980); N.Y. NOT-FOR-PROFIT CORP. LAW §§ 514, 717 (McKinney Supp. 1987).

48. Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (gross negligence); Joy v. North, 692 F.2d 880, 886 (2d Cir. 1982) ("an obvious and prolonged failure to exercise oversight or supervision"), *cert. denied*, 406 U.S. 1051 (1983).

49. *Duties of Charitable Trust Trustees*, *supra* note 2, at 561.

50. United States v. Mt. Vernon Mtg. Corp., 128 F. Supp. 629 (D.D.C. 1954), *aff'd*, 236 F.2d 724 (D.C. Cir. 1956), *cert. denied*, 352 U.S. 988 (1957); Graham Bros. v. Galloway Woman's College, 190 Ark. 692, 81 S.W.2d 837 (1935); Lynch v. John M. Redfield Found., 9 Cal. App. 3d 293, 88 Cal. Rptr. 86 (1970); Burt v. Irvine, 237 Cal. App. 2d 828, 47 Cal. Rptr. 392 (1965); Holt v. College of Osteopathic Physicians & Surgeons, 61 Cal. 2d 750, 40 Cal. Rptr. 2d 244, 394 P.2d 932 (1964).

cent years there has been a shift, if not an avalanche, toward the more flexible corporate duty of care.[51] There is now substantial agreement that the corporate standard is the governing standard of care.[52]

The *Sibley Hospital* case[53] reflects the major judicial discussion of differences in the standards of care and self-dealing between the trust and the corporation as they relate to the nonprofit corporation.[54] From the early 1950's until 1968, two director-officers — the hospital administrator and the treasurer — dominated the board and the executive committee, making all budgeting and investment decisions and receiving only cursory supervision from the board or the executive committee. Until 1971, nearly three years after the death of the hospital administrator, the other committees never met.[55] The hospital maintained most of its liquid assets in savings and checking accounts rather than in treasury bonds or investment securities. Non-interest bearing checking accounts held a disproportionate amount of the liquid assets. No adequate justification was offered for this utilization of the hospital's funds. These investment decisions, like all others, were made by the treasurer and approved by the board as a matter of course. The plain-

51. Stern v. Lucy Webb Hayes Nat'l Training School for Deaconesses & Missionaries, 381 F. Supp. 1003, 1013 (D.D.C. 1974) [referred to as *Sibley Hospital* in text]. For the proposition that charitable corporations have tended to adopt the corporate duty of care, the Court miscited United States v. Mt. Vernon Mtg. Corp., 128 F. Supp. 629 (D.D.C. 1954). *See* CAL. CORP. CODE 5231 (West Supp. 1980).

52. Bright, *New Investment Management Tools and Strategies*, in D. Kurtz & J. Small, *supra* note 27, at 9, 13; REVISED MODEL NONPROFIT CORP. ACT § 8.30 commentary at 8-52 (Exposure Draft 1986).

53. *Stern v. Lucy Webb*, 381 F. Supp. 1003 (D.D.C. 1974).

54. The Sibley Memorial Hospital was established in 1895 by the Lucy Webb Hayes National Training School for Deaconesses and Missionaries, a District of Columbia charitable corporation, to provide health care services to the poor of the Washington area. In 1960, because of the increase in volume and complexity of the hospital's business, the corporate bylaws were revised to increase the number of directors and to create a committee system of board management. Executive finance and investment committees were to function between the board meetings. *Id.* at 1007.

55. After the death of the hospital administrator in 1968, some of the other directors became more involved in running the hospital. At that time, the executive committee was activated. After some difficulties between the treasurer and the hospital's comptroller in which the latter was discharged, the investment and finance committees came to life. Only after the treasurer died in 1972 did all of the directors, as a board, exercise an identifiable supervisory role. *Id.* at 1008.

tiffs[56] charged the board with mismanagement and nonmanagement.[57]

In distinguishing between the duty of care of the trustee who is liable for simple negligence and the duty of care of the corporate director who must have committed "gross negligence," Judge Gerhard Gesell explained that "corporate directors have many areas of responsibility, while the traditional trustee is often charged only with the management of trust funds and can therefore be expected to devote more time and expertise to that task."[58] The real basis of his distinction was organizational size: the large charitable organization — a hospital — seemed particularly to resemble the corporate rather than the trust model, so the corporate standard was used.[59]

It has, however, been questioned whether hospitals should be permitted to use the nonprofit form.[60] A standard of care should not be based only upon the size of the organization and responsibilities of the board. A more salient factor is the nature of the decisions involved. Ascertaining whether liability is to be based upon the gross negligence standard of corporate law or the simple negligence standard of trust law is often very difficult. As one commentator has noted:

> Courts do not hear evidence as to what an "ordinary prudent man" would do, either in the conduct of his own affairs or in the particular circumstances of the case. Nor do they often compare the facts of cases. . . . Instead, courts repeat that "negligence is a question of fact dependent upon the circumstances of each case" and proceed to apply their own ideas of what is reasonable conduct for a director.[61]

Courts thus apply a result-oriented approach. If the court finds

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56. The plaintiffs were patients of the hospital. *See infra* note 113.

57. *Stern v. Lucy Webb*, 381 F. Supp. at 1007-12. Other relevant matters of fact in the case are discussed *infra* at notes 218-27 and accompanying text.

58. *Stern v. Lucy Webb*, 381 F. Supp. at 1013.

59. For similar arguments, see Marsh, *supra* note 28, at 608; *See also* Beard v. Achenbach Mem. Hosp. Ass'n, 170 F.2d 859, 862 (10th Cir. 1948).

60. Clark, *Does the Nonprofit Form Fit the Hospital Industry?*, 93 Harv. L. Rev. 1416 (1980). *See also* Office of Advocacy, U.S. Small Bus. Admin., Unfair Competition by Nonprofit Organizations with Small Business: An Issue for the 1980s (1984) [hereinafter Unfair Competition by Nonprofit Organizations].

61. Nielsen, *Directors' Duties under Anglo-American Corporation Law*, 43 U. Det. L.J. 605, 612 (1966).

that conduct was improper, a breach of duty will be found. The trust standard, which requires mere directorial negligence and lack of deliberateness in reaching a decision, more readily allows the court to conclude that there has been a breach of duty.

Unlike the trustee, the corporate director has been long able to delegate investment decisions to fellow directors, to a committee of the board, or to outsiders.[62] Nevertheless, Judge Gesell found the directors in *Sibley Hospital* guilty of a breach of the duty of care even though he applied the more lenient corporate standard. The directors were in default of their fiduciary duty to manage the fiscal and investment affairs of the hospital because they failed to use due diligence in supervising those to whom a delegation was made.[63] The *Sibley Hospital* court's failure to distinguish whether the trustees were guilty of mismanagement or nonmanagement confirms the theory that thus far, due care cases merely involve a court's general finding of negligence without distinguishing between deliberate misconduct and nonfeasance.[64] Under a trust or a corporate duty of care standard, delegation is permissible but abdication of responsibility is not. Where there is nonmanagement, the corporate and trust standards coalesce so as to find a breach of the duty of care. *Sibley Hospital* reflects the movement of standards of care for nonprofit corporations from the trust to the corporate norm.

2. *The Revised Model Nonprofit Corporation Act*

The Revised Model Nonprofit Corporation Act firmly adopts the business corporate standard of care[65] and attempts to end the ambiguity as to whether directors should be bound by

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62. Under §§ 4.02-4.03 of Draft No. 3, *supra* note 30, a director is entitled to rely on other directors or officers, employees, experts or other persons or may delegate to those persons matters requiring the attention of the board and a director is entitled to rely on the decisions, judgments or performance of such persons. However, directors cannot abdicate their oversight responsibilities. A director is not entitled to rely on information or reports or decisions of a duly authorized committee of the board if his reliance is not in good faith or if he knows or should know such reliance is unwarranted. *Id.* at §§ 4.02-4.03.

63. *Stern v. Lucy Webb*, 381 F. Supp. at 1015-16.

64. *See* Phillips, *supra* note 40, at 203.

65. *Compare* REV. MODEL NONPROFIT CORP. ACT § 8.30 (Exposure Draft 1986) *with* REV. MODEL BUSINESS CORP. ACT § 8.30 (1984).

trust or business corporate norms.[66] In determining whether the standard of care for directors has been met, the Model Act considers different factors depending upon whether the directors are affiliated with business corporations or nonprofit corporations. Relevant factors in relation to nonprofits include the type and objective of the nonprofit.[67] By contrast, an examination of the public benefit nonprofit[68] concentrates upon the nature of the activity for which a decision must be made rather than the nature and objective of the organization. Unlike the Revised Model Act the "special circumstances"[69] relate not only to the type and objectives of the nonprofit but to the special qualifications of the individual director and the role he plays in the organization.[70] The commentary seems to suggest that directors cannot be figureheads. However, in determining the standard of care against which directors' conduct should be measured, the courts have considered that most directors are uncompensated for their work. This approach will lead to a watering down of even the corporate standard. There could also be the possibility of differing, individualized standards on a particular board. The result of the Model Act's approach may be a "Gresham's Law"[71] of the fiduciary duty — that board members will be charged with the lowest standard of care of any particular member.

G. *Problems with Applying the Corporate Standard to Nonprofits*

In a business corporation, particularly in a public company, directors have a greater sense of shared expectations as to their responsibilities.[72] Corporate culture offers directors standard

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66. MODEL NONPROFIT CORP. ACT, *supra* note 52 § 8.30 commentary at 8-52.

67. *Id.* at 8.52-8.53.

68. *See infra* note 251.

69. MODEL NONPROFIT CORP. ACT, *supra* note 52, § 8.30 commentary at 8-55.

70. *Id.*

71. Gresham's Law is named for Sir Thomas Gresham (1519-1579), a financier and financial agent of the Crown. Gresham's Law states that in a bimetallic currency (e.g., gold and silver as backing for the pound or dollar) the cheaper metal will drive out the dearer because the dearer metal will be hoarded allowing the cheaper to circulate more freely. The law, as more commonly expressed, is: "bad money drives out good."

72. In the close corporation, directors often do not observe corporate formalities but these directors, who are usually shareholders and employees of the corporation, have a fiduciary duty to each other similar to partners. *See* Donohue v. Rodd Electrotype Co. of

patterns of behavior. Unlike many nonprofits, particularly smaller organizations, directors of business corporations are more likely to be affiliated with a similar institution, to be experienced in monitoring those who carry out the corporation's business, and to be knowledgeable about effective management.[73] Not only do directors have similar experiences with other institutions, but there is also more information relating to norms of directorial behavior.[74] Particularly in the public corporation, there may be reporting requirements which serve to inculcate standard methods of operation, regulatory agencies to monitor corporate behavior and, finally, unlike in much of the nonprofit world, an abundant supply of legal counsel.

Perhaps the most important constraint on directors of business corporations is market regulation. The securities, consumer, and occupational markets serve to place deterrents on directors' and management's behavior.[75] Thus, if a director has been remiss or management has performed poorly, the market price for the corporation's securities will drop as investors move on to other companies. The corporation may have difficulty raising capital. Job prospects and compensation of senior management will be adversely affected. Thus, market constraints act to externally enforce fiduciary limits.[76]

Market constraints are less efficient in the nonprofit area. There are no shareholders who could switch to other investments. Consumer demand may not correlate to quality. Patrons

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New England, 367 Mass. 578, 328 N.E.2d 505 (1975).

73. *See* Frankel, *supra* note 13, at 708-09.

74. Publications such as *The Corporate Director's Guidebook*, 33 Bus. Law. 1591 (1978), and the A.L.I. Principles of Corporate Governance, guide business directors in performing their responsibilities.

75. This analysis is termed "agency theory," which assumes that managers are deterred from misconduct by the impact of external markets which serve to informally regulate such behavior. Agency theory assumes that conduct by managers beneficial to the corporation will be reflected in the cost of the company's securities in the marketplace. This theory further assumes that the markets will be able to detect managerial abuses. *See* Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 Stan. L. Rev. 819, 836-42 (1981). The literature, which is vast, begins with Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. Fin. Econ. 305 (1976); and Fama, *Agency Problems and the Theory of the Firm*, 88 J. Pol. Econ. 288 (1980).

76. Cox, *Compensation, Deterrence, and the Market as Boundaries for Derivative Suit Procedures*, 52 Geo. Wash. L. Rev. 745, 748 (1984).

may have neither the capacity, the interest, nor the power under nonprofit corporate law to police the organization and its managers. Professor Hansmann has argued that "[s]uch weakness in the mechanisms available for policing the managers of nonprofits, and especially in the mechanisms directly available to patrons, argues for a stronger, clearer rule of fiduciary conduct for the managers of nonprofit corporations than for the managers of business corporations."[77]

The nonprofit board is more varied than the business corporate board.[78] Directors on the nonprofit board may have had no previous financial or business experience, and in some areas such as the arts and humanities, neither may senior inside management. Financial and business experience may not correlate with nonprofit experience. For instance, many nonprofit performing arts organizations lose more money when they perform with a full house than when they are closed. They may have balance sheets that would cause the directors of the business corporation to declare bankruptcy. Many nonprofits are underrepresented by counsel. With a few exceptions,[79] guidance may not be available.

Many nonprofits are non-membership corporations, so that shareholder equivalents — members — are unavailable to protect the corporation's interests. The charitable corporation is also not as closely regulated or monitored by public agencies as the public business corporation.[80] Many charitable organizations are dominated by one individual who is the *raison d'etre* for the corporation's existence. In such situations it is easy for the board to become passive. The lack of even marginal supervision by the board as shown in the *Sibley Hospital* case is not unique.[81] An inconsistently and infrequently applied corporate

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77. Hansmann, *supra* note 2, at 568-69.

78. The common business, professional, social and economic background of business corporate directors has been well documented. *See* Brudney, *The Independent Director — Heavenly City or Potemkin Village*, 95 HARV. L. REV. 597, 612-13 & nn.43-45 (1982); McAlmon, *The Corporate Boardroom: A Closed Circle*, BUS. & SOC'Y REV., Winter, 1974-75, at 65; Solomon, *Restructuring the Corporate Board of Directors: Fond Hope — Faint Promise?*, 76 MICH. L. REV. 581, 584-86 (1978).

79. *See* A. ULLBERG with P. ULLBERG, MUSEUM TRUSTEESHIP (1981).

80. *Stern v. Lucy Webb*, 381 F. Supp. at 1019; Abrams, *Regulating Charity — The State's Role*, 35 REC. A.B. CITY N.Y. 481, 484 (1980).

81. Another example of lack of even marginal supervision involved the Maryhill Museum which is located 110 miles east of Portland, Oregon. When the museum was

standard of care will not energize the passive board.

H. *Advocacy of a Lower Standard*

There are some who feel that even the corporate standard of care is too high. A persistent minority view maintains that because of the voluntary nature of a director's service on a nonprofit corporation board, the standard of care should be lower than the trust or even the corporate standard. *George Pepperdine Foundation v. Pepperdine*[82] reflects this attitude.

In *Pepperdine*, a California nonprofit corporation, known as the Pepperdine Foundation, sued Mr. Pepperdine who was the founder and a director, his wife, and former directors to recover over three million dollars allegedly wasted in speculation and mismanagement over an eleven-year period. The district court of appeals was outraged at the plaintiff's attempt to make Mr. Pepperdine account for money that he had originally contributed:

> Assuming that the alleged losses were due to the alleged egregious blunders of the board under the leadership of President Pepperdine, and to 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?[83]

Though the case has been criticized[84] and overruled,[85] the ap-

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organized, the board hired a relative of a trustee, a carpenter, to be the director. He served for 35 years and was succeeded by his son, a gardener. The trustees met at most once each year. The director treated the museum like a trading post — items were sold, given away, and exchanged without regard to value or authenticity. The remaining collection deteriorated in condition. When the trustees were confronted with the misdealings, they initially did nothing. Then they hired a director, who was professionally unqualified and a former trader with the museum, but who nevertheless began to straighten things out. He was suddenly fired by the board, and his secretary hired as director. At that point, the Attorney General of the State of Washington stepped in and after several months, the board was eased out. The Maryhill situation is described in Failing, *The Maryhill Museum: A Case History of Cultural Abuse*, ART NEWS, Mar. 1977, at 83. *See also* Merryman, *Are Museum Trustees and the Law Out of Step*, ART NEWS, Nov. 1975, at 24, *reprinted in* 2 J. MERRYMAN & A. ELSEN, *supra* note 25, at 7-68.

82. 126 Cal. App. 2d 154, 271 P.2d 600 (1954), *reh'g denied*, 126 Cal. App. 2d 164.

83. *Id.* at 159, 271 P.2d at 604. *See also* Taylor, *A New Chapter in the New York Law of Charitable Corporations*, 25 CORNELL L. REV. 382, 398 (1940).

84. Karst, *The Efficiency of the Charitable Dollar: An Unfulfilled State Responsibility*, 73 HARV. L. REV. 433, 444-45 (1960).

85. Holt v. College of Osteopathic Physicians & Surgeons, 61 Cal. 2d 750, 757, 394

proach of the *Pepperdine* court reflects a widespread, albeit covert, attitude held today that directors of nonprofit organizations are devoting their time voluntarily and that overly aggressive attempts to enforce their reponsibilities are unfair to public spirited, prominent individuals.[86] High standards, it is feared, will lead to the flight of the most competent board members.

In recent years, several jurisdictions have lowered the standard of care of nonprofit directors or made it impossible for third parties to sue the board.[87] This legislation was spurred by the staggering liability of the directors in *Smith v. Van Gorkum*[88] and by the difficulty of obtaining directors' and officers' liability insurance.[89] This concern has been transferred to the nonprofit sector where many organizations have neither the resources to indemnify directors as permitted by statute nor the financial capability to pay insurance premiums or self-insure.[90] Some jurisdictions have reacted to the insurance crisis of directors and officers of business corporations by expanding indemnification possibilities[91] or by allowing shareholders to amend the corporate charter to preclude monetary claims for breach of the duty of care.[92] In the nonprofit area, jurisdictions have diminished or eliminated directors' liabilities for duty of care viola-

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P.2d 932, 937, 40 Cal. Rptr. 244, 249 (1964). *See also* Lynch v. Redfield Found., 9 Cal. App. 3d 293, 88 Cal. Rptr. 861 (1970); Estate of Harvey, 36 Cal. Rptr. 788 (1964). In these cases a trust standard was applied. The *Pepperdine* rule was reversed again by CAL. CORP. CODE § 5230(b) (West Supp. 1987) which applies corporate standards of duty of care.

86. Interview with Daniel Kurtz, Esq., then Assistant Attorney General in Charge of the Trusts and Estates Bureau, New York State Law Department in New York City (August 1985).

87. *See* Kurtz, *supra* note 29, at 289.

88. 488 A.2d 858 (Del. 1985). After the decision, the case was settled by the payment of $23.5 million to the plaintiff class, of which $10 million was the limit of the insurance policy held by the corporation's directors. The balance was paid by the tender offeror. *See* Manning, *Reflections and Practical Tips on Life in the Boardroom After* Van Gorkom, 41 BUS. LAW 1 (1985) (Editor's note).

89. *See supra* note 29 and accompanying text.

90. *See* Kurtz, *supra* note 29, at 298.

91. *See* DEL. CODE ANN. tit. 8 § 145(b) (1986); N.Y. BUS. CORP. LAW §§ 722(c) & 723(a) (McKinney 1986 & Supp. 1987).

92. DEL. CODE ANN. tit. 8 § 102(b)(7) (1986).

tions where either the directors are uncompensated[93] or the legislature has required a finding of gross negligence.[94] Other jurisdictions, as part of comprehensive tort reform legislation, have conferred qualified immunity on directors.[95]

The reaction of these jurisdictions ignores the diversity of the nonprofit sector, the judicial history of duty of care violations, and the fact that gross negligence has generally been required for breaches of the duty of care. These statutes indicate a movement toward the lower standard of care which may lead to a general lessening of fiduciary responsibilities. Additional protection through expanded indemnification might be needed for some of the larger nonprofit boards — educational institutions or hospitals. The new legislation will only exacerbate the problems many nonprofits have in getting directors to actively direct.

The attitude that nonprofit directors should be free of liability for duty of care violations manifests itself in the paucity of enforcement efforts by state attorneys general, and by the fact that so few cases, when brought, reach trial.[96] Usually, these cases result in out-of-court settlements.[97] This may be a more

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93. 1986 Conn. Legis. Serv. P.A. 86-338, § 10 (West); MINN. STAT. ANN. § 317.201 (West Supp. 1987); 1986 N.J. Sess. Law Serv. ch. 13 (West) (officials, coaches and uncompensated volunteers for sports team not liable to player or participant); OHIO REV. CODE ANN. § 2305.38 (Anderson Supp. 1986); R.I. GEN. LAWS § 7-6-9 (1985); WASH. REV. CODE ANN. § 4.24.264 (West Supp. 1987).

94. N.Y. NOT-FOR-PROFIT CORP. LAW § 717 (McKinney 1970 & Supp. 1987); 1986 Conn. Legis. Serv. P.A. 86-338, § 10 (West).

95. 1986 Ill. Legis. Serv. P.A. 84-1431, art. 7 (West).

96. One case that did not reach trial was People *ex rel.* Scott v. George F. Harding Museum, 58 Ill. App. 3d 408, 374 N.E.2d 756 (1978), *rev'd sub nom.* People *ex rel.* Scott v. Silverstein, 86 Ill. App. 3d 605, 408 N.E.2d 243 (1980). There, the Illinois Attorney General alleged in a complaint against the George Harding Museum and five of its trustees, breaches of the trustees' duty of care. He sought removal of the trustees, appointment of a receiver, an inventory and accounting, and prohibition of further deaccessioning of the collection. The remedies all focused upon restoration of the museum to the purposes for which it was founded. There was no attempt to punish the trustees for their derelict behavior or to deprive the museum of its tax exempt status. The trustees were to return any money they had taken. The case is discussed in Weil, *supra* note 2, at 160-61.

97. *See* Lefkowitz v. Museum of American Indian-Heye Found., Stipulation File No. 41416/75 (Sup. Ct. N.Y. County Aug. 27, 1975), in L. DUBOFF, THE DESKBOOK OF ART LAW 887 (1977). For a description of this controversy, see Gerstenblith, *The Fiduciary Duties of Museum Trustees*, 8 ART & L. 175, 196-97 (1983). A dispute concerning allegations of self-dealing by a curator of the Brooklyn Museum was also settled. *See* Brenson, *Art People: Accord Ends Ethics Dispute*, N.Y. Times, March 18, 1983, at C17, col. 1.

efficient use of the limited resources of attorneys general, and it saves erring trustees from the public embarrassment of a trial. Yet, it offers little guidance to other directors of nonprofit organizations. The cases are not reported, and soon after the settlement is announced in the local press, the incident is forgotten. The *Pepperdine* attitude causes one of the larger difficulties in achieving effective supervision over charities. The scarcity of cases dealing with violators of the directors' standard of care illustrates the insufficiency of current duty of care standards. Effective duty of care provisions are central to the proper functioning of modern corporate governance.[98] Professor Myles Mace found that directors of business corporations often accepted a "nonquestioning, noninvolved role partly because they are not concerned about their legal liabilities as directors."[99]

In the nonprofit area, noninvolvement can become a problem for all boards for several reasons: 1) the belief that directors are providing a public service; 2) payment of fees for board service is rare; and 3) the lack of even minimal financial interest in the nonprofit corporation. If nothing else, explicit standards of care will provide a clearer guide for conduct and will sensitize board members not only to their responsibilities but to potential liabilities as well. Thus, the standard of care can best be perceived as a guideline or a level of expectation of a director's behavior. The corporate standard works well in the for-profit sector. The financial interests of shareholders, the efficiency of markets, governmental monitoring of corporate activity in public companies, an active plaintiff's bar, and internal mechanisms encourage compliance. Weaknesses in the mechanisms available for policing the managers of nonprofit corporations argue for a stronger, clearer rule of fiduciary conduct for the director of the nonprofit corporation than for the director of the business cor-

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The dispute involving the Maryhill Museum, *supra* note 50, was settled by the Washington State Attorney General without a lawsuit. The result was that there were neither actions taken against the erring trustees and directors nor was there any attempt to restore paintings to the collections. *See* Failing, *The Maryhill Museum: A Case History of Cultural Abuse*, *supra* note 81, at 90.

98. PRINCIPLES OF CORPORATE GOVERNANCE: RESTATEMENT AND RECOMMENDATIONS 128 (Tent. Draft No. 1, 1982).

99. Mace, *The President and the Board of Directors*, 50 HARV. BUS. REV. Mar.-Apr. 1972, at 37, 48. The same can be said about nonprofit boards.

poration.[100] Because self-enforcement mechanisms may be completely lacking in the nonprofit world, the corporate standard of the director's duty of care should not be applied in all situations.[101]

III. A Proposed Shifting Standard of Care

The duty of care should be a shifting standard depending upon the nature of the supervisory or managerial function involved. If the director's responsibility or function is ministerial or administrative,[102] involving the "housekeeping" functions of the corporation, for purposes of the legal context, his duty of care should be treated like that of the director of the business corporation. In those matters relating to the administration of the organization, the nonprofit director should be liable only for nonmanagement, intentional mismanagement, or for the grossest negligence. Nonprofit corporation law should offer broad protection to informed, deliberate business decisions in order to stimulate rational decisionmaking and creative activities. Board decisionmaking should not be chilled.

However, if a matter involves the corporation's charitable function or impacts upon its exempt purposes, a higher trust standard should apply, and the director should be liable for mere negligence. The higher standard should apply to matters of great importance to the future of the organization such as a merger, a dissolution, a change in the purposes for which the organization was formed, or a matter which is of import to the beneficiaries of the nonprofit corporation — the public. The higher standard of care should be applied in areas where the exempt purpose or the public will be affected.

Dual standards have occasionally been applied under business corporate law principles. At common law, the directors of banks and financial institutions had the duty of exercising a higher degree of care and skill than directors of ordinary corpo-

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100. Hansmann, *supra* note 2, at 568.

101. *See infra* note 111.

102. "By 'administration' we refer to the housekeeping of the corporation, the details of conducting its day-to-day operations and investing its funds." W. CARY & C. BRIGHT, *supra* note 8, at 19.

rations.[103] The rationale was that officers and directors of these institutions had responsibilities to the public for handling their deposits. A higher standard has been included legislatively in the case of trustees of ERISA pension funds.[104] Under the proposed Federal Securities Code, the standard of reasonableness for investigation or care in the filing of a registration statement is the trust law "prudent man" standard.[105]

A. *Applying the Dual Standard of Care*: Sibley Hospital

What standard would have been used in *Sibley Hospital* if the court had applied the shifting standard approach? A board should have an affirmative duty to ensure that a financial reporting system is in place and operating, and to be informed of board matters. The board of directors' budget oversight responsibilities are housekeeping functions which should be guided in most situations by business corporate practices and standards of management.[106] Thus, the court correctly applied the corporate standard for the breach of duty of care.[107]

According to additional facts in the opinion, Sibley Hospital was originally built on North Capitol Street in Washington to facilitate its work.[108] In the mid-1950's, the board decided to

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103. *See* Greenfield Sav. Bank v. Abercrombie, 211 Mass. 252, 255, 97 N.E. 897, 899 (1912) (the bank is designed to help the poorer members of society and directors have a higher responsibility). Under this view, banks relate to charitable organizations in that they have a public purpose. O'Connor v. First Nat'l Investors' Corp. of Virginia, 163 Va. 908, 927, 177 S.E. 852, 860 (1935). For a discussion and citation of cases, see W. CARY & M. EISENBERG, CORPORATIONS 523 (5th ed. unabr. 1980).

104. Employee Retirement Income Security Program, 29 U.S.C. § 1104(a)(1)(B) (1974). ("The fiduciary responsibility section, in essence, codifies and makes applicable to these fiduciaries certain principles developed in the evolution of the law of trusts."). S. REP. No. 127, 93d Cong., 2d Sess. 29, *reprinted in* 1974 U.S. CODE CONG. & ADMIN. NEWS 4838, 4865.

105. FEDERAL SECURITIES CODE § 1704(g) (1980).

106. A declaration of bankruptcy or the discontinuation of an organization's programs might be an exception to the use of the corporate standard. If the dissolution of the nonprofit is for mere financial reasons, the corporate standard should apply. The distribution of the nonprofit's assets upon dissolution should be governed by the trust standard.

107. Although the court did not distinguish between nonmanagement and mismanagement, *see supra* note 58, the Sibley Hospital directors would have been liable under a trust or corporate standard. Ray v. Homewood Hosp. Inc., 223 Minn. 440, 444, 27 N.W. 2d 409, 417 (1947); Lane v. Bogert, 116 N.J. Eq. 454, 174 A. 217 (1934).

108. Stern v. Lucy Webb Hayes Nat'l Training School for Deaconesses & Missiona-

move the hospital to a new location within the city. The new hospital was dedicated on June 17, 1962.[109] If the original purpose of locating the hospital on North Capitol Street had been to provide medical assistance to the poor, and if the move meant that this part of the city could no longer be serviced, then the trust standard should apply. If the directors decided to close Sibley Hospital so that the charitable corporation could focus upon training members of the Methodist faith to be deaconesses in the church, the decision should be also guided by the trust standard.

When a charitable organization's move to a different location has been challenged, courts have applied the corporate standard and given broad discretion to the board.[110] When a part of the public served by the organization will be affected in a substantial and foreseeable way by a board decision, directors should adhere to a trust standard which will encourage a considered decision. Normally, the "public" does not have standing to challenge the activities of a charity.[111] However, recognizing that the public may have a particular interest in the decisionmaking of a charitable corporation when that decision impacts upon the public, courts have granted broader standing for the public than traditional principles would allow.[112] For instance, in *Sibley*

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ries, 381 F. Supp. 1003, 1007 (D.D.C. 1974).

109. *Id.*

110. Paterson v. Paterson Gen. Hosp., 97 N.J. Super. 514, 235 A.2d 487 (1967); *cf.* Ames v. Attorney General, 332 Mass. 246, 124 N.E.2d 511 (1955).

111. The Attorney General is vested with the power to enforce charitable trusts and corporations. Persons having special interests in the performance of the charitable organizations can attain standing to sue. Generally, a private citizen has no standing to sue to enforce a charitable trust or the purposes of a charitable corporation merely on the ground that he believes he is within the class to be benefited and would receive charitable or other benefits from the operator of the organization. G.G. BOGERT & G.T. BOGERT, THE LAW OF TRUSTS AND TRUSTEES § 414 (rev. 2d ed. 1977); Wiegand v. Barnes Found., 374 Pa. 149, 97 A.2d 81 (1953).

112. *See* Fitzgerald v. Baxter State Park Auth., 385 A.2d 189 (Me. 1978) (Land was conveyed to the state in a deed of trust for a state park. The park authority and attorney general were sued to carry out purposes of the trust. Plaintiffs as Maine citizens and users of the park were given standing to sue.); Gordon v. Baltimore, 258 Md. 682, 267 A.2d 98 (1970) (taxpayer had standing to sue to prevent transfer by charitable corporation of its library to another corporation in order that City of Baltimore would support library); Jones v. Grant, 344 So. 2d 1210 (Ala. 1977) (faculty, staff, and students had standing to bring class action against president and board of directors for misuse of funds); Parsons v. Walker, 28 Ill. App. 3d 517, 328 N.E.2d 920 (1975) (citizens have

Hospital, a group of patients had standing to challenge the board's conduct.[113]

The trust standard should also be applied to decisions which drastically affect the exempt activities of the organization. Such decisions include a major change in the exempt activities of the organization, investments or activities which could jeopardize the charitable purpose, illegal activities or statutory violations, or the movement of the nonprofit into a new area of risk-taking.

Nonprofit organizations frequently develop new programs or goals which, because of limited resources, may affect old purposes. For example, a museum may decide to deaccession its coin collection to concentrate and strengthen other areas;[114] or it may desire to change its collection emphasis from modern art to

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standing to oppose deviation of gift of land made to state university for park); *Paterson*, 97 N.J. Super. 514, 235 A.2d 487 (residents of city and taxpayers had standing to sue to prevent move of hospital); Alco Gravure, Inc. v. Knapp Found., 64 N.Y.2d 458, 479 N.E.2d 752, 490 N.Y.S.2d 116 (1986) (employees of corporation in which founder of nonprofit corporations was involved had standing because of preference in distribution of nonprofit corporations' funds). *But see* Simon v. Eastern Ky. Welfare Rights Org., 426 U.S. 26 (1976) (indigents had no standing to maintain a class action against the Secretary of the Treasury and Internal Revenue Service to set aside a revenue ruling which provided that nonprofit hospitals that did not provide free or below cost services to the poor were still exempt from taxation).

113. Stern v. Lucy Webb Hayes Nat'l Training School for Deaconesses and Missionaries, 367 F. Supp. 536, 540 (D.D.C. 1973) (Hospital patients were certified as a class under Fed. R. Civ. P. 23(b)(2) for purposes of seeking injunctive relief and possibly an award of damages to be paid into hospital funds. Certification under Fed. R. Civ. P. 23(b)(3) which might entitle patients to personally receive monetary recovery was denied.). *But see* Christiansen v. National Sav. & Trust Co., 683 F.2d 520 (D.C. Cir. 1982) (subscribers of health plan did not have standing to enforce director's fiduciary duties).

Paterson is not analogous to the hypothetical situation of moving a hospital location. There, plaintiffs who were residents of the City of Paterson, New Jersey, sought to prevent the Paterson General Hospital from moving its site from center city to a tract 3-½ miles away. 97 N.J. Super. at 516, 235 A.2d at 488. The plaintiffs argued that this was a violation of a charitable trust (the hospital was a corporation) whose purpose was to maintain a public hospital in Paterson. *Id.*. The court granted standing to the plaintiffs, but held that it was within the powers of the directors to authorize the move. The court applied the corporate test. *Id.* at 527, 235 A.2d at 494.

114. This example is taken from the activities of the Metropolitan Museum of Art, which sold its coin collection at auction in November 1972 and April 1973. *See* METROPOLITAN MUSEUM OF ART, REPORT ON ART TRANSACTIONS, 1971-73 (1973), *reprinted in* 2 LAW, ETHICS & THE VISUAL ARTS, *supra* note 36, at 7-114 to 7-154. Compare the discussion of the transactions in Weintraub, *Museums Without Walls: Public Regulation of Deaccessioning and Disposal*, 1 ART & L. 1 (1975).

classical art;[115] or a public television station may decide to exchange its channel frequency for cash and a channel with a weaker signal. The station would invest the funds received but some viewers would lose access to public-television viewing because of the weaker signal.[116]

These types of decisions are within the powers of a nonprofit board but should be governed by the trust standard. When a charitable corporation makes a major decision of this sort, it is incumbent upon the board to exert an ongoing monitoring function. This means that a director will not be liable if the decision itself was wrong as long as the decision-making process was thorough. However, if the negligence of the director contributed to the error in the decision,[117] he should be held liable. In hindsight, the initial decision may be disastrous for the organization; but if the board made an informed decision and monitored the consequences of its decision, the board should be held blameless under the best judgment rule. The use of a trust standard would encourage a more deliberative approach to the initial decisionmaking.

In recent years, most nonprofit organizations have faced a difficult financial environment. To counter inflation and decreased sources of funding, nonprofits have moved into new areas of risk-taking and activities to increase earned income.[118] A significant distinction between nonprofit and business corporations involves the role of risk in management decisions. While innovation which always involves *some risk* is fundamental to

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115. This example is drawn from the controversy surrounding the Norton Simon Museum in Pasadena, California. *See* Rowan v. Pasadena Art, Case No. C322817 (Calif. Superior Court, County of Los Angeles, Sept. 22, 1981); Failing, *Is the Norton Simon Museum Mismanaged*, ART NEWS, Oct. 1980, at 136; Weaver, *A New Slant on Deaccessioning: The Norton Simon Case*, 6 ART & L. 51 (1981).

116. Smith, *WNET Studies a Cut in Its Signal to Gain Cash*, N.Y. Times, Mar. 18, 1985, at C17, col. 3; Smith, *Channel 13 Rejects VHF-Swap Idea*, N.Y. Times, June 14, 1985, at C30, col. 4.

117. Under the trust standard, the director will be held liable for mere negligence as opposed to the corporate standard where the director will be held liable for gross negligence.

118. Kurtz, *Non-Traditional Revenue Ventures of Tax Exempt Organizations: The Role of Trustees*, 39 REC. A.B. CITY N.Y. 129 (1984); Levitan, *Serving God & Mammon: Financing Alternatives for Nonprofit Cultural Enterprise*, 8 ART & L. 403 (1984); Note, *The Participation of Charities in Limited Partnerships*, 93 YALE L.J. 1355 (1984); Meyers, *The Nonprofits Drop the 'Non,'* N.Y. Times, Nov. 24, 1985, § 3, at 1, col. 2.

nonprofits, particularly those with creative purposes, risk is the *essential element* for profit-making entities. If a nonprofit is to undertake entrepreneurial risk, its board has a particular responsibility to be as informed as possible about the decision and to inquire about the activity's progress. A few organizations such as the Children's Television Workshop, which has licensed the Sesame Street characters, and the Public Theater of New York City, which has produced such Broadway hits as "A Chorus Line," have been very successful.

The rush of nonprofits into the marketplace, however, is a path filled with danger.[119] Several prominent nonprofit organizations have skirted financial disaster after inadvisable entries into nonprofit capitalism. The rationale for tax exempt status may have become strained.[120] When an organization involves itself in new activities, the board should proceed carefully and monitor the results of the decision particularly if there is a risk to the exempt purposes of the organization. The application of a trust standard would ensure diligent consideration and ongoing oversight.

B. *A Second Application of the Dual Standard of Care: The Case of National Public Radio*

National Public Radio (N.P.R.) is a national cooperative of 281 public radio stations with an audience of eight million. It features daily news and informational and cultural affairs programs. In 1983, the organization nearly went bankrupt. The financial crisis led to the forced resignation of its president and the executive vice president for finance. The chairman of the board of directors was ousted. The chairman of the finance committee of the board resigned his position although he remained a member of the board.[121]

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119. Kurtz, *supra* note 118, at 129-31. Even the Children's Television Workshop (C.T.W.), one of the most successful "commercial" nonprofits, earning 70% of its revenue from licensing and other ventures tied to Sesame Street, stumbled when it introduced computer software and a children's computer magazine just as the market for personal computers collapsed. The C.T.W. lost ten million dollars in this venture. Meyers, *The Nonprofits Drop the 'Non,'* N.Y. Times, Nov. 24, 1985, § 3, at 1, col. 4-5.

120. UNFAIR COMPETITION BY NONPROFIT ORGANIZATIONS, *supra* note 60, at 6.

121. The facts relating to National Public Radio's financial crisis have been taken from a series of articles in the New York Times on Mar. 15, 1983, § 3, at 14, col. 4; Apr.

Apparently, the board of directors did not realize until halfway into its fiscal year that N.P.R. was running a deficit of six million dollars, which eventually grew to a nine million dollar deficit — beyond its total annual budget of twenty-six million dollars.[122] The General Accounting Office concluded that the network's practices were sloppy and constituted mismanagement.[123] The causes of the near disaster included the introduction of new and supposedly profitable ventures that proved an unexpected drain on the organization;[124] an unrealistic budget; and the fact that no one knew the full extent of the debt.[125] Allegedly, because of a conversion to a new accounting system, the finance department did not provide monthly budget tracking. When the board was informed of the deficit in March of 1983, midway through the fiscal year, it had been unaware of any financial problems. N.P.R. had recently hired eighty-six new employees and had given all employees a six-percent wage increase.

There were several derelictions of board duty. The board failed to install an internal financial reporting system which

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20, 1983, § 3, at 27, col. 1; May 11, 1983, § 3, at 23, col. 1; June 22, 1983, § 4, at 20, col. 4; Aug. 26, 1983, § 4, at 19, col. 4; and in BROADCASTING, Apr. 25, 1983, at 76-77; May 2, 1983, at 77-78; June 27, 1983, at 35-38; July 4, 1983, at 78-79; Aug. 1, 1983, at 21; Feb. 6, 1984, at 150; Feb. 13, 1984, at 82.

122. The news of the budget crisis was announced at a Public Radio Conference on April 17, 1983. Attendees expected to hear of budget cuts, but few were braced for a deficit of three million dollars. N.P.R. maintained that the deficit was "discovered" in the first week of April, though no formal announcement was made at the Conference. BROADCASTING, Apr. 25, 1983, at 76.

123. N.Y. Times, Feb. 11, 1984, at 54, col. 6.

124. Contributions to N.P.R. had been overestimated and its technological business subsidiary, NPR Ventures, was slow in starting. NPR Ventures hoped to lease FM band subcarrier channels for all sorts of commercial sources, for instance, to establish a nationwide paging system or the transmission of digital data information. The venture was dependent upon the Federal Communications Commission deregulating FM subcarrier channels. This did not occur until Apr. 11, 1983. BROADCASTING, Apr. 11, 1983, at 35; *Id.*, Apr. 25, 1983, at 76.

125. The debt grew to 9.1 million dollars. There were inadequate financial controls combined with inadequate accounting systems and a lack of experienced venture management. The board was not advised of the financial situation. *Id.*, June 27, 1983, at 35-38. The General Accounting Office accused N.P.R. of 1) informal financial management which allowed budget deficits to grow without detection; 2) poor decisionmaking which resulted in their beginning a six-year program to raise funds through outside commercial ventures when the network's finances were not solid; and 3) inadequate supervision of employees, marked by such things as extravagant distribution of credit cards. N.Y. Times, Feb. 11, 1984, at 54, col. 6.

would have kept it apprised of the organization's financial situation. This board responsibility may be more important for the nonprofit corporation than for its business counterpart, for few nonprofits, save private foundations, have the financial reserves to cover disastrous financial mistakes. The budget is a most important agenda item for every nonprofit board. However, the approval of an unrealistic budget could have been caused by reliance on officers, directors, or a board committee.

When N.P.R. decided to test its entrepreneurial skills, the board initially had a responsibility to be informed about the decision and then had an ongoing responsibility to inquire about the progress of the venture. A board cannot sit back after a decision has been made without installing information systems to keep it abreast of developments. The duty to monitor the general finances of N.P.R. should be guided by the corporate standard. If the board could reasonably rely upon the corporate officers' financial reports, the directors should not be held liable.[126] If the allegations of complete board lack of awareness of N.P.R.'s finances are true, then the directors of N.P.R. breached their duty of care under any standard because of nonmanagement.

When N.P.R.'s new ventures were considered, the duty of care surrounding those decisions should have been based upon a trust standard. Under the trust standard, the board would be liable for mere negligence. If the N.P.R. board had been knowledgeable about the trust standard and not guilty of nonmanagment, it would have proceeded more carefully in approving the venture and would have observed the progress of the project more closely. If an organization moves into new areas that might jeopardize its existing charitable purposes, the board must remain informed, so that a decision, if necessary, to terminate the new project to protect the organization will be timely.[127]

126. Draft No. 4, *supra* note 30, § 4.02.

127. WNET, a public television station in New York, created *Dial*, a television magazine and program guide. The start-up costs were defrayed through a grant from the John Ben Snow Foundation. Despite a successful initial issue, the magazine became a heavy financial drain, threatening the financial solvency of the New York public television channel. The premise behind *Dial* was that public television's highly affluent audience would attract advertising. As a nonprofit organization, WNET would have lower postage costs which would assist in turning a profit. The financial, advertising, and reve-

The board may have acted improperly under the trust standard and yet escape liablity under the best judgment rule. But, it cannot make a decision that foreseeably could have great consequences to the organization, ignore the progress of the organization resulting from the decision, and then claim the best judgment rule. In the National Public Radio situation, the board had an affirmative responsibility to monitor the progress of its new ventures. Whether it reasonably and rationally could rely upon senior management and the board's chairman of the finance committee is a key question.[128]

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nue projections were wrong. A magazine consultant brought in to analyze the magazine's problems said, "It was a disaster from the beginning." *See* Bedell, *Channel 13, in Fund Squeeze, Halts Series and Weighs Cuts*, N.Y. Times, Nov. 24, 1982, at A1, col. 1. The poor planning combined with other financial problems led to the worst financial crisis in the station's history. Over 3.7 million dollars in general funds had to be diverted to *Dial*. Other financial problems included: a $1.2 million expenditure in another "profit potential" venture, a money-losing tape duplication facility; commitment to specific programs before full financial backing; and increased interest costs because of bank loans. *Id.* In this case the issue was whether the Board of WNET exercised due care in approving the establishment of the magazine, a notably risky enterprise in any situation. According to the Magazine Publishers Association, nine out of ten new magazines fail within eighteen months of their first issue. Salmans, *Health Magazine is in Fine Shape*, N.Y. Times, Dec. 14, 1983, at D1, col. 4. Furthermore, given WNET's already difficult financial position, the risk in establishing periodicals in this country, and the unwillingness of other public television stations to continue in what was to be a cooperative enterprise, the critical questions became whether the Board of WNET exercised due care in approving the estabishment of the venture, including whether it sought appropriate outside advice.

The magazine lost six million dollars over two years. Did the Board monitor the development of the magazine? Initially, the Board agreed to allow the publishers of *Oui*, an erotic magazine, to take over the distribution, printing and sale of the magazine. Smith, *Oui Magazine Agrees to Takeover the Dial for Channel 13*, N.Y. Times, Mar. 12, 1983, at 48, col. 1. This rescue eventually unraveled. Bedell, *Channel 13 Rescue Attempt Said to Unravel*, N.Y. Times, Mar. 24, 1983, § 3, at 31, col. 2.

The establishment of *Dial* also provoked several lawsuits from the publisher of several for profit magazines and newspapers challenging its tax exempt status. The risk of litigation can always be present, but if successful, *Dial* could have been an investment jeopardizing WNET's exempt purposes. *Cf.* Treas. Reg. § 53.4944(2) (1984). The litigation is discussed in Kelly, *Dial's Dilemma: With Privilege Come Lawsuits*, AM. LAW, Oct. 1980, at 15-17. Perhaps a trust standard would have forced the Board to make a more deliberative decision. One result of the *Dial* fiasco was that the Board began to exert a measure of restraint on WNET's operations and revised its operational structure, diminishing its role as the principal supplier of programming to the Public Broadcasting System. *See* Boyer, *Iselin of Channel 13 Quits After 15 Years at the Public Station*, N.Y. Times, Oct. 16, 1986, at A1, col. 1.

128. Published reports suggest that the N.P.R. Board was completely unaware of developments. BROADCASTING, June 27, 1983, at 35, 36.

The price for board neglect is high.[129] National Public Radio was saved but its cultural affairs programs were curtailed, its budget was decreased to seventeen million dollars, and its staff sharply reduced. Furthermore, the Corporation for Public Broadcasting, which had arranged a package of loans, set conditions upon the network that critics said might interfere with its independence.

IV. The Duty of Loyalty

A director owes a duty of loyalty to the corporation on whose board he serves. This duty requires him to act in a manner that does not harm the corporation; it further requires him to avoid using his position to obtain improperly a benefit for himself or an advantage which might more properly belong to the corporation. The fact that the transaction is interested[130] is less significant than whether it was fair to the corporation at the time the decision was made and whether the decision was reached in an impartial board environment. The duty of loyalty requires that a director place the interests of the corporation ahead of his personal gain. A director is expected to make decisions objectively, to refrain from participation, and to obtain approval from the corporation where there is a relationship which impairs the director's objectivity.[131] In a conflict of interest situation, the director receives returns more favorable to himself than he would gain in an open market or gives himself a priority over open market competitors.[132]

A. *The Problem of Self-Dealing in the Nonprofit World*

Conflicts of interest, divided loyalties, and transactions among directors, officers, and nonprofit corporations abound in the nonprofit sector. Breaches of loyalty are not only much eas-

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129. *See supra* notes 121-27 and accompanying text. Unfortunately, the recent statutory trends reducing nonprofit directors' liabilities will only exacerbate problems of board neglect.

130. *See* R. Clark, Corporate Law § 4-1, at 147 (1986) for definition of interested transaction.

131. A.L.I., Principles of Corporate Governance: American Law Institute, Analysis and Recommendations 16-17 (Tent. Draft No. 5) [hereinafter Draft No. 5].

132. *See* Scott, *supra* note 3, at 935-36.

ier to identify than breaches of care, they are much more prevalent. Patterns of interested transactions parallel business corporate practices. In many situations, interested transactions are a healthy necessity. They may provide access to resources unavailable from the marketplace. The financial status of the nonprofit organization may be so poor that market sources of credit, supplies, or services are unattainable. A loan of money, goods, or services may be obtainable only from a director, an individual concerned with the organization's welfare. In other situations the interested transaction may be unethical or illegal and, therefore, violate the director's duty of loyalty to the corporation and to the public.

In analyzing conflicts of interest, it is necessary to focus upon both the procedural aspects of the transaction and upon its substantive nature. The procedural aspects of the transaction relate to the process by which the transaction is approved for the corporation by the board of directors. The procedural inquiries include whether corporate procedures for interested transactions have been established and whether they were followed in the particular transaction; whether the board environment was impartial and objective at the time the decision was made; whether the information relating to the transaction was fully disclosed by the interested director to the relevant decisionmakers; and whether the interest of the director was disclosed to the relevant decisionmakers. Substantive factors in conflict of interest transactions involve the fairness of the transaction to the corporation in terms of what the corporation received, the frequency of interested transactions between directors and the organization, and the overall financial status of the organization in relation to the transaction.

Whether an interested transaction should be permitted or not depends greatly on its facts and circumstances and the director's motivations for entering the transaction. A type of transaction which may be perfectly proper in one context may be inappropriate under slightly different circumstances. For example, nonprofit organizations have been formed as successors to proprietary corporations, typically schools, hospitals, and nursing homes. The shareholder directors of the proprietary organization become the directors of the nonprofit corporation. If the successor organization pays the proprietary organization a

fair rental value for its property or reasonable compensation for the proprietary's assets, the interested transaction should be permitted. If the nonprofit successor serves the directors' own interests, assumes for-profit liabilities in a bailout context, or overpays the rental costs or purchases the assets at an inflated price, the transaction is impermissible self-dealing.[133]

B. *Patterns of Impermissible Interested Transactions*

The scope of impermissible interested transactions — conflicts of interest — is limited only by human ingenuity. Several common patterns of self-dealing abuses occur in the nonprofit world.[134] There are few reported cases. While nonprofit self-dealing is a violation of the Internal Revenue Code, the focus of the Internal Revenue Service's enforcement efforts is upon lost revenue to the Treasury rather than upon directors' standards of conduct and violations of corporate principles.[135]

1. *The Dominant Director*

The primary cause of improper self-dealing in the nonprofit sector is the dominance of a director over an organization and its board. The dominant director causes the organization to serve his interests rather than those of the public, thereby violating the prohibition against private inurement.[136] The dominant director may use the charitable corporation as a vehicle for his personal investment activities. The organization may be a shelter to avoid taxation, and its exempt activities may reward the director, his family, or other business interests.[137]

Dominance by a director frequently occurs in the smaller

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133. *Cf.* Rev. Rul. 76-441, 1976-2 C.B. 147; B. HOPKINS, THE LAW OF TAX-EXEMPT ORGANIZATIONS 217-18 (4th ed. 1983).

134. The categories discussed are not intended to be mutually exclusive. There is substantial overlapping. Most of the examples cited in this section are drawn from violations of the Internal Revenue Service's prohibitions against private inurement. *See* Treas. Reg. §§ 1.501(c)(3)-1(d)(1)(ii), 1.501(c)(3)-1(c)(2) (1986).

135. Blumenfield v. United States, 306 F.2d 892, 900 (8th Cir. 1962) ("The primary purpose of the revenue statutes is to obtain revenue.").

136. Ginsberg v. Commissioner, 46 T.C. 47 (1966); Rev. Rul. 76-206, 1976-1 C.B. 154; Treas. Reg. 1.501(c)(3)-1(d)(1)(ii) (1986).

137. *See infra* notes 143-60 and accompanying text. *See* Macaluso v. Jenkins, 95 Ill. App. 3d 461, 420 N.E.2d 251 (1981).

nonprofit where the board's procedures or lack thereof resemble the close business corporation in its informality.[138] It may also occur in the larger nonprofit corporation.[139] Directorial dominance may be difficult to detect. The interested transaction may meet corporate procedural requirements. The dominant director might not vote on the transaction or even attend the board meeting.

At common law, interested transactions involving a dominant director could be voided even though the director did not participate in the approval of the transaction.[140] A director has an affirmative duty to discuss and inform the board of the fairness of the transaction.[141]

2. *Insider Advantages and Insider Profits*

The Internal Revenue Code's statutory prohibition against private inurement[142] contemplates the type of transaction between a tax exempt organization and an individual who is an "insider." An insider is a director or senior manager of a corporation who is able to direct the allocation of the organization's

138. There is no single generally accepted definition of close corporation. The term is used to emphasize an integration of ownership and management in which the shareholders occupy management positions. There is no established market for the corporation's stock. The close corporation is more functionally related to a partnership than to a corporation. *See* CARY & EISENBERG, *supra* note 103, at 377; 1 F. O'NEAL, CLOSE CORPORATIONS §§ 1.02, 1.07 (1971). For a case applying close corporation principles to a charitable corporation, see American Center Educ., Inc. v. Cavnar, 80 Cal. App. 3d 476, 145 Cal. Rptr. 736 (Cal. Ct. App. 1978).

139. In 1969, William Paley, President of the Board of Trustees of the Museum of Modern Art, preemptorily dismissed the Director of the museum without a meeting of the Board. Only one trustee protested that action. The objection was to no avail. The protesting trustee had been the personal attorney of the Board President for forty years and his law firm represented CBS. Both the trustee and his law firm lost their clients. *See* 2 LAW, ETHICS AND THE VISUAL ARTS, *supra* note 25, at 7-75 to 7-79.

Many of the examples in this section are taken from the museum world. The author does not mean to suggest that museum boards are more venal or that museums are more poorly run than other nonprofit activities. The reverse may be true. Because of the public's interest in the arts, abuses which lie undetected in other nonprofit sectors have been uncovered through the efforts of the press.

140. Globe Woolen Co. v. Utica Gas & Elec. Co., 224 N.Y. 483, 489, 121 N.E. 378, 379-80 (1918) ("A dominating influence may be exerted in other ways than by a vote.").

141. *Id.* at 492, 121 N.E. at 381. *See* Draft No. 5, *supra* note 131, § 5.02(a)(1) commentary, at 30.

142. *See supra* note 136.

assets for private purposes as the result of his exercise of control or influence.[143] The improper use of corporate assets, property, or information occurs when the organization's interests are sacrificed to the private interests of the director.

Insider advantages range from the common and justified practice of offering directors priority in participating in the organization's activities[144] to board members' appropriation of products or assets in situations where the public has no comparable option and the corporation is harmed.[145] At their worst, insider activities involve a waste of corporate assets.[146]

3. *Private Inurement — Payment of Excessive Compensation*

A director or officer may not acquire an organization's resources beyond reasonable compensation for goods and services because of the prohibition against private inurement.[147] Directors have used the nonprofit format to further private investment goals or to receive an organization's surplus or profit. Improper insider advantage may occur where the directors provide themselves with excessive salaries,[148] benefits which serve a busi-

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143. HOPKINS, *supra* note 133, at 211.

144. Directors may get first preference for selection of seats at a performing arts organization's activity or preview. This is proper and may be seen as a form of reasonable compensation for board service. The appropriate corporate law approach would be for the board to establish policies and procedures for such insider benefits. Draft No. 5, *supra* note 131, § 5.06(b), at 126-34.

145. There have been several allegations of insider advantage and insider disabling conflicts of interest between trustees of museums and the collections they hold in trust. *See* Merryman, *Are Trustees and the Law Out of Step?*, ART NEWS 24 (Nov. 1975), *reprinted in* 2 LAW, ETHICS AND THE VISUAL ARTS, *supra* note 25, at 7-68. At the Museum of the American Indian in New York City, which houses the world's largest collection of American Indian art and artifacts, the Director permitted members of the Board of Directors to purchase items directly from the collection. *See The Museum of the American Indian*, 2 LAW, ETHICS AND THE VISUAL ARTS, *supra* note 25, at 7-161.

146. At a time when the Harding Museum in Chicago ran annual deficits of $200,000, the Board voted itself salaries amounting to $100,000 per year and sold items from the collection to support such munificence. People *ex rel.* Scott v. Silverstein, 86 Ill. App. 3d 605, 408 N.E.2d 243 (1980).

147. I.R.C. § 4941(d)(2)(E) (1987); HOPKINS, *supra* note 133, at 218.

148. Founding Church of Scientology v. United States, 412 F.2d 1197 (Ct. Cl. 1969), *cert. denied*, 397 U.S. 1009 (1970) (church founder paid commissions and royalties in addition to salary; family received loans and percentage of gross income).

ness purpose or are excessive,[149] compensation on a percentage basis,[150] distribution of organization earnings in the guise of salary payments,[151] or awards of corporate assets.[152] A determination of whether compensation is appropriate or excessive or whether it is an attempt to divert the nonprofit's assets are questions of fact regarding the nature and purposes of the organization.[153]

4. *Sale, Exchange, or Lease of Real Property Between the Organization and a Director or Officer — Furnishing of Goods and Services*

Inappropriate interested transactions have arisen where property, goods, or services are exchanged between the director and the organization for the personal benefit of the director in an amount unfair to the corporation compared to prevailing market conditions. The director or senior executive should not use his position to obtain corporate property in a manner which allows him to secure a benefit at a rate less than the fair market value unless the corporation has, prior to the action, established procedures to justify such usage.[154]

Improper interested transactions have arisen where a school paid excessive rents to its landlords who were also officers of the school. The officers caused the school to erect expensive improvements which would benefit them individually when the lease expired.[155] A common situation involving hospitals,[156] nurs-

149. Horace Heidt Found. v. United States, 170 F. Supp. 634 (Ct. Cl. 1959) (Educational and medical expenses of young performers were paid by the founder who was in show business. Expenditures were a form of compensation and furthered business interests of founder of charitable organization.).

150. *Founding Church of Scientology*, 412 F.2d 1197; Gemological Inst. of America v. Commissioner, 17 T.C. 1604 (1952), *aff'd per curiam*, 212 F.2d 205 (9th Cir. 1954). *But see* Rev. Rul. 69-383, 1969-2 C.B. 113.

151. Birmingham Business College, Inc. v. Commissioner, 276 F.2d 476 (5th Cir. 1960).

152. *See* 2 LAW, ETHICS AND THE VISUAL ARTS, *supra* note 25, at 7-161 to 7-166.

153. B. HOPKINS, *supra* note 133, at 218. Wages in absolute dollar amount, rather than the percentage of gross receipts, have been the guide.

154. Draft No. 5, *supra* note 131, § 5.04(a)(2), at 67-68, 95-96.

155. Texas Trade School v. Commissioner, 30 T.C. 642 (1958), *aff'd*, 272 F.2d 168 (5th Cir. 1969).

156. *See* Sonora Community Hosp. v. Commissioner, 46 T.C. 519 (1966), *aff'd*, 397 F.2d 814 (9th Cir. 1968).

ing homes,[157] and educational institutions[158] exists when a nonprofit organization is founded to be the successor to a proprietary institution. Shareholders and directors of the proprietary institution and directors of the charitable organization are the same. In these situations, the permissibility of the interested transaction depends upon whether fair value was given, whether the charitable organization was serving the directors' and former shareholders' private interests, whether similarly situated individuals, such as a doctor in a hospital setting, have equal but not greater access to the nonprofit's facilities,[159] and whether the sale was an arms-length transaction or a device for the property owners to escape losses or to benefit personally from tax exempt status.[160] The problem in this area is one of proof. The crucial inquiry is whether the director was acting privately in his own interest at the expense of the charitable corporation or the public.

5. *Indirect Interested Transactions*

Some improper interested transactions may be indirect in that the transaction may do no harm to the charitable corporation, but may benefit a director's private needs. For example, an exempt organization may purchase real or personal property from a director at a fair price but may do so only to provide needed funds to the director who cannot find another purchaser. Or, a director may lease property to a charitable corporation at a fair price, but the director may need advance leases in order to secure financing for construction or acquisition of the property and the charity either does not need, or has, an alternative source for the transaction.[161]

The exempt organization may also serve private investment needs when a director attempts to transfer business or individ-

157. M. Mendelson, Tender Loving Greed 197, 200, 203 (1975).

158. *See Texas Trade School*, 30 T.C. at 642.

159. Rev. Rul. 76-441, 1976-2 C.B. 147.

160. Harding Hosp., Inc. v. United States, 505 F.2d 1068 (6th Cir. 1974).

161. Staff of Joint Comm. on Internal Revenue Taxation, 91st Cong., 2d Sess., General Explanation of the Tax Reform Act of 1969 30-31 (Comm. Print 1970). Indirect self-dealing usually concerns a self-dealing transaction between a "disqualified person" and an organization controlled by a private foundation. *See* Treas. Reg. § 53.4941(d)(1)(a)(6) (1986); B. Hopkins, *supra* note 133, at 440-43.

ual assets to a controlled nonprofit corporation so as to avoid taxes.[162] A charitable entity might invest in a transaction without loss or even with benefit, but the primary objective of the transaction is to benefit the private interests of a director.[163] Enforcement of corporate law violations in such situations is extremely difficult absent a derivative suit by a director, which is rare. Such transactions are likely to occur in a nonprofit with a dominant director.

6. *Improper Use or Waste of Corporate Assets, Property, Goodwill and Information*

Some insider transactions are benign and cause no harm to the organization though they are a breach of the director's fiduciary duties;[164] others may result in a harmful waste of corporate assets or of goodwill. The latter may occur where a director or senior officer receives 1) an inappropriate pecuniary benefit such as the rental of office or storage space at a below-market rate; 2) preferential treatment compared to other members of the community;[165] 3) gifts which harm the charitable corporation;[166] or 4) the use of non-public information for his own advantage.

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162. Rev. Rul. 69-266, 1969-1 C.B. 151.

163. *See* Leon A. Beeghly Fund v. Commissioner, 35 T.C. 490 (1960), *aff'd*, 310 F.2d 756 (6th Cir. 1962) (The foundation's exempt status was revoked even though the foundation suffered no financial loss from a transaction with related interests. The foundation's primary purpose in entering the transaction was to benefit shareholders of a business corporation.). Rev. Rul. 67-5, 1967-1 C.B. 123.

164. *See supra* note 161.

165. Harding Hosp., Inc. v. United States, 505 F.2d 1068 (6th Cir. 1974) (preferential lease for office space). Since 1966, the Metropolitan Museum of Art provided a storage conclave for nearly 10,000 Chinese works for private collector, Dr. Arthur Sackler. Metropolitan Museum officials expected to receive assurances that were never forthcoming that the museum would eventually receive a substantial part of the collection. Most of the collection was promised to the Smithsonian. Dr. Sackler's conduct was also scrutinized when he was sued by the Museum of the American Indian. His wife was a museum trustee and Dr. Sackler was provided with storage space there. He was charged with allowing surreptitious and wasteful exchange transactions of objects from its collections. The museum had no record of payment from Dr. Sackler of objects obtained from the museum by him. The complaint was dropped after the Attorney General found that the money raised by Dr. Sackler for the museum was more than the value of the objects obtained. Glueck, *An Art Collection Sows Largesse and Controversy*, N.Y. Times, June 5, 1983, § 2, at 1, col. 1.

166. *See* J. MERRYMAN & A. ELSON, *supra* note 25, at 7-161 to 7-166. For a discussion of the Maryhill Museum situation, see *supra* note 81.

Perhaps the most unconscionable form of self-dealing involves loans by a charitable corporation to a director or officer. Twenty-eight states prohibit this practice.[167] There is little excuse for such loans.[168] In each of the foregoing examples of insider transactions the director has used his position to further his individual pecuniary interest in a manner that may cause foreseeable harm to the corporation.

7. *Corporate Opportunities — Competition with the Corporation*

An opportunity that could be advantageous to the corporation should be offered by a director or senior officer to the corporation before he takes it for himself.[169] If the opportunity is rejected by the corporation after fair consideration by the disinterested directors, then the director or officer is free to pursue the opportunity.[170] An example of corporate opportunity might be where a gallery owner, specializing in African art, sits on the board of a museum that concentrates in that area of collecting. A prominent collector may approach the gallery owner and inform him that she wishes to dispose of her whole collection. The gallery owner would be under a duty to inform the museum board of the opportunity to purchase the collection.[171]

167. The states which prohibit loans to directors of nonprofits are: ALA. CODE § 10-3A-45 (1986); ALASKA STAT. § 10.20.141 (1986); ARIZ. REV. STAT. ANN. § 10-1027 (1979); ARK. STAT. ANN. § 64-1909 (1963); COLO. REV. STAT. § 7-24-111 (1962); D.C. CODE ANN. § 29-528 (1981); HAW. REV. STAT. § 416-21 (1981); ILL. REV. STAT., ch. 32, para. 163a26 (1986); IND. CODE ANN. § 23-7-1.1-15 (Burns 1984); IOWA CODE § 504A.27 (1986); KY. REV. STAT. ANN. § 273.241 (Michie/Bobbs-Merrill 1986); ME. REV. STAT. ANN. tit. 13-B, § 712 (1977); MINN. STAT. § 317.18 (1987); MO. ANN. STAT. § 355.190 (Vernon 1953); MONT. CODE ANN. § 35-2-412 (1982); NEB. REV. STAT. § 21-1926 (1983); N.M. STAT. ANN. § 53-8-29 (1975); N.Y. NOT-FOR-PROFIT CORP. LAW § 716 (McKinney 1970 & Supp. 1987); N.C. GEN. STAT. § 55A-18 (1955); N.D. CENT. CODE § 10-24-27 (1959 & Supp. 1985); OR. REV. STAT. § 61.170 (1985); R.I. GEN. LAWS § 7-6-32 (1985); S.D. CODIFIED LAWS ANN. § 47-24-5 (1983); TEX. REV. CIV. STAT. ANN. art. 1396-2.25 (Vernon 1959); UTAH CODE ANN. § 16-6-43 (1963); VT. STAT. ANN. tit. 11, § 2374 (1984); WASH. REV. CODE § 24.03.140 (1967); W. VA. CODE § 31-1-145 (1982).

168. In certain situations they have been upheld after strict scrutiny by the Internal Revenue Service. Griswold v. Commissioner, 39 T.C. 620 (1962), *acq.* 1965-1 C.B. 4. *But see* Best Lock Corp. v. Commissioner, 31 T.C. 1217 (1959).

169. Draft No. 5, *supra* note 131, § 5.05, at 107-08.

170. *Id.* at 104.

171. This could be a very harsh rule, but the gallery owner might be entitled to a commission from the seller for advice.

Competing with the corporation is analogous to seizing corporate opportunities.[172] In the nonprofit area, this competition may include seeking similar funding sources or donations or competing to win contracts. In the gallery example above, competition with the corporation would exist if the gallery owner and the museum entered a bidding contest for the African art collection. Another example of corporate opportunity/competition would be if the lead dancer who is also the choreographer of a small dance company were to receive individual bookings or have a solo career of his own. If the dancer receives an offer to perform individually, he should take this opportunity on behalf of his company. However, if the opportunity which if taken individually will ultimately benefit the company has been disclosed to and authorized by the board, the dancer could take the individual booking.

8. *Interlocking Directorates*

An interlocking directorate occurs when a director serves on the boards of two corporations[173] which compete with one another. Directors commonly serve on the boards of similar nonprofit corporations. The difficulty of finding knowledgeable directors and the need to place affluent, interested people on boards may lead to overlapping of board memberships. A problem arises where the organizations' exempt purposes, programs, or sources of funding, are similar. For instance, most cultural organizations seek support from the National Endowment for the Arts. If the cultural institutions seek funds within the same division of the Endowment, the organizations are competing. The interlocking director may be placed in a situation where he cannot maintain a duty of loyalty to either organization.

V. The Law Relating to Interested Transactions

A. *The Trust Standard*

The rationale for the proscription against self-dealing is found in the injunction in the Scriptures — "a man cannot

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172. Draft No. 5, *supra* note 131, § 5.13, at 191.
173. BALLENTINE'S LAW DICTIONARY 650 (3d ed. 1969).

serve two masters."[174] The most fundamental responsibility of a trustee is the duty of loyalty.[175] It is imposed because of the fiduciary relationship which arises from the creation of the trust.[176] The trustee occupies a position to which the courts have fixed a strict and high standard of conduct whenever his personal interest comes or could come into conflict with his duty to the beneficiaries.[177]

A trustee breaches his duty of loyalty whenever he engages directly or indirectly in any sale, purchase, loan, or similar transaction between himself in his capacity as trustee and 1) himself as an individual or 2) a member of his family or 3) a corporation in which he has a significant interest.[178] Prohibited acts of self-dealing include retention of investments, personal use of trust property, competition with beneficiaries, acquisition of interests adverse to beneficiaries, and transactions between the trustee

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174. *Matthew*, 6:24 ("No man can serve two masters.' "). *See* Stone, *The Public Influence of the Bar*, 48 HARV. L. REV. 1, 8 (1934) ("I venture to assert that when the history of the financial era which has just drawn to a close comes to be written, most of its mistakes and its major faults will be ascribed to the failure to observe the fiduciary principle, the precept as old as holy writ, that 'a man cannot serve two masters.' ").

175. RESTATEMENT, *supra* note 44, § 170; 2 A. SCOTT, *supra* note 44, § 170. Loyalty is "the willing and practical and thorough-going devotion of a person to a cause." J. ROYCE, THE PHILOSOPHY OF LOYALTY 16 (1930).

176. A. SCOTT, *supra* note 44, § 170. "The first duty of a trustee is . . . to 'administer the trust in the interest of the beneficiary.' " Scott, *The Fiduciary Principle*, 37 CALIF. L. REV. 539, 540 (1949). Perhaps the most widely quoted definition of loyalty is that of Justice Cardozo in *Meinhard v. Salmon* which dealt with the loyalty of one partner to another:

> Many forms of conduct permissible in a workaday world for those acting at arm's length are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the "disintegrating erosion" of particular exceptions. Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd.

249 N.Y. 458, 464, 164 N.E. 545, 546 (1928).

The duties of the trustee of a charitable trust are similar to those of a trustee of a private trust. RESTATEMENT, *supra* note 44, § 379.

177. A. SCOTT, *supra* note 44, § 170.25.

178. *Duties of Charitable Trust Trustees*, *supra* note 43, at 555; RESTATEMENT, *supra* note 44, § 170. *See generally* Committee on Trust Administration and Accounting, *The Trustee's Duty of Loyalty*, 6 REAL PROP. PROB. & TR. J. 528 (1971).

and the trust in his fiduciary capacity.[179] The trustee is an insurer. His duty is absolute. Good faith, reasonableness, innocence, benefit to the trust or beneficiary are immaterial.[180]

B. *The Business Corporate Standard*

The standards of loyalty of corporate directors originated by analogy to trust law during the late nineteenth and early twentieth centuries.[181] At that time, contracts between directors and corporations were prohibited. Directors were trustees.[182] The rationale of the early common law prohibition against interested directors' transactions included, "among other things," the need of the business corporation for unprejudiced advice and the avoidance of embarrassment to the remaining directors.[183] The fiduciary principle precluded a director from representing both himself and the corporation on the theory that when a self-interested situation arose, the director would favor his own interest.[184] The strict voidability of all interested directors' transactions at common law meant that there was no need for inquiry into the fairness of the transaction whatsoever.[185] Another rea-

179. An exception is if the trust instrument has special provisions, or the consent of all beneficiaries is obtained after full disclosure or a court authorization is obtained in advance.

180. *Duties of Charitable Trust Trustees, supra* note 43, at 555.

181. *See, e.g.*, Luther v. C.J. Luther Co., 118 Wis. 112, 94 N.W. 69 (1903); Bosworth v. Allen, 168 N.Y. 157, 61 N.E. 163 (1901).

182.

> [T]he Directors of a corporation are charged with the duties of trustees and bound to care for its property and manage its affairs in good faith, and for violation of that duty resulting in waste of its assets, injury to its property, or unlawful gain to themselves, they are liable to account in equity the same as ordinary trustees.

Bosworth v. Allen, 168 N.Y. 157, 166, 61 N.E. 163, 164-65 (1901).

Marsh, *Are Directors Trustees? Conflict of Interest and Corporate Morality*, 22 Bus. Law. 35, 37 (1966). *See also Luther*, 118 Wis. 112, 94 N.W. 69.

183. Marsh, *supra* note 182, at 37.

184. Bulbulia & Pinto, *Statutory Responses to Interested Directors' Transactions: A Watering Down of Fiduciary Standards?*, 53 Notre Dame Law. 201, 203 (1977). In the words of the United States Supreme Court in an early case: "[such] relations . . . ordinarily excite a conflict between self-interest and integrity . . . . [T]he danger in all cases [is] that the dictates of self-interest will exercise a predominant influence, and supersede that of duty." Michoud v. Girod, 45 U.S. (4 How.) 503, 555 (1846).

185. Bulbulia & Pinto, *supra* note 184, at 202.

> [The law] does not stop to inquire whether the contract or transaction was fair or unfair. It stops the inquiry when the relation is disclosed, and sets aside the transaction or refuses to enforce it, at the instance of the party when the fiduciary

son interested transactions were prohibited, which is of particular importance today in the smaller nonprofit corporation, was that disinterested directors who were representing the corporation might be influenced by their interested co-director, and this influence would be difficult, if not impossible, to evaluate.[186]

The erosion of the strict rule began in the last two decades of the nineteenth century[187] and continues today. The early common law rule was predictable and mechanical in its application. However, the practical necessities of modern business meant that banning interested directors would preclude men of experience and ability from board service.[188] This, combined with a recognition that the modern business corporation could be better served through transactions with its directors and with other corporations,[189] led to the easing of the rule forbidding any director interest.

The widespread use of interlocking and interested directorships was rationalized on a theoretical basis through an analogy to trust law. A trustee, while forbidden to deal with himself in connection with trust property, could deal with the *cestui que* trust[190] if the trustee fully disclosed the transaction and took no unfair advantage.[191]

In corporate law, a movement — if not a race — toward

> undertook to represent, without undertaking to deal with the question of abstract justice, in the particular case.

Munson v. Syracuse, G & C Ry. Co., 103 N.Y. 58, 74, 8 N.E. 355, 358 (1886).

186. *Munson*, 103 N.Y. at 74, 8 N.E. at 358 ("The law cannot accurately measure the influence of a trustee with his associates . . . .").

187. Marsh, *supra* note 182, at 39 ("This principle, absolutely inhibiting contracts between a corporation and its directors or any of them appeared to be impregnable in 1880 . . . . Thirty years later this principle was dead.").

188. Goodwin v. Agassiz, 283 Mass. 358, 363, 186 N.E. 659, 661 (1933) ("Fiduciary obligations of directors ought not to be made so onerous that men of experience and ability will be deterred from accepting such office.").

189. G. Hornstein, Corporation Law and Practice § 439, at 542 (1959). *See also* Robotham v. Prudential Ins. Co. of America, 64 N.J. Eq. 673, 709, 53 A. 842, 856 (1903) ("Common directors abound and common directors are better than 'dummies'.").

190. A *cestui que* trust is defined as

> He who has a right to a beneficial interest in and out of an estate the legal title to which is vested in another. The person who possesses the equitable right to property and receives the rents, issues and profits thereof; the legal estate of which is vested in a trustee.

Black's Law Dictionary 208 (5th ed. 1979).

191. Marsh, *supra* note 182, at 40.

increased laxity in the regulation of interested transactions occurred. By the turn of the twentieth century, the rule was that a majority of the disinterested directors could approve a contract with an interested director, if it were fair.[192] The rule relating to transactions between corporations with common directors was even more liberally applied[193] as courts often abandoned the requirement that a disinterested majority approve the transaction.[194] Later, the general common law rule was that a self-interested transaction was not voidable, whether or not there was a disinterested majority of the board, but the courts could review the contract for fairness.[195] The judicial decisions have been more result-oriented than consistent, depending upon whether the court thought the transaction was fair or not. If the court is uncertain about the fairness of the transaction, it may require approval by a majority of disinterested directors or shareholders.[196]

Statutory responses to interested directors' transactions were influenced by California, which in 1931 enacted former Section 311 of the California Corporate Code.[197] That section provided that interested transactions were neither void nor voidable if: disclosure of the common directorship or financial interest was made or known to the board of directors or board committee and the transaction was ratified by a vote sufficient without counting the votes of interested directors *or* the disclosure was made to the shareholders who in good faith ratified the transaction *or* the contract was just and reasonable as to the corporation at the time it was authorized or approved. The language in the statute was clearly disjunctive in that all that was required was any one of the above circumstances.[198] Other states, such as New York, based their statutes upon the California Code. The

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192. *Id.*

193. Bulbulia & Pinto, *supra* note 184, at 203-04. This resulted from a judicial recognition of the corporate practice that directors served on more than one board.

194. Everett v. Phillips, 288 N.Y. 227, 43 N.E.2d 18 (1942).

195. Marsh, *supra* note 182, at 43.

196. R. HAMILTON, CORPORATIONS 716 (3rd ed. 1986).

197. CAL. CIV. CODE § 311, retitled CAL. GEN. CORP. LAW § 820 in 1947, amended CAL. CORP. CODE § 310 in 1977 (West 1977). Comment, *Corporations: Effect of Directors' Adverse Interest or Conflicting Duties to Invalidate Contracts: California Civil Code Section 311*, 29 CALIF. L. REV. 480 (1941); Bulbulia & Pinto, *supra* note 184, at 204-12.

198. Bulbulia & Pinto, *supra* note 184, at 206.

issue then became whether the requirement of fairness was eliminated when disclosure was substituted. The commentators have differed.[199] In *Remillard Brick Co. v. Remillard-Dandini Co.*,[200] the California Supreme Court held that procedural compliance with the California statute did not validate a transaction in the absence of fairness.[201] The same conclusion has been argued for New York's statute[202] and has been reached judicially both in New York by an intermediate appellate court[203] and in Delaware.[204]

Like the general common law rule, the duty of loyalty for directors of New York business corporations has passed through several stages.[205] At first, contracts with interested directors were automatically voidable without regard to fairness.[206] In the second stage, a contract between a corporation and an interested director could survive if it had been approved by a disinterested majority of the board *and* if it were found to be fair.[207] Finally, a contract between corporations with common directors would be upheld if the contract were fair and did not involve bad faith, fraud, or any other breach of trust.[208] New York's current interested director's provision is modeled on California's former statute and repeats the same ambiguity of language.[209]

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199. *Id.* at 207.

200. 109 Cal. App. 2d 405, 241 P.2d 66 (1952).

201. *Id.* In 1975 California revised its statute explicitly to require fairness. Sections 310(a)(2) and (a)(3) require that a contract or transaction must be "just and reasonable" for it to be approved by the board of directors. CAL. CORP. CODE § 310 (West 1977).

202. Note, *"Interested Director's Contracts" — Section 713 of the New York Business Corporation Law and the "Fairness" Test*, 41 FORDHAM L. REV. 639 (1973); Note, *The Status of the Fairness Test Under Section 713 of the New York Business Corporation Law*, 76 COLUM. L. REV. 1156 (1976) [hereinafter *The Status of the Fairness Test Under Section 713*].

203. Aronoff v. Albanese, 85 A.D.2d 3, 446 N.Y.S.2d 368 (1982).

204. Fliegler v. Lawrence, 361 A.2d 218 (Del. Sup. Ct. 1976). This conclusion may only apply to situations where there is not ratification by disinterested shareholders.

205. 7 WHITE ON NEW YORK CORPORATIONS, NOT-FOR-PROFIT CORPORATION LAW ¶ 715.01, at 7-122 to 7-131 (13th ed. B. Prunty 1986).

206. *Munson*, 103 N.Y. 58, 8 N.E. 355.

207. Globe Woolen Co. v. Utica Gas & Elec. Co., 224 N.Y. 483, 491, 121 N.E. 378, 380 (1918).

208. *Everett*, 288 N.Y. 227, 43 N.E.2d 18; Chelrob, Inc. v. Barrett, 293 N.Y. 442, 57 N.E.2d 825 (1944).

209. N.Y. BUS. CORP. LAW § 713 (McKinney 1986). *See also supra* note 197.

C. *Nonprofit Corporate Law Standards Related to Interested Transactions*

1. *Common Law Developments*

In the nonprofit area, the law of interested directors' transactions has reflected corporate law developments. Initially the trust rule applied. *In re Taylor Orphan Asylum*[210] is a typical case. By a special act of the legislature, a charitable corporation was established in accordance with the terms of a will. The will permitted the sale of property by the directors. The executor and the directors of the will conveyed the property to their attorney, instructing him to accept the highest bid at an auction. Three of the directors then purchased the property for the bid price, resold it for twice the amount, and pocketed the profit. Without examining the fairness of the transactions, the court voided them. Trustees were not permitted to purchase trust property because the probability was so great they would engage in self-dealing without detection. Such transactions were prohibited entirely.[211]

As later decisions moved toward the corporate standard, there was little consistency or guidance as to whether courts would apply a trust or corporate law standard in a given situation. An egregious breach of duty or shocking lack of fairness would be disallowed. Rationale was an afterthought and the results were the same no matter what standard was applied.[212] An

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210. 36 Wis. 534 (1875).

211. Today, in most states, so long as the auction was a public auction at arms-length, the submission of the property to auction was voted by a disinterested majority of the directors, and the auction price was fair at the time of the auction, the directors could purchase the property and resell it so long as they did not have a customer in the wings.

212. *Duties of Charitable Trust Trustees, supra* note 2, at 556. *See* Eurich v. Korean Found., 31 Ill. App. 2d 474, 176 N.E.2d 692 (1961) (The president of the foundation sought to oust the old board at an improperly noticed meeting so as to install successors who would rubberstamp the investment of funds in the president's real estate. The foundation was dissolved, self-dealing and mismanagement were held improper under any standard. The court did not specify which standard it applied.); Fowle Memorial Hosp. v. Nicholson, 189 N.C. 44, 126 S.E. 94 (1925) (Hospital property was leased to defendant senior officer and member. A majority of members were in attendance but not all of the total membership voted. The defendant abstained. The court applied the corporate standard. The transaction was voidable; it would be sustained only if openly and fairly made for an adequate consideration and burden of proof was upon the defendant.); Samuel and Jessie Kenney Presbyterian Home v. State, 174 Wash. 19, 24 P.2d 403 (1933) (Trust-

early case analogizing the duty of loyalty to the corporate standard was *Gilbert v. McLeod Infirmary*[213] where a trustee attempted to purchase an unused lot owned by the hospital at a bargain price. Board consent was obtained at an improperly noticed meeting.[214] Applying a corporate law standard to set aside the transaction, the court found that although there was no finding of actual fraud or fraudulent intent, the director's conduct failed to measure up to the high standard required by one in his fiduciary relation to the hospital.[215]

The standard adopted by the court seems to parallel the common law business corporate rule.[216] The director's presence was overbearing and thereby undermined any impartial consideration of the transaction. The trustee exercised a controlling influence over the board because of his business stature, and he failed to abstain sufficiently from consideration of the transaction.[217] Under the court's approach, the burden of proof was upon the interested director when the transaction was attacked.

The modern judicial approach to directors' interested transactions is illustrated in the *Sibley Hospital* case.[218] Plaintiffs alleged that five directors were involved in a conspiracy to enrich themselves at the expense of the hospital. Each director held a senior position with a financial institution with which the hospital dealt. The defendant directors were accused of maintaining unnecessarily large amounts of Sibley assets on deposit drawing

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ees were alleged to have used irregular accounting practices to further desire for financial compensation and interest transactions by trustees with the institution. The trust standard was applied; no breach was found.); Old Settlers Club of Milwaukee County, Inc. v. Haun, 245 Wis. 213, 13 N.W.2d 913 (1944) (A nonprofit corporation sued a director to recover commissions paid to the director's brokerage firm. The trust standard was applied. The court ordered restitution though other directors approved.); People v. Larkin, 413 F. Supp. 978 (N.D. Cal. 1976) (Use of a charitable corporation's assets to secure a loan made to a director's closely held corporation was deemed a breach of duty even though the charitable corporation might ultimately benefit. The court applied the trust standard. The decision is overruled by CAL. CORP. CODE § 5233 (West 1980).).

213. 219 S.C. 174, 64 S.E.2d 524 (1951).

214. *Id.* at 178-80, 64 S.E.2d at 525-26.

215. *Id.* at 191, 64 S.E.2d at 531.

216. Globe Woolen v. Utica Gas & Elec. Co., 224 N.Y. 483, 121 N.E. 378 (1918).

217. *In re* Taylor Orphan Asylum, 219 S.C. at 189, 64 S.E.2d at 530.

218. Stern v. Lucy Webb Hayes Nat'l Training School for Deaconesses & Missionaries, 381 F. Supp. 1003 (D.D.C. 1974) [referred to in the text as *Sibley Hospital*].

inadequate or no interest.[219] The placement of the deposits was recommended by the treasurer and approved by the directors as a matter of course.

The plaintiffs also alleged that a mortgage was continued with the same financial institution although the hospital could have paid off the loan without impairing itself financially, and that an investment advisory agreement was signed with a company of which a hospital director was chairman of the board and a principal stockholder.[220] The investment company principal/hospital director presented the proposal to the investment committee of Sibley Hospital's Board, urged its approval, "and may have voted in favor of that recommendation at an informal session of the Investment Committee . . . ."[221] Thereafter, the director resigned from the investment committee, but for a short time he served as acting treasurer over the objection of some trustees. The price for the investment service was fair and equitable.[222]

Judge Gesell found that there was no conspiracy and applied corporate principles to determine whether there was improper self-dealing. The court stated that a "director should not only disclose his interlocking responsibilities but also refrain from voting upon or otherwise influencing a corporate decision to transact business with a company in which he has significant interest or control."[223] The court found that the bank affiliations of the directors were generally known, but that the conflicting interests were not revealed to the relevant committees when they voted to approve specific transactions.[224] The interested bank directors failed to alert corporate officers as to better terms known to be available elsewhere. Therefore, the directors breached their duty of loyalty. However, the court concluded that the hospital was not injured by the self-dealing

219. *Id.* at 1011.

220. *Id.* at 1012.

221. *Id.* The investment advisory contract was approved by counsel for the hospital and by the Executive Committee of the Board. *Id.*

222. *Id.*

223. *Id.* at 1014.

224. *Id.* at 1015. The court held that the D.C. business corporate standard applied to all nonprofit corporations organized under the Nonprofit Corporation Act of the District of Columbia. D.C. CODE ANN. § 29-502(3) (1981). The Nonprofit Corporation Act does not contain a section on interested transactions.

transactions.[225]

The court stated that "[i]t must be made absolutely clear that Board membership carries no right to preferential treatment in the placement or handling of the Hospital's investments and business accounts" and recommended that the hospital restrict membership on the board to representatives of financial institutions with which the hospital had no substantial business relationship.[226] In many situations this may be easier said than done.

The standard used by the court is similar to, but more restrictive than, the statutes in many jurisdictions. Under the District of Columbia rule, a director breaches his duty of loyalty if he knowingly enters into a business transaction in which he holds a position as trustee without previously having informed all persons charged with approving the transaction of his interest *and* of any significant facts known to him that indicate the transaction might not be in the best interests of the organization;[227] or if he actually participates in the decision except as to disclosure; or votes in favor of transacting business with himself or any corporation in which he has a senior position, as a director or substantial shareholder.[228] *Sibley Hospital* is the modern judicial application of the corporate duty of loyalty rule, but many nonprofit statutes are now not so strong, for they do not require disclosure of both the director's interest in the transaction and the materiality of the transaction to the corporation.[229]

2. *Statutory Treatment of Interested Transactions*

The statutory treatment of conflicts of interest by directors of nonprofit corporations has paralleled corporate developments.[230] Rigid prohibitions against any transaction between a

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225. *Stern v. Lucy Webb*, 381 F. Supp. at 1019.

226. *Id.*

227. *Id.* at 1020.

228. *Id.*

229. *Compare* N.Y. Not-for-Profit Corp. Law § 715 (McKinney 1970 & Supp. 1987) (director's interest in transaction) *and* the common law rule, *Globe Woolen*, 224 N.Y. at 489, 121 N.E. at 380 ("duty to warn and to denounce, if there is improvidence or oppression, either apparent on the surface, or lurking beneath the surface, but visible to [the interested director's] practiced eye").

230. The treatment of interested transactions in New York is illustrative. In the

director and a nonprofit corporation have given way so that today an interested transaction is neither void nor voidable if: 1) the conflict is disclosed to the board and the contract is approved by a disinterested majority of the directors; 2) the conflict of interest is disclosed to the members, a disinterested majority of whom ratify the transaction; or 3) the transaction is fair to the corporation.[231] Only twelve states have provisions for validation of interested transactions in their nonprofit corporation statutes.[232] The others incorporate by reference the interested

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nineteenth century directors of nonprofit corporations were held in check through strict limitations upon corporate powers and statutory prohibitions against self-dealing. The New York General Incorporation Act of 1848 limited charitable corporations' holding of real property to $50,000 and personal property to $75,000. The annual income from real and personal property could not exceed $10,000. Ch. 319, § 2 [1848] N.Y. Laws 447. Trustees were jointly and severally liable for all debts due. *Id.* at 448. All charitable corporations were subject to visitations by justices of the supreme court. Directors were required to file annual reports with the county clerk in which the certificate was filed. *Id.* at 449. They could not engage in transactions in which they were interested unless authorized in the bylaws and concurred in by vote of all of the directors. Ch. 104, § 1 [1872] N.Y. Laws 247. From the enactment of the Membership Corporations Law in 1895, ch. 559 [1895] N.Y. Laws 329, the standards of conduct for directors of nonprofit corporations have progressively eroded. Under that statute, directors had to present to their members an annual report showing acquisition, disposal, and holding of property, and unlike their business corporation counterparts, still personally were liable for short term debts. *Id.* at 335. Restrictions on the purchase, sale, and leasing of property were mitigated, but court approval was required for leases exceeding five years. *Id.* at 336-37. The ban on interested transactions was relaxed. Now such transactions could be approved if authorized by the bylaws *and* by a concurring vote of all of the directors. *Id.* at 336.

By 1926, directors no longer had liability for the corporation's debts, and interested transactions could be approved if authorized by the bylaws *or* by a concurring vote of two thirds of the directors. Chs. 46, 47 [1926] N.Y. Laws 1308, 1319. The New York Not-for-Profit Corporation Law, which was enacted in 1970 and superseded the Membership Corporation Law, utilized virtually the same requirements for standards of care and interested transactions as New York's Business Corporation Law. *Compare* N.Y. NOT-FOR-PROFIT CORP. LAW § 715 (McKinney 1970 & Supp. 1987) *with* N.Y. BUS. CORP. LAW § 713 (McKinney 1986 & Supp. 1987).

231. Hansmann, *supra* note 2, at 567.

232. Twelve states that have specific provisions on interested directors in their not-for-profit statutes on interested transactions are: ARIZ. REV. STAT. ANN. § 10-1044 (1977 & Supp. 1986); CAL. CORP. CODE § 5233 (West Supp. 1987); CONN. GEN. STAT. ANN. § 33-457 (West 1960 & Supp. 1987); IND. CODE ANN. § 23-7-1.1-61 (Burns 1984); LA. REV. STAT. ANN. § 12:228 (West 1968); ME. REV. STAT. ANN. tit. 13-B § 713 (1977); MICH. COMP. LAWS ANN. §§ 450.2545, 450.2546 (West 1986); N.J. STAT. ANN. § 15A:6-8 (West 1984); N.Y. NOT-FOR-PROFIT CORP. LAW § 715 (McKinney 1970 & Supp. 1987); OHIO REV. CODE ANN. [§ 1702.30.1] § 1702.301 (Anderson 1985); VA. CODE ANN. § 13.1-223.1 (1978); WIS. STAT. ANN. § 181.225 (West 1957 & Supp. 1986).

transaction provision of the general corporate code.[233]

New York's statutory provision for interested directors[234] is similar to those in most other states and typifies the drafting weaknesses of this legislation. An internal ambiguity results from the language of the statutes derived from California's original effort which seems to imply that disclosure and approval by a majority of disinterested directors are sufficient to validate the statute even if the transaction is unfair. The legislative history of New York's statute is murky on this point. The initial version clearly specified that fairness and disclosure were required, but the statute was amended ostensibly to clarify disclosure with respect to burden of proof.[235] Failure to disclose in and of itself is unfair,[236] but disclosure alone should never validate an unfair contract.

A determination of the nature and extent of the disclosure required in the statutes is problematic. To whom should disclosure be made? How extensive should it be? Just what should be disclosed? New York's requirement of disclosure of one's interest in the transaction is insufficient.[237] The nature of the interest, what it is and how far it extends, or the potential unfairness to the corporation should be forthcoming.[238] Only one state, Ohio, with interested transaction provisions in its nonprofit corporation statute requires disclosure of the nature of the interest and the facts as to the transaction.[239]

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233. This is what Judge Gesell did in *Sibley Hospital.* One jurisdiction, Delaware, has no nonprofit corporate code. In other states, a general chapter of the corporation statute applies to all nonprofit corporations. It is followed by specific chapters for different types of nonprofits — agricultural corporations, educational corporations, cemetary associations, etc. *See* OHIO REV. CODE ANN. §§ 1715, 1721, 1729 (Anderson 1978). For a description of the various approaches to state nonprofit statutes, see H. OLECK, NONPROFIT CORPORATIONS, ORGANIZATIONS, AND ASSOCIATIONS 44-48 (4th ed. 1980).

234. N.Y. NOT-FOR-PROFIT CORP. LAW § 715 (McKinney 1970 & Supp. 1984-85).

235. Ch. 1066, § 715 [1969] N.Y. Laws 2740. The legislative history is exhaustively discussed in *The Status of the Fairness Test Under Section 713, supra* note 202, at 1181-82.

236. Washington *ex rel.* Hayes Oyster Co. v. Keypoint Oyster Co., 64 Wash. 375, 391 P.2d 979, 984 (1964); *Stern v. Lucy Webb,* 381 F. Supp. 1003, 1014-15 (D.D.C. 1974).

237. N.Y. NOT-FOR-PROFIT CORP. LAW § 715 (McKinney 1970 & Supp. 1987) ("material facts as to such director's or officer's interest in such contract or transaction . . . .").

238. DEL. CODE ANN. tit. 8, § 144(a)(1) & (2) ("material facts as to his relationship or interest and as to the contract or transaction are disclosed . . . .").

239. OHIO REV. CODE ANN. [§ 1702.30.1] § 1702.301 (Anderson 1985).

New York further reduces the amount of disclosure because only the "material facts" of the conflict of interest must be disclosed and there is no guidance as to the meaning of that term.[240] A nonprofit director's "financial interest" in corporations or other entities which do business with the nonprofit come under the interested transaction provision but only if the interest is "substantial."[241] The statute offers no definition as to what that term means. Likewise, the term "fairness" is left without standards for evaluation. "Fairness" of a transaction is not defined. Although "fairness" is usually evaluated in terms of the adequacy of the consideration,[242] in many interested transactions with nonprofits, there may be no readily identifiable market price for comparison.

The effect of disclosure of the interested transaction or the director's interest therein is to shift the burden of proof to the individual challenging the transaction (assuming that there will be someone who will "challenge" an unfair conflict of interest). This burden is extremely difficult to meet given the latitude granted by courts to the best judgment rule.

The conflict of interest statutes may be adequate for business corporations because shareholders and others can monitor abuses.[243] With the exception of California, jurisdictions with interested director statutes in their not-for-profit statutes treat all nonprofit corporations alike. They implicitly assume that nonprofits have members who, like shareholders of a business corporation, would have standing to sue to correct an abuse.[244] However, many nonprofit corporations are nonmembership corporations with self-perpetuating boards. In these situations, only the attorney general or a director would have standing to sue to correct the violation of the conflict of interest provi-

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240. N.Y. NOT-FOR-PROFIT CORP. LAW § 715 (McKinney 1970 & Supp. 1987).

241. *Id.* at § 715(a)(1).

242. Pepper v. Litton, 308 U.S. 295, 306-07 (1938) ("The essence of the test is whether or not under all the circumstances the transaction carries the earmarks of an arm's length bargain."). *See The Status of the Fairness Test Under Section 713, supra* note 202, at 1159.

243. *See supra* notes 102-05 and accompanying text.

244. *See* CAL. CORP. CODE §§ 5420, 7420, 7710 (West Supp. 1987); N.Y. NOT-FOR-PROFIT CORP. LAW § 623(a), 720(b)(3) (McKinney 1970 & Supp. 1987). Most states have added prohibitions to any self-dealing if the organization is classified as a private foundation under the Internal Revenue Code. Hansmann, *supra* note 2, at 570.

sions.[245] Rarely will a director bring a derivative suit against his board colleagues. The commentators agree that there is inadequate supervision of nonprofit corporations by the attorneys general[246] who have a multiplicity of responsibilities and extremely limited resources.[247] Under trust and corporate principles, the public has no standing to sue a charitable organization absent a specific statutory grant.[248] The existing interested transaction statutes are inadequate to provide meaningful enforcement. California's new statute[249] offers a different approach.

D. *Interested Transactions by Directors of California Public Benefit Corporations*

California has enacted an innovative but complex statute to deal with interested transactions by directors of public benefit corporations.[250] It recognizes that different kinds of nonprofit or-

245. Enforcement of charities has long been exercised by the State Attorney General, or in a few jurisdictions, by the District Attorney. G.G. Bogert & G.T. Bogert, The Law of Trusts and Trustees § 411 (rev. 2d ed. 1979).

246. Abrams, *supra* note 80, at 484; M. Fremont-Smith, Foundations and Government 226-28 (1965); Hansmann, *supra* note 2, at 600-01; Karst, *supra* note 84, at 434, 449-53, 476 (1960).

247. In 1977, only eight states assigned attorneys full-time to the enforcement of charitable trusts and charitable corporations. Eleven states had no attorneys assigned, while most states had one or two attorneys assigned part-time to enforcement of charitable trusts and charitable corporations. National Association of Attorneys General, State Regulation of Charitable Trusts and Solicitations 8 (1977). These figures have probably not changed measurably.

248. The rationale is that property is devoted to the accomplishment of purposes which are beneficial to the community at large rather than to a specific person. 4 Scott, *supra* note 44, at 364; Tushnet, *The New Law of Standing: A Plea for Abandonment*, 62 Cornell L. Rev. 663, 675 (1977).

249. Cal. Corp. Code § 5233 (West Supp. 1987).

250.

(a) Except as provided in subdivision (b), for the purpose of this section, a self-dealing transaction means a transaction to which the corporation is a party and in which one or more of its directors has a material financial interest and which does not meet the requirements of paragraph (1), (2), or (3) of subdivision (d). Such a director is an "interested director" for the purpose of this section.

(b) The provisions of this section do not apply to any of the following:

(1) An action of the board fixing the compensation of a director as a director or officer of the corporation.

(2) A transaction which is part of a public or charitable program of the corporation if it: (i) is approved or authorized by the corporation in good faith and without unjustified favoritism; and (ii) results in a benefit to one or more direc-

ganizations require different approaches to the regulation of in-

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tors or their families because they are in the class of persons intended to be benefited by the public or charitable program.

(3) A transaction, of which the interested director or directors have no actual knowledge, and which does not exceed the lesser of 1 percent of the gross receipts of the corporation for the preceding fiscal year or one hundred thousand dollars ($100,000).

(c) The Attorney General or, if the Attorney General is joined as an indispensable party, any of the following may bring an action in the superior court of the proper county for the remedies specified in subdivision (h):

(1) The corporation, or a member asserting the right in the name of the corporation pursuant to Section 5710.

(2) A director of the corporation.

(3) An officer of the corporation.

(4) Any person granted relator status by the Attorney General.

(d) In any action brought under subdivision (c) the remedies specified in subdivision (h) shall not be granted if:

(1) The Attorney General, or the court in an action in which the Attorney General in [sic] an indispensable party, has approved the transaction before or after it was consummated; or

(2) The following facts are established:

(A) The corporation entered into the transaction for its own benefit;

(B) The transaction was fair and reasonable as to the corporation at the time the corporation entered into the transaction;

(C) Prior to consummating the transaction or any part thereof the board authorized or approved the transaction in good faith by a vote of a majority of the directors then in office without counting the vote of the interested director or directors, and with knowledge of the material facts concerning the transaction and the director's interest in the transaction. Except as provided in paragraph (3) of this subdivision, action by a committee of the board shall not satisfy this paragraph; and

(D)(i) Prior to authorizing or approving the transaction the board considered and in good faith determined after reasonable investigation under the circumstances that the corporation could not have obtained a more advantageous arrangement with reasonable effort under the circumstances or *(ii) the corporation in fact could* not have obtained a more advantageous arrangement with reasonable effort under the circumstances; or

(3) The following facts are established:

(A) A committee or person authorized by the board approved the transaction in a manner consistent with the standards set forth in paragraph (2) of this subdivision;

(B) It was not reasonably practicable to obtain approval of the board prior to entering into the transaction; and

(C) The board, after determining in good faith that the conditions of subparagraphs (A) and (B) of this paragraph were satisfied, ratified the transaction at its next meeting by a vote of the majority of the directors then in office without counting the vote of the interested director or directors.

(e) Except as provided in subdivision (f), an action under subdivision (c) must be filed within two years after written notice setting forth the material facts of the transaction and the director's interest in the transaction is filed with the Attorney General in accordance with such regulations, if any, as the Attorney General may

terested transactions.[251] The statute attempts to minimize in-

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adopt or, if no such notice is filed, within three years after the transaction occurred, except for the Attorney General, who shall have 10 years after the transaction occurred within which to file an action.

(f) In any action for breach of an obligation of the corporation owed to an interested director, where the obligation arises from a self-dealing transaction which has not been approved as provided in subdivision (d), the court may, by way of offset only, make any order authorized by subdivision (h), notwithstanding the expiration of the applicable period specified in subdivision (e).

(g) Interested directors may be counted in determining the presence of a quorum at a meeting of the board which authorizes, approves or ratifies a contract or transaction.

(h) If a self-dealing transaction * * * has taken place, the interested director or directors shall do such things and pay such damages as in the discretion of the court will provide an equitable and fair remedy to the corporation, taking into account any benefit received by the corporaton and whether the interested director or directors acted in good faith and with intent to further the best interest of the corporation. Without limiting the generality of the foregoing, the court may order the director to do any or all of the following:

(1) Account for any profits made from such transaction, and pay them to the corporation;

(2) Pay the corporation the value of the use of any of its property used in such transaction; and

(3) Return or replace any property lost to the corporation as a result of such transaction, together with any income or appreciation lost to the corporation by reason of such transaction, or account for any proceeds of sale of such property, and pay the proceeds to the corporation together with interest at the legal rate. The court may award prejudgment interest to the extent allowed in Section 3287 or 3288 of the Civil Code. In addition, the court may, in its discretion, grant exemplary damages for a fraudulent or malicious violation of this section.

Id.

251. California's nonprofit corporation law, adopted in 1978 and effective in 1980, divides nonprofit corporations into three categories: nonprofit public benefit corporations, nonprofit religious corporations and nonprofit mutual benefit corporations. *See generally California's New Nonprofit Corporation Law: An Introduction and Conceptual Background*, 13 U.S.F. L. Rev. 729 (1979). California's classification system reflects the vast diversity in purposes, nature, and governance of organizations that comprise the nonprofit sector. Nonprofits within each category are separately regulated by the statute and differently supervised by the Attorney General.

Public benefit corporations, a category most analogous to "501(c)(3)" organizations under the Internal Revenue Code, and more traditional charities are those which are formed for public or charitable purposes, not for the private gain of any individual. They have a distribution constraint not only while operating but also upon dissolution. CAL. CORP. CODE §§ 5049, 5111, 5130, 5410 (West Supp. 1987).

Religious corporations are those organized primarily or exclusively for religious purposes and not for private inurement. CAL. CORP. CODE §§ 5061, 9111, 9130 (West Supp. 1987). Religious corporations are substantially less regulated than public benefit corporations. *Compare* CAL. CORP. CODE §§ 9240-9251 *with* §§ 5230-5241 (West Supp. 1987). There are two justifications for less stringent supervision: 1) fear of first amendment entanglements, and 2) the appropriateness of self-regulation given religious corporations'

sider dominance of the board[252] and to create a system whereby interested transactions are scrutinized by the board of directors before they occur.

1. *The Definition of Self-Dealing*

A "self-dealing transaction" is defined as a transaction in which a public benefit corporation is a party and in which one or more of its directors has a "material financial interest."[253] Neither "material" nor "financial interest" is defined. There is also uncertainty as to whether "material" refers to the materiality of the transaction from the standpoint of the director since it is the director's financial interest to which the phrase refers,[254] or whether "material" is to be measured from the corporation's perspective. In the nonprofit area, a matter may not be particularly material to a director but could be to the organization.[255]

Apparently, the drafters felt that a definition was neither feasible nor desirable. One view is that the lack of a definition will have a therapeutic *in terrorem*[256] effect in that it requires prudent directors to resolve any doubts by construing all per-

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unique functions and moral postures. *See* Abbott & Kornblum, *The Jurisdiction of the Attorney General Over Corporate Fiduciaries Under the New California Nonprofit Corporation Law*, 13 U.S.F. L. Rev. 753, 789-93 (1979). Mutual benefit corporations under the California Code are a residual category and include all corporations which are not public benefit corporations or religious corporations. Cal. Corp. Code §§ 5059, 9912(5) (West Supp. 1987). They include trade associations, fraternal organizations, and activities which provide some benefit to their members. The theory behind less regulation is that mutual benefit corporations resemble business corporations. Their members, similar in many ways to shareholders, will enforce the fiduciary duties of the directors and officers so that the requirements of transactions involving directors are similar to business corporate principles. Cal. Corp. Code §§ 7233-34 (West Supp. 1987).

252. Under § 5227 not more than 49% of the board members may be employees, past employees within the 12 previous months, independent contractors, or related to any of the previous members. Cal. Corp. Code § 5227 (West 1987). This provision encourages the naming of dummy directors.

253. Cal. Corp. Code § 5233(a) (West 1987).

254. 1B A.H. Ballantine & G. Sterling, California Corporation Laws § 406.02, at 19-203 (R.B. Clark 4th ed. 1984).

255. In the original version of this section enacted in 1978, the material financial interest "would have been measured by the interest of the director in the party other than the public benefit corporation rather than the interest of the director in the transaction itself." 1978 Cal. Stat. ch. 567. 1B A.H. Ballantine & G. Sterling, *supra* note 254, § 406.02, at 19-203-04.

256. *In terrorem* is defined as "in fright or alarm or terror." Black's Law Dictionary 420 (abr. 5th ed. 1983).

sonal interest in a particular transaction as material.[257] On the other hand, the ambiguities may simply drive from boards the types of people nonprofits seek to attract — individuals with material financial interests.[258] The definitional ambiguities provide little guidance. Given the paucity of litigation involving nonprofit corporations, it is not realistic to expect case law to develop for a very long time, if at all.[259]

2. *Exclusions from the Definition of "Self-Dealing Transaction"*

Several exclusions from the common meaning of "self-interested transaction" make section 5233 of the California Code a trap for the unwary and provide an enormous loophole for the cagey. The statute was amended in 1980 so that common director transactions between a public benefit corporation and another corporation, on whose board also sits a director of the public benefit corporation, would not involve "material self-interest."[260]

Transactions with relatives and self-dealing by officers are also not considered interested transactions.[261] The self-dealing transaction section only applies to directors. The theory behind this distinction is that self-dealing by officers or employees is ultimately under the control of the board of directors which will be liable if it violates its duty of care by authorizing or failing to oversee a transaction which is not in the best interests of the corporation.[262] In the larger corporation, one cannot expect that the board can supervise activities of all employees.[263] A board could develop standards of review relating to interested transac-

257. 1 A.H. BALLANTINE & G. STERLING, *supra* note 254, § 406.02 at 19-203 (R.B. Clark 4th ed. 1984). The self-dealing provisions of the California nonprofit statute are ably discussed in A.H. BALLANTINE & G. STERLING and in 3 H. MARSH, CALIFORNIA CORPORATION LAW § 22.13 (1986). This section borrows heavily from these sources.

258. 1B A.H. BALLANTINE & G. STERLING, *supra* note 254, § 406.02, at 19-203.

259. Most cases involving nonprofits are settled before trial. The cost, publicity, and ensuing embarrassment of litigation place heavy pressure upon a nonprofit organization to settle.

260. CAL. CORP. CODE § 5234 (West Supp. 1987).

261. *Id.* at § 5233(a) (except for an interested person as a director under § 5227).

262. Abbott & Kornblum, *supra* note 251, at 775.

263. Graham v. Allis-Chamers, Mfg. Co., 41 Del. Ch. 78, 188 A.2d 125 (1963); Manning, *supra* note 11, at 1481.

tions by officers and employees.

Transactions which are specifically excluded from the self-dealing provisions include actions of the board fixing the compensation of a director as a director or officer of the corporation[264] and transactions which are part of a charitable program of the corporation in which a director is a member of a beneficiary class.[265] The rationale of this latter exemption is that the beneficiaries of a program who can offer input based upon first-hand knowledge should have representation on the boards of nonprofit organizations. These exemptions are designed to exclude claims against such directors on grounds of self-interest because the directors receive a salary or benefit from an organization's activities. However, a nonprofit corporation established solely to benefit an individual will violate the prohibition against self-inurement under both the Internal Revenue Regulations[266] and the California statute.[267]

Another exception to the self-dealing provision is a transaction about which the interested directors have no actual knowledge, and which does not exceed the lesser of one percent of the gross receipts of the public benefit corporation for the preceding fiscal year or $100,000.[268] Prominent individuals may serve on many boards and may also be substantial shareholders in several corporations. They may have a broad range of financial interests, yet they may have no role in the nonprofit's management.[269] Thus, to categorize transactions which are relatively small to a director as self-interested would drive desirable director-types from nonprofit boards. Apparently this exception was included to prevent courts from imposing "an unreasonably low

264. CAL. CORP. CODE § 5233(b)(1) (West Supp. 1987). Compensation is covered by § 5235 and provides that the board should fix the compensation of a director or officer and no agreement to pay compensation otherwise valid shall be voidable if the persons receiving compensation participated in the decision, so long as the compensation is fair and reasonable at the time authorized. There is also a ceiling on liability for unreasonable compensation limited to the amount by which the compensation exceeded what was just and reasonable plus interest.

265. CAL. CORP. CODE § 5233(b)(2) (West Supp. 1987).

266. Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii) (1986).

267. 3 H. MARSH, *supra* note 257, § 22.13, at 120-21.

268. CAL. CORP. CODE § 5233(b)(3) (West Supp. 1987).

269. *See supra* note 35. Johnston v. Greene, 35 Del. Ch. 479, 121 A.2d 919 (1956) (director on the boards of several corporations not obligated under corporate opportunity doctrine to pass along any opportunity that came to director in individual capacity).

threshold of materiality in connection with such transactions."[270] However, although there is no exception for equally small transactions where the director has knowledge, there should be.

The definition of "self-dealing" is unrelated to any benefit or detriment of the transaction to the corporation. Even though a transaction in which a director has a "material financial interest" is vital to the corporation, it still will be prohibited self-dealing unless validated according to the statute.[271]

3. *The Validation of Self-Dealing Transactions*

Transactions in which one or more of the corporation's directors have a material financial interest and which would seem to be interested under the California statute are not voidable if certain approvals are obtained. There are three ways to validate such transactions: 1) approval in advance by the board of directors; 2) prior approval by a committee of the board or other person and subsequent board ratification; and 3) approval by the Attorney General.

a. *Board Authorization*

To validate a self-dealing transaction in California, each of four requirements must be met: 1) the corporation must enter into the transaction for its own benefit; 2) the transaction must be fair and reasonable to the corporation when entered into; 3) the board must approve the transaction in advance by the vote of a majority of the directors in office (although the vote of the interested director cannot be counted), and with knowledge of the material facts concerning the transaction and the director's interest therein; and 4) prior to approving the transaction, "the board must have considered and in good faith determined after reasonable investigation under the circumstances that the corporation could not have obtained a more advantageous arrangement with reasonable effort under the circumstances or the corporation in fact could not have obtained a more advantageous

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270. 3 H. MARSH, *supra* note 257, § 22.13, at 121. These exclusions are governed by the duty of care.

271. *Id.* at 120.

arrangement with reasonable effort . . . ."[272] If the above four requirements are met, the transaction is not self-dealing in the context of the statute, and no remedies for conflicts of interest are available.[273]

The statute reflects a tension between the drafters as to how rigorously interested transactions should be scrutinized.[274] Even after enactment, the debate continued. The statute was amended in the following session of the legislature. Under the original version of the self-dealing provision as enacted, transactions which had received approval from the board, from a board committee, or from the Attorney General were still "self-dealing" transactions by definition. However, the approvals were questions of proof. The burden was upon those seeking to establish the validity of the transaction if challenged in a legal proceeding.[275] Under an amendment adopted in 1980, the *absence* of the requisite approval for a transaction between the corporation and an interested director became an element of the plaintiff's cause of action for relief against the interested director.[276] This shifted the burden to the individual challenging the transaction. If the requisite approvals had been obtained, the cause of action could be dispensed with through a motion for summary judgment.

A major problem with the procedure of board approval of all interested transactions is that it involves the board too deeply in day-to-day operations, particularly if there are many such transactions. Benign interested transactions may be stifled by this procedure. It creates an excessive number of board meetings and fills the board agenda with the approval of such transactions, a waste of precious board resources. It forces the director, who has knowledge of a series of small interested transactions to go through with this structured procedure for

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272. CAL. CORP. CODE § 5233(d)(2) (West Supp. 1987). The interested director can be counted for board quorum purposes. *Id.* at § 5233(g).

273. CAL. CORP. CODE § 5233(a), (d); 1B A.H. BALLANTINE & G. STERLING, *supra* note 254, § 406.02, at 19-205.

274. Hone, *California's New Nonprofit Corporation Law — An Introduction and Conceptual Background,* 13 U.S.F. L. REV. 733, 746-47 (1979).

275. 1B A.H. BALLANTINE & G. STERLING, *supra* note 254, § 406.02, at 19-204; Abbott & Kornblum, *supra* note 251, at 777.

276. 1980 Cal. Stat. 3835 (ch. 1155 § 4) (codified at CAL. CORP. CODE § 5233(d)(1) (West Supp. 1987)).

each one. The board approval process ignores the informalities of smaller nonprofits and creates work for corporate secretaries.

b. *Approval by the Board Committee*

If it is not reasonably practical to obtain the approval of the full board prior to entering the transaction, then approval for an interested director transaction can be obtained from an authorized board committee if followed by full board validation. The committee must undertake the same process of approval as the full board. The board must ratify the transaction using its original criteria at its next meeting by a vote of the majority of the directors without counting the vote of interested directors.[277] It is possible, however, that subsequent approval by the full board may lead to second guessing of the committee's decision. The dynamics of board action are such that once a board committee has given approval to a transaction it would be very unlikely for the full board to disagree. While the legislation implies that prior committee approval and subsequent board ratification should be used in limited circumstances, section 5233 may become the main means of validating interested transactions in those corporations which have a large number of such transactions.

c. *Approval by the Attorney General*

The Attorney General or a court in an action in which the Attorney General is an indispensable party can approve a transaction before or after it is consummated.[278] The Attorney General has published regulations which require submission by the board of detailed information about the transaction.[279] It has been suggested that if virtually everything about a transaction is not submitted to the Attorney General, it could be subject to subsequent attack on grounds of insufficient or misleading disclosure.[280] It is questionable whether the Attorney General will

277. CAL. CORP. CODE § 5233(d)(3) (West Supp. 1987).

278. *Id.* at § 5233(d)(1).

279. CAL. ADMIN. CODE tit. 11, § 999.1 et seq. (1981).

280. 1B A.H. BALLANTINE & G. STERLING, *supra* note 254, § 406.02, at 19-206-07. In addition, there is the ghost of Holt v. College of Osteopathic Physicians & Surgeons, 61 Cal. 2d 750, 394 P.2d 932, 40 Cal. Rptr. 244 (1964), where the Attorney General's ap-

be able to act quickly enough if this provision is widely used. It is also questionable whether the taxed resources of the Attorney General should be devoted to essentially internal governance matters in a context other than a judicial proceeding. This author contends that this section involves the Attorney General too deeply in the ordinary affairs of nonprofit corporations. It is a return to the concession theory of corporateness.[281]

Even if the necessary procedures and validation steps have not been taken — e.g., a nonprofit has neither an attorney nor understands this complex statute and enters into an interested transaction — the Attorney General can give subsequent approval.[282] The fear that a nonprofit should have is that the Attorney General might not approve the transaction. A more likely scenario would occur where a corporation does not seek necessary approval for an interested transaction which is beneficial to the corporation. If a director is sued, a court may retroactively validate the transaction and deny any recovery against the director.[283] There are detailed standing, statute of limitations, and remedy provisions.[284]

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proval of the transaction was treated as a nullity because the wrong standard was applied.

281. The concession theory holds that the corporation existed as a person only because it was recognized by a sovereign authority. The centrality of the sovereign's act to the corporation's existence makes all corporate officers ultimately accountable to the state. *See* R. WINTER, GOVERNMENT AND THE CORPORATION 1 (1978). Chief Justice Marshall so described the status of a corporation in federal law: "A corporation is an artificial being, invisible, intangible, and existing only in contemplation of law. Being the mere creature of law, it possesses only those properties which the charter of its creation confers upon it, either expressly, or as incidental to its very existence." Dartmouth College v. Woodward, 17 U.S. (4 Wheat.) 518, 636 (1819).

282. CAL. CORP. CODE § 5233(d)(1) (West Supp. 1987).

283. *Id.* at § 5233(f).

284. Under section 5233(b)(3), the following have standing to sue a director for an improper self-dealing transaction: the Attorney General, the non-profit corporation, a member reserving the right in the name of the corporation, a director or officer of the corporation, and any individual granted relator status by the Attorney General. CAL. CORP. CODE § 5233(b)(3) (West Supp. 1987). In transactions for which prior approval has been obtained from the Attorney General, there is a two year statute of limitations; or if no notice is filed within three years of the transaction, the Attorney General has ten years from the date of the transaction. CAL. CORP. CODE § 5233(e) (West Supp. 1987). If the self-dealing transaction has taken place, the court may require such damages or require the defendant to do such things as in its discretion will provide an equitable and fair remedy to the corporation taking into account any benefit received by it and whether the interested director or directors acted in good faith and with intent to further

4. *Section 5233 — A Misstep in the Right Direction*

What is to be made of this statute? To its credit, it does differentiate between the types of nonprofits. It will make directors aware of the self-dealing problem before the transaction occurs and will encourage validation. It provides perhaps an overly effective shield for directors against lawsuits. The complexities of the statute are such that it will be ignored by smaller organizations. The premium on corporate procedure will be used by larger nonprofits to create a trail of paper to validate all transactions without necessarily increasing oversight of such transactions.

The statute does not deal with the dominant director. The requirement in section 5233(d)(2) that the board make an investigation reasonable under the circumstances to ascertain whether the corporation could not have obtained a more advantageous arrangement does not reflect how boards work nor should work. At best, this statute will create procedural folderol and will be an invitation to perjury. There is no statutory guideline as to how to determine "fairness" or to measure it at the time of the transaction. Even assuming good faith on the part of the board, it is questionable whether there will ever be a time when the board will conclude that there was a more advantageous transaction that could have been entered. To substitute the board's reasoned inquiry with a judicial decision or the Attorney General's decision guts the best judgment rule. The statute neither recognizes the needs of smaller organizations where interested transactions are more common and procedures more informal, nor creates a process by which the organization can establish a standard so that conduct of a particular kind would be permitted if prior to the transaction that type of conduct or transaction had been approved by a disinterested majority of the

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the best interest of the corporation. *Id.* at § 5233(h). Without limiting the remedial powers of the court, the statute provides that the court may order the director to do any or all of the following: account for the profits made from the transaction and remit them to the corporation; pay the corporation the value of the use of any of its property; return or replace any property lost to the corporation as a result of a transaction together with any income of appreciation; or account to the corporation for any proceeds of sale of such property and pay the proceeds to the corporation together with legal interest. The court may award prejudgment interest and in its discretion grant exemplary damages for a fraudulent or malicious violation of section 5233. *Id.* at § 5233(h).

board.

VI. Alternative Approaches to Interested Transactions

A. *Problems of Monitoring Directors' Conduct*

It has been suggested herein that directors and officers of business corporations may not always act in the best interests of the public or the corporation.[285] In the nonprofit sector, market monitoring and enforcement mechanisms do not exist to the same extent and with the same impact as with business corporations.[286] In any discussion of the improvement of fiduciary performance, the costs of an enforcement system must be weighed against the results derived. Violations of fiduciary duties are difficult to detect. Enforcement of legal rules can be expensive and an inefficient use of resources.[287]

A fundamental problem with any statutory approach to the regulation of interested transactions is the need for both unambiguous rules and adequate leeway so that a director can use his judgment and make decisions.[288] As nonprofit corporation law has adopted business corporate rules, the balance has shifted toward the discretion and flexibility of the director.[289] The public as the ultimate beneficiary of any charitable organization's activities has such attenuated control, particularly over non-membership corporations, that directors' standards should be more rigorous than for business corporations.

B. *An Absolute Prohibition of Conflicts of Interest?*

The movement toward arm's-length treatment of interested transactions by directors of nonprofits has been criticized by some scholars. A return to stricter standards has been urged.[290]

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285. *See* Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819 (1981).

286. *See supra* text accompanying notes 75-77.

287. Part of this section is derived from a framework developed by Frankel, *Fiduciary Law*, 71 CALIF. L. REV. 795 (1983).

288. *Id.* at 826.

289. Branson, *Countertrends on Corporation Law: Model Business Corporation Act Revision, British Company Law Reform, and Principles of Corporate Governance and Structure*, 68 MINN. L. REV. 53, 58-62 (1983).

290. Hansmann, *supra* note 2, at 569-72.

Perhaps the easiest approach would be to return to the rules of the past and to adopt a strict prohibition against any interested transactions by a director of a nonprofit corporation.

The rigidity of the trust law approach offers the advantages of predictability and ease of application. The *in terrorem* penalty that fair as well as unfair transactions can be rescinded provides a sure deterrent to self-dealing. A supposed but not necessarily empirically verified benefit of the absolute prohibition would be a lessening of judicial and attorneys' general burdens. A total prohibition against all interested transactions would reinforce the fiduciary concept and help ensure that the "public" purpose of the organization is achieved.

It has also been argued that in certain nonprofit areas such as hospitals and nursing homes, abuses of the private inurement proscription are so common that the benefits of tax exemption should be denied.[291] In 1969, Congress prohibited self-dealing transactions by private foundations and provided severe penalties for violation of the proscription.[292] Congress had perceived that private foundations had engaged in widespread improper activities including self-dealing. The former rules for arm's-length dealing had required disproportionate enforcement efforts by the Internal Revenue Service. The sanctions then available had been ineffective and tended to discourage the enforcement effort. In other situations, the severity of the sanction compared to the offense involved undermined enforcement.[293]

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291. *See generally* Clark, *supra* note 60 (advocating elimination of the property tax exemption for non-profit hospitals).

292. The Tax Reform Act of 1969, Pub. L. 91-172, 83 Stat. 487 (1970), for the first time, defined "private foundation" in the I.R.C. § 509(a) to mean every domestic or foreign charitable organization described in I.R.C. § 501(c)(3) except four categories referred to in I.R.C. § 509(a)(1), (2), (3), (4). Charitable organizations in I.R.C. § 509(a) are divided into two classes — private foundations or public charities which obtain support from a broad segment of the public. The Tax Reform Act of 1969 also introduced to the Internal Revenue Code other sections affecting private foundations including I.R.C. § 4940, an excise tax based on investment income; I.R.C. § 4941, taxes on self-dealing transactions between a "disqualified person" and § 501(c)(3) organizations that are private foundations; I.R.C. § 4942, taxes for failure to distribute income; I.R.C. § 4943, taxes on excess business holdings; I.R.C. § 4944, taxes on investments which jeopardize charitable purposes; and I.R.C. § 4945, taxes on taxable expenditures. The Tax Reform Act of 1969 introduced several provisions strengthening disclosure requirements. *See* I.R.C. §§ 6065, 6104, 6652, 6684 & 6685.

293. STAFF OF JOINT COMM. ON INTERNAL REVENUE TAXATION, 91ST CONG., 2D SESS.,

It is this author's contention that a total prohibition against any conflicts of interest by nonprofits would be too severe, for it would carry 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. Nonprofit corporations must engage in transactions with their directors in order to survive. Generally, few people have as much interest in the welfare of the nonprofit or understand it better than its directors. 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 know the organization best. Because the organization may not be able to obtain equivalent goods in the market, these benign interested transactions may be the only source. 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.

Despite the predictability and mechanical attractiveness of a prohibition on all self-dealing, a complete ban would fail as directors intent on misdeeds would conceal their conduct.[294] The detection burden would be the same. 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.[295]

C. *Monitoring the Director: Reporting Requirements*

Virtually all jurisdictions require annual reports from nonprofits to indicate financial status or solicitation activities. Reporting requirements alone will not stop abuses. At most, they may facilitate policing. The costs of evaluating nonprofits' reports are so great that there is little enforcement capability.[296]

GENERAL EXPLANATION OF TAX REFORM ACT OF 1969, at 30-31 (Comm. Print 1970).

294. Note, *The Fiduciary Duties of Loyalty and Care Associated with Directors and Trustees of Charitable Organizations*, 64 VA. L. REV. 449, 460 (1978).

295. Marsh, *supra* note 28, at 627.

296. The sheer number of nonprofit organizations is enormous. The Internal Revenue Service reported 851,012 active nonprofits in 1981. ANNUAL REPORT OF THE COMMISSIONER OF INTERNAL REVENUE AND THE CHIEF COUNSEL FOR THE INTERNAL REVENUE SER-

The staffs of attorneys general and of secretaries of state cannot fully investigate the uses of the charitable dollar. Enforcement costs to donors may be too great to be worth the effort.[297]

It is difficult to institute an effective statutory approach to directors' standards of conduct or to dismiss a director who has engaged in self-dealing. The position of a director is usually voluntary, the rewards are intangible, and the responsibilities require substantial freedom of action.[298]

D. *A Suggested Statutory Approach to Interested Transactions*

Any statutory approach to interested transactions must recognize the differences between the kinds of nonprofit corporations and reflect the need for various levels of regulation and prohibition.[299] It is time to return to the common law approach which focused on the protection of the organization first and on flexibility for directors second.

Fairness should explicitly blanket any statute. The procedure of approval and the substantive terms of the contract at the time considered must be fair in the judgment of the disinterested directors. Interested directors should be utilized only for quorum purposes if absolutely needed. After the presentation of the facts of the transaction and the director's interest, the interested director should exclude himself from any deliberation by the board. The presence of the interested director only makes consideration more difficult.[300] Boards may be too polite to their interested colleagues.

Disclosure means that the board must be informed: 1) of the director's interest in the transaction, and 2) of the material facts surrounding the transaction including the director's estimate of the benefit of the transaction to the nonprofit corporation and to himself or to the corporation in which he has an interest. The director has an affirmative duty to disclose all material facts. Failure to disclose per se is unfair, and the transaction could be

VICE 54, Table 20 (1981).

297. *But see* Hansmann, *supra* note 2, at 608-12.

298. Frankel, *supra* note 287, at 813.

299. *See supra* note 251.

300. Globe Woolen Co. v. Utica Gas & Elec. Co., 224 N.Y. 483, 121 N.E. 378 (1918).

voided even if the appropriate procedure is followed.

In its deliberations, the board should consider whether it can obtain similar goods, services, or capital from other sources at equivalent prices. If it can, the question becomes whether the cost of the interested transaction to the corporation is more favorable than the cost on the open market or whether there is some exigency which requires the corporation to enter the transaction. The standard for evaluating the directors' decision should be whether they reasonably could reach such a judgment.

The board should establish in advance a procedure whereby recurrent transactions or types of transactions are automatically validated. Such transactions would be recorded in reports to state authorities and in the minutes of board meetings. Such a procedure should include identification of those officers who have the authority to approve the transactions.[301] Procedures for automatic validation of recurring transactions should be adopted by the disinterested directors. In a membership corporation, the procedures should be ratified by disinterested shareholders.

E. *The Need for High Standards of Fiduciary Conduct*

It remains to be seen whether any statutory approach will improve the standards of conduct of nonprofit directors. Is there any way to encourage directors not to neglect their responsibilities or to engage only in interested transactions beneficial to the corporation? Can any statutory approach ease the enforcement problems? Only indirectly can any legislative or judicial approach have that impact. The size of the nonprofit sector is so vast, self-dealing so pervasive, the enforcement capabilities of attorneys general so limited, and standing requirements so restrictive that no statute can directly lead to higher fiduciary standards. The costs of an effective enforcement system are just too great. Is the argument for higher standards of conduct of theoretical import only?

Because of the problems of monitoring nonprofits, for all practical purposes they are self-regulated.[302] High, rigorous standards of conduct which are well articulated should eventually re-

301. Draft No. 5, *supra* note 131, § 5.09 and commentary at 147-51.
302. Abrams, *supra* note 80, at 484.

sult in improving directors' behavior and increasing their responsibility. Self-regulation may offer the only practical enforcement. It reduces wasteful enforcement costs. But for self-regulation to work, the standards for directors must be strict and clear. However, such standards must also offer the directors broad leeway to make decisions.[303] The development of effective standards of conduct requires a balance between society's interest in charities being able to effectively accomplish their purposes and the need to avoid undue restrictions or burdensome procedures that would make it difficult to recruit directors.

The remedy imposed in *Sibley Hospital* illustrates how articulated standards of conduct could be helpful to directors. Judge Gesell neither removed the trustees nor awarded money damages. He did order the treasurer to prepare a written statement of all transactions conducted since the last meeting.[304] Each present and future trustee had to read the Order and attached Memorandum Opinion. The decision discussed in detail the fiduciary responsibilities of directors. The rationale behind requiring directors to read the decision was to give them necessary guidance with respect to their directorial responsibilities. All members of the Sibley Hospital Board were public-spirited individuals whose lapses were based upon ignorance of their responsibilities. Development of clearly articulated standards of conduct, widely distributed throughout the nonprofit sector, would achieve the same results as Judge Gesell's remedy.

Over time, high standards of conduct should lead to changed board behavior. Most directors want to do what is appropriate. The problem has been that for many the standards have not been sufficiently clear. In the words of Professor Eisenberg, "in most areas of behavior most people will voluntarily conform their conduct to the aspirational standards expressed by the society through its laws and indeed through its morality."[305] Given the legal obligation of nonprofit directors to act for the public benefit, the function of nonprofit corporate law is to reinforce and provide greater precision to the inclination to do

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303. Frankel, *supra* note 287, at 826.

304. *Stern v. Lucy Webb*, 381 F. Supp. at 1021.

305. Eisenberg, *New Modes of Discourse in the Corporate Law Literature*, 52 GEO. WASH. L. REV. 582, 589 (1984).

right and to address the situations where the fiduciary may not share the inclination or may not understand or know what is right.[306]

Unambiguously drafted standards of conduct should lead to changes in directors' behavior as those standards are widely communicated. If the rules are clear, they will be accepted. Lawyers will have a socializing impact upon board members. They will stress to nonprofit boards the need to obey legal rules.[307] Higher standards of directors' conduct will ensure that tax exempt dollars will be applied to public purposes in the most efficient way.

306. *Id.* at 590.

307. Coffee, *Litigation and Corporate Governance: An Essay on Steering Between Scylla and Charybdis*, 52 GEO. WASH. L. REV. 789, 797 (1984).