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# The Limits of Charity Fiduciary Law

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# THE LIMITS OF CHARITY FIDUCIARY LAW

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To be a charity fiduciary is to undertake a range of important legal obligations. The practical challenges of governing a charity, however, produce the concern that charity fiduciaries are not working as well as they could—or should. The following four stories illustrate four paradigmatic areas in which the law struggles to ensure that charity fiduciaries carry out their duties:

> *Weak Board, Strong Executive.* For a dozen years, Adelphi University's president Peter Diamandopoulos strove to recast the tuition-dependent commuter school as "the Harvard of Long Island,"[1] but enrollment continued to plunge.[2] Meanwhile, Diamandopoulos's salary and benefits ballooned to $523,000 plus perquisites and expense reimbursements that included use of a furnished Manhattan apartment and trips to Greece.[3] Finally, the New York State Board of Regents removed and replaced eighteen of Adelphi University's nineteen trustees—not for failing to improve the university's finances, but for acting "blindly, recklessly and heedlessly" in setting the unreasonable compensation paid to Diamandopoulos.[4] New York's attorney general has sued the former

1. George Judson, *Inquiry Faults Trustees' Acts at Adelphi U.*, N.Y. TIMES, Apr. 18, 1996, at B1, *available in* LEXIS, News Library, Nyt File.

2. *See* Lee A. Sheppard, *Exempt Organizations: A Tale of Guyland Greed*, 72 TAX NOTES 797, 800 (1996) (noting that Adelphi University's enrollment fell 37% during Diamandopoulos's term).

3. *See id.* at 797-98 (detailing Diamandopoulos's compensation and fringe benefits).

4. Panel of New York State Board of Regents, Report and Recommendations After a Hearing to the Full Board of Regents at 26-33, Committee to Save Adelphi v. Diamandopoulos (Feb. 5, 1997) [hereinafter Panel] (discussing the failure to meet performance objectives as evidence of unreasonableness of compensation); *accord* Jack Sirica et al., *Board Departs: Adelphi Trustees Resign; Way Cleared for New Board*, NEWSDAY, Feb. 14, 1997, at A3, *available in* LEXIS, News Library, Majpap File (noting that the Regents voted 14-1 to re-

trustees, seeking, among other forms of relief, to surcharge them for "any loss or waste of University assets" resulting from their misconduct, plus interest.[5] Separately, the Internal Revenue Service could make this a test case of its new powers to recover "excess benefits" and penalty taxes from the benefited insider and the assenting trustees.[6]

Fundamental Change. The Sisters of Charity of St. Augustine (CSA) Health System, owner of four hospitals, desired to enter into a fifty-fifty joint venture with the for-profit chain Columbia/HCA Healthcare Corporation.[7] When the seventeen-member board of one of the hospitals, Timken Mercy Medical Center in Canton, Ohio, was asked to approve the letter of intent, the twelve community trustees asked for details—including the terms of the deal and the identity of the buyer.[8] When this request was denied, the community trustees unanimously voted not to proceed.[9] Within a month, they were dismissed, and the five remaining board members (four from the CSA system and the president/CEO) approved the letter of intent.[10] In succeeding months, the CSA considered other offers, in part to satisfy its due diligence and in part to allay the concerns of some bishops who ob-

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move the trustees). Several trustees were also found to have conflicts of interest, and to have violated their duty of loyalty. Panel, *supra*, at 33-46.

5. Plaintiff's Complaint at 44, Vacco v. Diamandopoulos, No. 97401253 (N.Y. Sup. Ct. Mar. 24, 1997).

6. *See* I.R.C. § 4958 (West 1997) (imposing "excise taxes" against charity "insiders" who receive private inurement through excess benefit transactions, as well as against consenting charity managers, occurring on or after September 14, 1995, unless pursuant to a written contract that was binding on September 13, 1995); *see also* Sheppard, *supra* note 2, at 799 (suggesting this as a test case).

7. Bruce Japsen & Sandy Lutz, *Catholic System Drops Local Board Members*, MOD. HEALTHCARE, May 29, 1995, at 2, 2-3.

8. Kurt Eichenwald, *F.B.I. Reported Examining Hospital Operator in Ohio*, N.Y. TIMES, Apr. 1, 1997, at D2, *available in* LEXIS, News Library, Nyt File.

9. *Id.*

10. *See id.*; Japsen & Lutz, *supra* note 7, at 2. See also Jay Greene, *Power Struggle with System Leads to Hospital Board's Ouster*, MOD. HEALTHCARE, Aug. 12, 1996, at 8, 8, reporting that the Eastern Mercy Health System, which operates in six states, fired the 23-member board of a Fort Lauderdale hospital. Nineteen of those board members filed suit against Eastern Mercy. *Id.* The 14 new members approved bylaws that weaken local control by transferring authority to the system. *Id. See generally* Ellen Hale, *Selling or Selling Out? How Community Hospitals Are Changing Hands*, GANNETT NEWS SERVICE, Oct. 13, 1996, at S11, *available in* 1996 WL 4388615 (explaining how "dozens of community . . . hospitals . . . have been sold to for-profit companies"); Robert Kuttner, *Patients or Shareholders?*, ST. PETERSBURG TIMES, Nov. 24, 1996, at D1, *available in* LEXIS, News Library, Stpete File (observing that some for-profit hospital chains have gone on a "buying binge" during the 1990s).

jected to the commodification of health care.[11] The Vatican, however, following canonical law procedures regarding church property, gave its blessing to the joint venture.[12] The CSA used the $200 million of cash proceeds to set up grant-making foundations where the hospitals operated.[13] According to a news report, the money would be used "to act on issues that affect the quality of life, change attitudes and structures that oppress people, provide direct relief to the poor and listen to the poor and educate others to their needs."[14] Shortly after the closing, Columbia/HCA nominated Sister Judith Ann Karam, the major superior of the CSA, to serve on its board.[15] The Timken name was removed from the Canton facility at the request of the family.[16]

Commingled Purpose. With its subscriber base aging and its main product losing appeal, *Reader's Digest* lost more than half its stock value between 1996 and 1997.[17] Its decision to halve its dividend payout threatened the financial comfort of several major charities supported by foundations established by *Reader's Digest* founders DeWitt and Lila Wallace with non-voting stock of the company.[18] Such beneficiary charities as the Metropolitan Museum of Art, Lincoln Center, Colonial

11. *See, e.g.*, *Jack Curley, President and CEO, Catholic Health Association of the United States, Issues Statement*, PR NEWSWIRE, Nov. 2, 1995, *available in* LEXIS, News Library, Wires File ("The arrangement is especially regrettable given that a comparable alternative proposal was offered by several Catholic healthcare organizations, but subsequently rejected by the Sisters of Charity of St. Augustine."); Raquel Santiago & Bruce Japsen, *CSA to Consider Other Options*, CRAIN'S CLEVELAND BUS., Sept. 11, 1995, at 3 (reporting that three Catholic bishops urged CSA to consider other Catholic partners before linking with Columbia/HCA); Cathy Tokarski, *For Whom the Church Bell Tolls*, HOSPITALS & HEALTH NETWORKS, Oct. 20, 1995, at 41, 41-42 (questioning "whether Catholic hospitals can retain their religious values" when they merge with non-Catholic hospitals).

12. Bruce Japsen, *Vatican Allows Columbia, CSA to Complete Deal*, MOD. HEALTHCARE, Nov. 6, 1995, at 3, 3.

13. *See* Michael K. McIntyre, *St. Augustine Sisters Start Foundation*, PLAIN DEALER (Cleveland), May 11, 1996, at B3, *available in* LEXIS, News Library, Clevpd File (discussing what portion of the proceeds each foundation received).

14. *Id.*

15. *Sister Judith Ann Karam Nominated to Columbia Board of Directors*, PR NEWSWIRE, Apr. 4, 1996, *available in* LEXIS, News Library, Wires File.

16. Mary Chris Jaklevic, *Ohio Hospital's New Name Is More Than a Mouthful*, MOD. HEALTHCARE, July 1, 1996, at 12, 12.

17. *See* Jill J. Barshay, *Macalester's Stock Lagging: As Reader's Digest Shares Go, So Goes College Endowment Fund*, STAR TRIB. (Minneapolis), May 22, 1997, at D1, *available in* 1997 WL 7567281 (noting that *Reader's Digest* stock plunged from $51 to $24.37 between the beginning of 1996 and May 1997).

18. *See* Geraldine Fabrikant, *Reader's Digest Gives the Arts a Lesson in Finance*, N.Y. TIMES, Aug. 26, 1997, at A3, *available in* LEXIS, News Library, Nyt File (reporting that the Wallaces had created nine charities, including two large foundations, during their lifetimes).

Williamsburg, the Memorial Sloan-Kettering Cancer Center, and Macalester College convinced their "supporting organizations" to divest some of the *Reader's Digest* stock in the early 1990s, but as the stock soared, the charities allowed themselves to become complacent.[19] Apparently, the charities had a "tacit agreement . . . that it [was] in the best interest of the group to act in concert and not to sell shares unilaterally."[20] Moreover, "[t]here [was] talk that some decision-makers were keener to maintain good relations with Reader's Digest than to create a prudent investment portfolio and were fearful that a fuller divestment could be interpreted as an affront."[21] Indeed, George Grune—who from August 1997 to April 1998 was brought back from retirement to rejoin the Reader's Digest Association as chairman and chief executive—had never relinquished his chairmanship of two other Wallace foundations that own over seventy percent of the company's voting stock, and Grune also heads each of the seven supporting organizations.[22]

*Trusting Relationships.* Hundreds of charities and donors fell for the "double your money" offer from the Foundation for New Era Philanthropy.[23] But the promised anonymous matching donors never existed, and the collapse of the Ponzi scheme threatened the stability of dozens of charities, ranging from small bible colleges to mainstream Philadelphia cultural institutions—and still threatens the credibility of the entire charitable sector.[24]

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19. *See* Barshay, *supra* note 17 (observing that Macalester's supporting foundation sold 40% of its 10 million shares in two public offerings in 1990 and 1991, but failed to undertake further diversification).

20. *Id.*

21. *Id.*

22. *See* Vince Stehle, *Falling Price of Reader's Digest Stock Is Big Blow to Wallace Funds*, CHRON. PHILANTHROPY, Feb. 26, 1998, at 21, 21 ("So far, . . . none of the trustees of the supporting organizations has been willing to take any action or to speak out publicly against Mr. Grune and his management of the company."); *see also* Jon Elsen, *Vacco Probes Why Mag's Woes Are Hard to Digest*, N.Y. POST, Feb. 4, 1998, at 28, *available in* LEXIS, News Library, Nypost File (reporting that the state attorney general has begun a preliminary investigation of George Grune's reported conflicts of interest in order to protect the assets of New York cultural institutions); Patrick M. Reilly, *Reader's Digest Names Thomas Ryder of American Express as Chairman, CEO*, WALL ST. J., Apr. 29, 1998, at B6.

23. *See* G. Bruce Knecht & Jeffrey Taylor, *SEC Charges New Era, Bennett Defrauded Charities, Big Investors*, WALL ST. J., May 19, 1995, at A3, *available in* 1995 WL-WSJ 8712866 (reporting on the New Era fraud that cheated hundreds of charitable organizations and a number of wealthy financiers).

24. *See* C. Quinn Hanchette & Grant Williams, *Claims Against New Era Foundation Total More Than $350-Million*, CHRON. PHILANTHROPY, Oct. 19, 1995, at 34, 34-37 (listing the loss claimed by each of hundreds of charities and individual donors, along with the net loss, or

Looking to the law for a guarantee of a well-run charitable sector invites disappointment. Our legal structure excels at establishing or requiring processes in which individuals may make substantive decisions, but it falters at dictating results.[25] Consistent with their limited role in our political economy, the best laws assist private parties in enforcing their agreements; the worst laws tell private parties what their agreements should be.[26]

Charity laws focus on three general areas: the relationship between the charity and its fiduciaries,[27] fundraising and charitable solicitations,[28] and the tax requirements for exemption of the entity and deductibility of contributions.[29] This Article concentrates on the first

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even gain, for each as calculated by the bankruptcy trustee). Hundreds of the organizations that benefited from the scheme agreed to pay $41 million to reimburse those who lost money. *See Pyramid Scheme Victims to Be Paid $41 Million*, N.Y. TIMES, Apr. 4, 1997, at A20, *available in* LEXIS, News Library, Nyt File [hereinafter *Pyramid Scheme*]. That figure is in addition to the $30 million in existing assets and an expected $15-18 million settlement from Prudential Securities (the escrow agent). *Id.* Bankruptcy officials now estimate losses at $100 million. *Id.*

25. *See generally* Evelyn Brody, *Institutional Dissonance in the Nonprofit Sector*, 41 VILL. L. REV. 433 (1996) [hereinafter Brody, *Institutional Dissonance*] (opining that significant reform of nonprofit laws would either fail to fix problems in the nonprofit sector or create additional ones).

26. I use the terms "best" and "worst" in their positive, rather than normative, sense. That is, assuming that private agreements do not violate fundamental public policy, a law is good if it interferes as little as possible in private decisionmaking, and is bad if it distorts behavior.

27. *See, e.g.*, Brody, *Institutional Dissonance*, *supra* note 25, at 482 (stating that trustees and directors of nonprofit organizations owe legal duties of loyalty and care).

28. According to a survey of top state charity officials (38 states responding), their "biggest problem" relates to charitable solicitations, and whether charities spend their money as represented to donors. Sean Mehegan et al., *Charity Regulation Today: How the States See It*, NONPROFIT TIMES, Mar. 1994, at 1, 1. Connecticut mentioned the improper use of charitable assets and management self-dealing. *Id.* at 13. Massachusetts mentioned "board stewardship." *Id.* at 15. Oregon found "that a lot of small and medium-sized charities are being run . . . by one or two people rather than a board, or the board is not involved, or there is self-dealing in terms of benefits." *Id.* at 17. Pennsylvania offers "training sessions for charities." *Id.* at 18. Texas reported that "[m]oney is misspent or even outright stolen." *Id.* Many complained of a lack of resources. *See id.* at 1 (citing lack of enforcement personnel as an obstacle to proper enforcement of charitable solicitation laws). Floyd Perkins, chief of the Illinois Attorney General's charitable trusts and solicitation division, once suggested, "'We should tell our citizens that nobody in Illinois is looking at this stuff' . . . . 'If you want to give to charity, you're on your own.'" Robert Franklin, *Critics Say Charity Watchdogs Are Nearly Toothless; Many State Agencies Have Inadequate Staff, Resources*, STAR TRIB. (Minneapolis), Sept. 28, 1992, at 3B, *available in* LEXIS, News Library, Strib File (quoting Perkins).

29. *See, e.g.*, Henry Hansmann, *The Evolving Law of Nonprofit Organizations: Do Current Trends Make Good Policy?*, 39 CASE W. RES. L. REV. 807, 807-12 (1988-1989) [hereinafter Hansmann, *The Evolving Law*] (analyzing charity laws under three categories, including a fiscal law category that focuses on tax exemptions and other tax treatment of charities). For discussion of the tax issues, see generally Evelyn Brody, *Of Sovereignty and Subsidy: Con-*

area. The law imposes on fiduciaries only the twin duties of loyalty and care.[30] Within broadly bounded charitable purposes, no law tells the entity or its managers how to "do" charity. In general, moreover, the same rules apply to fiduciaries in the full range of charitable institutions, from a small neighborhood soup kitchen to a major university.

We might expect close regulation of charities, but this is not the case. The state attorney general enjoys nearly exclusive authority and discretion to challenge a charity manager's actions. Such a structure puts pressure, as the Delaware Attorney General once complained, on "'the inclination and budget of a public official to vindicate [the beneficiaries'] rights.'"[31] Weak enforcement, however, is a symptom rather than a cause of the independence of the charitable sector. While the state polices fiduciaries who breach their duty of *loyalty* (such as by self-dealing), enforcement of the duty of *care* is weak because we do not want the state to run charities.[32] Thus, on the duty-of-care side, charities are not significantly more supervised than publicly traded business corporations, and courts, by long tradition, only reluctantly intrude in proprietary decisionmaking.[33]

Good corporate governance often requires more than satisfying the legal threshold.[34] The admitted gaps between the legal requirements and sound business practices do not, however, necessarily mean

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*ceptualizing the Charity Tax Exemption*, 23 J. CORP. L. (forthcoming 1998) (on file with author) [hereinafter Brody, *Of Sovereignty and Subsidy*], and Evelyn Brody, Charities in Tax Reform: Threats to Subsidies Overt and Covert (Mar. 25, 1998) (unpublished manuscript, on file with author).

30. *See* DANIEL L. KURTZ, BOARD LIABILITY: GUIDE FOR NONPROFIT DIRECTORS ch. 4 (1988). Some commentators identify a third fiduciary duty, the duty of obedience to the purposes of the charity. *See, e.g., id.* at 84-90. Others, including the author of this Article, find the obligation subsumed under the directors' duties of care and loyalty.

31. Oberly v. Kirby, 592 A.2d 445, 468 (Del. 1991) (quoting the Attorney General's Opening Brief at 16).

32. *See* HARRIET BOGRAD, THE ROLE OF STATE ATTORNEYS GENERAL IN RELATION TO TROUBLED NONPROFITS 6 (Program on Non-Profit Orgs., Yale University, Working Paper No. 206, 1994) (stating that nonprofit regulators believe that they "should not 'micromanage' a group nor substitute their own judgment for that of the board and staff").

33. Note that the vaunted oversight provided by self-interested shareholders founders on many of the same economic forces that operate in the nonprofit sector. *See* Evelyn Brody, *Agents Without Principals: The Economic Convergence of the Nonprofit and For-Profit Organizational Forms*, 40 N.Y.L. SCH. L. REV. 457, 490 (1996) [hereinafter Brody, *Agents Without Principals*] (observing that, as with for-profit businesses, competition among nonprofit organizations "weed[s] out nonperforming or nonresponsive" agencies, thus creating a market-driven control over directors).

34. For example, in the context of avoiding violations of the duty of loyalty, Daniel Kurtz urges:

> It is essential that organizations adopt policies to deal with conflicts or they will have to rely on the law, which sets only minimum standards[,] or an *ad hoc* ap-

that formal laws should be expanded or reformed to mandate those practices.[35] Charity management is located in the private sector precisely because society prefers reasonable discretion exercised by different participants under different conditions to the uniformity of government-directed action.[36]

Some observers charge that charity fiduciary law has weakened in recent years; they lament a perceived shift from strict trust-law fiduciary standards to hands-off business-corporation director standards. Critics fault the American Bar Association (ABA) for basing its model nonprofit statutes on its model business corporation statutes.[37] However, I do not believe that statutory reform is responsible for the judi-

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> proach, which tends to personalize decisions and either inhibit a frank exchange of views among board members or alienate them. . . .
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> . . . Thus, while the law both allows an interested director's voting on a transaction that involves a conflict and does not preclude his participating in discussion and debate, there seems to be little good reason for allowing this participation.

KURTZ, *supra* note 30, at 64-65.

35. For example, a leading scholar (and maker) of corporate law, Delaware Supreme Court Chief Justice E. Norman Veasey, seems untroubled by the difference between what the law requires and the recent demands of shareholders (notably the activist institutional investors):

> There is a long checklist of issues regularly raised by institutional investors. Many of these issues may never become issues in litigation. For example, in contested litigation, courts might not find important those parts of an institutional investor's agenda which would urge: (i) separation of the office of chief executive officer (CEO) and the office of board chair; (ii) creation of a position of "lead director," an independent director who would be designated to stand in the wings to lead a critical evaluation of the CEO or manage independent board consideration of major "ownership" issues such as changes in control; (iii) payment of directors in stock rather than cash and elimination of outside director pension plans; or (iv) the structural elimination of poison pills or staggered boards.

E. Norman Veasey, *The Defining Tension in Corporate Governance in America*, 52 BUS. LAW. 393, 402 (1997) (citing institutional investors' demands as described by Dennis J. Block & Jonathan M. Hoff, *Mergers and Acquisitions: Corporate Governance and Institutional Activism*, N.Y. L.J., Jan. 18, 1996, at 5).

36. *See, e.g.*, James Douglas, *Political Theories of Nonprofit Organization*, *in* THE NONPROFIT SECTOR: A RESEARCH HANDBOOK 43, 47 (Walter W. Powell ed., 1987) ("The classic pluralist argument is that a voluntary nonprofit sector permits a greater diversity of social provisions than the state itself can achieve.")

37. Henry Hansmann charges that the ABA "simply took the Model Business Corporation Act and deleted from it *all* provisions that seemed inappropriate for nonprofits, such as those dealing with the issuance of stock. The result was a rather empty enactment." Hansmann, *The Evolving Law*, *supra* note 29, at 814; *accord* Howard L. Oleck, *Mixtures of Profit and Nonprofit Corporation Purposes and Operations*, 16 N. KY. L. REV. 225, 243-44 (1988) (criticizing the ABA for referring the revision of the model act to its Section on Corporation, Banking, and Business Law, "because that section is the wrong one for planning law for altruistic, voluntaristic, *pro bono* organizations—organizations whose purposes are supposed to be selfless, spiritual, and in the public service").

cial treatment of nonprofit directors like business directors; nor, at least as to duty-of-care issues, is the trend to do so that recent.[38] What has undeniably changed, however, is the size and behavior of the charitable sector itself, and the need of thousands of new charities to reach beyond traditional populations to staff their boards.[39] Explosive growth and expansion into commercial activities have transformed the typical charity from a perpetual fund invested by trustees into a modern enterprise subject to the management demands of a complex operating business.[40]

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The Reporter for both the 1980 California nonprofit statute and the ABA's 1987 revision found the following:

> [Earlier] nonprofit laws are the poor stepchild of the state business statutes. Legislators have paid little attention to the structure, activities, needs, and role of nonprofit corporations. Scholars, too, have devoted relatively little time and effort to the study and analysis of nonprofit statutes. The body of statutory and case law applicable to nonprofit corporations remains sparse and undeveloped.

Michael C. Hone, *Aristotle and Lyndon Baines Johnson: Thirteen Ways of Looking at Blackbirds and Nonprofit Corporations: The American Bar Association's Revised Model Nonprofit Corporation Act*, 39 CASE W. RES. L. REV. 751, 759 (1988-1989). In drafting both the California statute and the *Revised Model Nonprofit Corporation Act*, Professor Hone sent over a thousand copies of an exposure draft "to nonprofit organizations, the Internal Revenue Service, academics, accountants, and others for their comments. The input received from nonprofit organizations was crucial in shaping the law." *Id.* at 760 (footnote omitted).

38. One commentator notes:

> There are only a handful of these cases [dealing with duty-of-care issues independent of director self-dealing], and the decisions in all but one espouse a corporate standard, although they span almost fifty years and emanate from different jurisdictions. These few cases deal with issues such as losses on investments, the breadth of investment authority, and the propriety of compensation to staff or advisors.

KURTZ, *supra* note 30, at 23. One court made a similar observation:

> [I]ll-success or bad judgment not so reckless or extravagant as to amount to bad faith or gross or wilful negligence on the part of directors in the discharge of their duties do not warrant the appointment of a receiver for the corporation or the rendition of a personal judgment against the directors.

Beard v. Achenbach Mem'l Hosp. Ass'n, 170 F.2d 859, 862 (10th Cir. 1948); *accord* Taylor v. Baldwin, 247 S.W.2d 741, 750 (Mo. 1952) ("The court will not substitute its judgment and discretion for that of the governors of the charity unless the governors (the Board) are guilty of misconduct, or the charity is impossible of execution, or is about to fail, or its purpose has been or is about to be perverted.").

39. *See* PETER DOBKIN HALL, INVENTING THE NONPROFIT SECTOR 138 (1992) ("[T]he increase in the numbers of nonprofit organizations serving broader and more diverse constituencies has transformed patterns of trustee recruitment. More women, ethnics, and minorities . . . have joined the ranks of trustees.").

40. Hansmann was among those who observed the evolving commercialism of charitable organizations:

> By 1950, . . . the nonprofit sector had begun to have a new look. It was becoming populated with large numbers of "commercial" nonprofits—nonprofits that were neither donatively supported on the one hand, nor clubs on the other, but instead had the sale of personal services as their primary activity and derived nearly all of their income from the prices charged for those services.

We cannot simply say, however, that fifty years ago "the law" would have looked the way it does now had only charities functioned then as they do today. At a practical level, it is not so easy to say what "the law" has been[41]—or even is now. While every state has statutory provisions governing nonprofit corporations,[42] not all express the same fiduciary standards,[43] and few cases involving nonprofit fiduciary issues have reached the courts.[44] It might even be that "the law" as actually practiced by charity advisors and regulators approximates ideal standards more closely than the language of the statutes requires. Reform rather than punishment is generally the goal of the charity regulator, whether the state attorney general or the Internal Revenue Service.[45] Both the government and the charity prefer settle-

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Hansmann, *The Evolving Law*, *supra* note 29, at 813.

41. For example, Carl Zollman's *American Law of Charities* completely ignores the governance of a corporate charity—even though he extols the corporate charity for avoiding many of the difficulties of a charitable trust, which he discusses in the other six hundred pages of his treatise. *See* CARL ZOLLMAN, AMERICAN LAW OF CHARITIES 222-45 (1924) (discussing charitable corporations); *id.* at 329-32 (discussing corporate trustees). Hansmann charges that the original *Model Nonprofit Corporation Act* "is muddled concerning permissible purposes for incorporation, vague and excessively permissive about distributions of net assets to members on dissolution, and completely silent about the critical issue of directors' and officers' fiduciary obligations." Hansmann, *The Evolving Law*, *supra* note 29, at 814.

42. Forty-six states plus the District of Columbia have a separate statute governing corporations variously termed nonprofit, not-for-profit, nonstock, or voluntary. Delaware is one of four states whose general corporation law also covers corporations without stockholders. The ABA's *Revised Model Nonprofit Corporation Act* has been adopted, in whole or in part, in several states, while being rejected in other revisions, such as Illinois's. *See* 805 ILL. COMP. STAT. ANN. 105/103.05 (West 1993) (allowing organization of nonprofits for any of 30 enumerated purposes, rather than adopting the *Revised Model Nonprofit Corporation Act*'s categorization of three separate types of nonprofit corporations). California's statute provided the inspiration for the ABA's model. *See supra* note 37. Similar to the California statute, the *Revised Model Nonprofit Corporation Act* divides "nonprofits into Public Benefit, Mutual Benefit, and religious nonprofits." Hansmann, *The Evolving Law*, *supra* note 29, at 816; *see* CAL. CORP. CODE §§ 5110-5111, 7110-7111, 9110-9111 (West 1990 & Supp. 1998). New York has a unique nonprofit corporation statute. *See* N.Y. NOT-FOR-PROFIT CORP. LAW § 201 (McKinney 1992) (permitting not-for-profit corporations to form for four different types of purposes).

43. Indeed, not all statutes contain explicit fiduciary rules.

44. *See* James J. Fishman, *The Development of Nonprofit Corporation Law and an Agenda for Reform*, 34 EMORY L.J. 617, 676-77 (1985) [hereinafter Fishman, *Development of Nonprofit Law*] ("There are few cases dealing with a director's standards of proper conduct that apply to charitable corporations.").

45. For example, at a recent conference, the top charity official from Ohio discussed five enforcement remedies available to the attorney general. Craig Mayton, Assistant Attorney General of Ohio, Comments at a Conference on "Governance of Nonprofit Organizations: Standards and Enforcement," National Center on Philanthropy and the Law, New York University School of Law (Oct. 30-31, 1997) (author's notes). Mayton described the injunctive remedy as the remedy of "first resort," characterized criminal sanctions and monetary damages as onerous, commented that removal of a fiduciary "damages reputa-

ment to the win-or-lose structure of litigation.[46] Settlement often best accomplishes a regulator's goals to ensure a well-managed charitable sector and to preserve public confidence in the use of contributed funds;[47] for charity managers, settlement offers a chance to improve their behavior while avoiding embarrassment and personal liability. "Closing agreements" between the regulator and the charity to end an enforcement action can be quite detailed, often spelling out specific terms regulating future conduct.[48] Lately, perhaps responding to criticism that closing agreements create a secret body of law, some regula-

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tion" and has a "chilling effect on getting new members to serve," and mentioned receivership as an "unusual" remedy. *See also infra* note 235.

46. Even where a court exercises equity jurisdiction, judicial resources do not permit extended supervision. As a separate matter, the courts are available to charity fiduciaries seeking instruction or approval "as to the existence or extent of their powers and the proper manner of their exercise." EDITH L. FISCH, CHARITIES AND CHARITABLE FOUNDATIONS § 473, at 382 (1974); *see also* 4A AUSTIN WAKEMAN SCOTT & WILLIAM FRANKLIN FRATCHER, THE LAW OF TRUSTS § 394, at 382-84 (4th ed. 1989). However, a court will not give instructions if the issue calls for an exercise of discretion. For example, one court noted:

> While the court will not interfere with a discretionary power vested in a trustee, in the absence of a showing of fraud, bad faith or an abuse of discretion, trustees may properly seek its advice as to the legality of action which they propose to take. The trustee would not be entitled to ask the court to advise it in the selection of the particular purposes to which the fund should be devoted, but, having selected such a purpose, it would be entitled to seek advice as to whether that purpose was a proper one to benefit by the distribution of the fund.

Westport Bank & Trust Co. v. Fable, 13 A.2d 862, 867 (Conn. 1940) (citation omitted).

47. *See, e.g.*, Lisa M. Bell & Robert B. Bell, *Supervision of Charitable Trusts in California*, 32 HASTINGS L.J. 433, 458 (1980) (explaining that, in order to avoid alarming the donating public, the California Attorney General does not publicize the large amount of money it recovers for charities). But see, for example, Dana Wilkie, *Merger Inspector Carries Formidable Credentials*, SAN DIEGO UNION-TRIB., Nov. 23, 1996, at A1, *available in* 1996 WL 12577736, which states:

> [California Deputy Attorney General James Schwartz's] high-profile cases have included a $1 million settlement in the case of Stanford University bookstore directors accused of mismanaging and diverting store assets for personal profit; a $2.7 million settlement in the case of Los Medanos Hospital District directors accused of mismanaging hospital assets; and a $2.5 million settlement in the case of Hastings Law School trustees accused of diverting student scholarship funds to imprudent investments.

48. *See, e.g.*, Carolyn Wright, *IRS Has High Hopes for Intermediate Sanctions, Owens Says*, TAX NOTES TODAY, June 10, 1996, at 113-3, *available in* LEXIS, Fedtax Library, Tnt File (according to IRS Exempt Organizations director Marcus Owens, "closing agreements . . . commonly incorporate an organization's promises to draft and implement internal audit procedures, a written conflict-of-interest policy, and an open-door policy for employees to raise questions with executives"). *See generally* James J. Bloom & Thomas J. Miller, *Closing Agreements*, *in* IRS EXEMPT ORGANIZATIONS TECHNICAL DIVISION, 1992 EXEMPT ORGANIZATIONS CONTINUING PROFESSIONAL EDUCATION TECHNICAL INSTRUCTION PROGRAM 263 (1992) (stating that closing agreements provide guidance to tax-exempt charities and help nonprofits to maintain future compliance with IRS regulations).

tors have conditioned settlement on the charity's assenting to public disclosure of the agreement.[49] Nevertheless, invisibility at the informal end of the regulation spectrum makes it very difficult to judge the effectiveness of regulators in influencing charity behavior.[50]

Moreover, regulators or courts might intone tough-sounding legal standards while actually going easier on the charity fiduciary in order not to discourage charity service. In one admittedly extreme case, a state court absolved the founder and dominating foundation manager of any breach of duty in running up a $300 million loss through poor investments:

> If Mr. Pepperdine had never organized the Foundation, but had set himself up to bestow his fortune on deserving charities and had at the same time continued to "invest and reinvest" his own moneys and properties and finally by miscalculations have lost it all, would any one be so crazy and cruel as to assert a claim against him for his carelessness in not holding intact the fortune which he intended to bestow on others?[51]

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49. *See, e.g.*, *Closing Agreement as to Final Determination Covering Specific Matters*, 10 EXEMPT ORG. TAX REV. 1035, 1036 (1994) (detailing an agreement between Hermann Hospital and the Internal Revenue Service to change physician recruitment practices and to pay nearly $1 million—the value of federal income tax exemption for 1991); *Public Statement, Jimmy Swaggart Ministries, Baton Rouge, Louisiana*, 5 EXEMPT ORG. TAX REV. 206, 206-07 (1992) (detailing an agreement to desist from political activities—Jimmy Swaggart Ministries had endorsed Pat Robertson's presidential bid—and to pay about $170,000 in back taxes and interest); Letter from the Commonwealth of Massachusetts, Office of the Attorney General, to Dr. Arthur G.B. Metcalf, Chairman, Trustees of Boston University (Nov. 16, 1993), *reprinted in* PHILANTHROPY MONTHLY, Oct. 1993, at 7 (detailing an agreement between Boston University and the Attorney General that the University will make changes in its corporate governance); *CBN Press Release in Agreement with IRS* (Mar. 16, 1998), *available in* LEXIS, Fedtax Library, Tnt File, *as* 98 TNT 55-78 (Mar. 23, 1998) (announcing a settlement between the Christian Broadcasting Network and the IRS in which, among other terms, CBN loses its tax exemption in 1986 and 1987 "due to the application of the rules prohibiting intervention in political campaign activities," pays a "significant" amount to the IRS, increases the number of outside directors on its board, and makes "other organizational and operational modifications to ensure ongoing compliance with the tax laws").

50. *See* Bell & Bell, *supra* note 47, at 451 n.116 ("[P]ublic files do not give information on the many settled cases or the vast number of unreported court opinions."). In private correspondence, California Deputy Attorney General James R. Schwartz wrote to me:

> I believe that my colleagues, both in the California Attorney General's office and in other Attorney General offices nationally, have had a similar experience [with cases involving breaches of duty of care]. However, because these cases are almost always resolved at the state trial court level, and, therefore, do not result in published opinions, they do not hit the radar screens of most academics.

Letter from James R. Schwartz, California Deputy Attorney General, to Evelyn Brody (May 13, 1997) [hereinafter Letter to Brody].

51. George Pepperdine Found. v. Pepperdine, 271 P.2d 600, 604 (Cal. Dist. Ct. App. 1954).

While the state later reversed this standard, the "*Pepperdine* attitude causes one of the larger difficulties in achieving effective supervision over charities."[52] Michael Hone, the reporter of both the new California nonprofit law and the ABA's revision to its model act, observed that the law allows volunteer directors, "in some cases in fact, to almost be asleep at the gate":

> It is my impression, from talking with state Attorney Generals [sic], that it is almost impossible to win cases involving only inattentive management. Where the directors are pillars of the community or spending hours of their time, they are not good emotional defendants. Therefore, the [Revised Model Nonprofit Corporation] Act has adopted a duty of care which imposes liability only in particularly egregious cases. If one could show years of inattention, then there would be liability. But if one had just a single lapse, a terrible judgment, the business judgment rule would protect directors . . . . The trust standard would hold the directors personally liable for mere negligence. . . . It was the subcommittee's opinion that if that were the standard adopted by the Act, very few sensible people would serve on the boards of nonprofit organizations.[53]

Such a state of affairs prompted Harvey Goldschmid to observe that the nonprofit law's single greatest problem is "the nonfunctioning dead board."[54]

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52. James J. Fishman, *Standards of Conduct for Directors of Nonprofit Corporations*, 7 PACE L. REV. 389, 413 (1987) [hereinafter Fishman, *Standards of Conduct*]. Similarly, Kurtz comments:

> The attitude [*Pepperdine*] reflects is more pervasive than one would expect from the few cases that seem to proclaim it explicitly. It is another way in which the applicable legal standards and the realities of nonprofit governance are at odds. What courts most often do with these situations is to dissemble but obscure the bases of decision making. *Pepperdine* and *Miami Retreat* [*Foundation v. Ervin*, 62 So. 2d 748 (Fla. 1952),] make clear what is often present but unarticulated, *i.e.*, that the law may tolerate excesses by a founder because, in some sense, the founder is regarded . . . as having a proprietary interest. *See also, Haines v. Elliot*, 58 A. 718 (Conn. 1904).

KURTZ, *supra* note 30, at 157 n.21.

53. Hone, *supra* note 37, at 771-72.

54. Harvey J. Goldschmid, Dwight Professor of Law, Columbia University School of Law, Comments at a Conference on "Nonprofit Conversions," Program on Philanthropy and the Law, New York University School of Law (Oct. 18, 1996) (author's notes). *See generally* Harvey J. Goldschmid, *The Fiduciary Duties of Nonprofit Directors and Officers: Paradoxes, Problems, and Proposed Reforms*, 23 J. CORP. L. pt. IV.A (forthcoming 1998) (on file with author) (recommending self-help by the nonprofit community: a more precise specification of functions, guidelines, and enhanced educational efforts).

Paradoxically, then, more exacting standards for the fiduciary's duty of care can do more harm than good. With statutory and contractual limitations on directors' and officers' insurance coverage and indemnification from the charity, the fear of potentially high monetary liability discourages good directors from serving, while the desire to save directors from financial ruin leads courts to degrade the legal standards by avoiding findings of liability. One salutary statutory reform might be to specify the *worst* monetary harm a fiduciary could suffer—setting the risk at a level that would be low enough to continue both attracting directors and making attorneys general and courts more willing to find breaches, yet high enough to induce fiduciaries to take their tasks more seriously.

Similar concerns have led most states to alter their business corporation statutes to grant directors a monetary cap or even a waiver on their liability for breaches of their duty of care.[55] (Such a shield usually requires an amendment to the articles of incorporation, with shareholder approval.[56]) A waiver does *not* change the standard of care, but rather limits the corporation to equitable remedies, such as injunction or removal of the director.[57] The ABA's *Revised Model Nonprofit Corporation Act* includes a charter-amendment option, and a few states adopted such a reform.[58] Some might feel uneasy granting charity directors a total monetary shield for duty-of-care breaches. Even capping monetary relief to a director's compensation—as the American Law Institute (ALI) suggested that a business corporation

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55. *See* Committee on Corp. Laws, *Changes in the Revised Model Business Corporation Act—Amendment Pertaining to Liability of Directors*, 45 BUS. LAW. 695, 696 (1990) [hereinafter Committee I] (stating that in a majority of states, charter option statutes authorize a corporation to adopt a provision that will eliminate or limit the personal liability of a director to the corporation or the shareholders for monetary damages for breach of fiduciary duty); Committee on Corp. Laws, *Changes in the Revised Model Business Corporation Act—Amendment Pertaining to Liability of Directors*, 46 BUS. LAW. 319, 319 (1990) [hereinafter Committee II] (stating that developments in the mid- and late-1980s, including the decision of the Delaware Supreme Court in *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985), and the resulting reluctance of qualified individuals to serve as directors, "highlighted the need to permit reasonable protection of directors from exposure to personal liability . . . so that directors would not be discouraged from fully and freely carrying out their duties").

56. *See* Committee I, *supra* note 55, at 696 (explaining that most of the statutes authorize a corporation to amend the articles of incorporation).

57. *See id.* (explaining that the waiver of liability applies only to monetary damages).

58. *See* REVISED MODEL NONPROFIT CORP. ACT alternative § 2.02(b)(5) (1987) (Optional Article Provision); *id.* alternative § 8.30(d) (General Standards for Directors); *see also infra* Part III.A. Given that charities do not have shareholders, perhaps for memberless corporate charities such a monetary shield should be self-executing, rather than on a charity-by-charity "opt-in" basis. Similar legislation might be appropriate for trustees of charitable trusts whose trust instruments do not already provide a shield.

could do by charter amendment (with shareholder approval)[59]—would amount to a full waiver for the overwhelming majority of nonprofit directors who serve without compensation. Thus, the state might prefer to impose a minimum as well as a maximum potential financial risk.

Meanwhile, concerns of federalism overlie the regulation of nonprofit fiduciaries. The old turf accommodation—that states cover substantive law and the federal government sets tax policy—no longer holds. Regulatory authority over nonprofit fiduciaries, particularly charity managers, has moved increasingly to the federal level through the income tax laws.[60]

Part I of this Article describes the basic legal obligations of trustees of charitable trusts and directors of nonprofit corporations under state law, as well as the consequences of attorney general enforcement and limited private standing. Part II considers the federal tax laws relating to charity fiduciary behavior, including the recent tax on "excess benefit" transactions between charities and their insiders. Finally, Part III returns to the duty of care, which presents the greatest challenge to the fiduciary legal regime. Using as a guide the stories that introduced this Article, four central questions within the duty of care will be discussed: Should charity directors who abdicate their responsibilities face monetary penalties? (Adelphi University); what checks, if any, should be placed on directors' ability to adopt fundamental changes to the charity's purposes or activities? (Timken Mercy hospital); should a duty to diversify investments trump donor directions? (the *Reader's Digest* foundations); and has the law ceded supervision of charities to the marketplace for donations? (Foundation for New Era Philanthropy).

Over all, a laissez-faire structure for charity fiduciary law makes sense—or at least constitutes the "least bad" outcome—if we accept the framework in which charity functions as a system of private decisions free from government dictate. Such a structure, however, recognizes the limits of the law: Charity managers must behave at a higher level than the law requires in order to retain the public's trust. The price of forfeiting this trust could be a realignment of the political

59. AMERICAN LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 7.19, at 238 (1992) [hereinafter ALI PRINCIPLES].

60. *See, e.g.*, Hansmann, *The Evolving Law*, *supra* note 29, at 837 ("[U]ntil now, we have essentially not had nonprofit corporation law. . . . We have turned to federal tax law to establish the fiduciary duties of officers and directors. It has been federal tax law by default because the state corporation statutes have been empty, completely empty, on the subject.").

accommodations to charity, resulting, perhaps, in blanket imposition of strict fiduciary rules, falling donations, and denial of tax benefits.

## I. OVERVIEW OF THE LEGAL SYSTEM REGULATING CHARITY FIDUCIARIES

### A. *Choice of Form*

The traditional view of the charity fiduciary is of someone who must strictly adhere to donor-defined terms, and who must run to court for approval for even the slightest deviation from donor direction.[61] Such an image, however, fails to describe the modern charity fiduciary.

From the earliest days of Anglo-American charity, a charity could take either of two legal forms, one court-defined (common law) and the other legislative (statutory).[62] The *trust* can be created wholly in the private sphere: A settlor makes an agreement with a trustee for the management and disposition of a fund of money or property.[63] If the beneficiaries are indefinite and the trust has a charitable purpose, the trust may exist in perpetuity.[64] A *corporation*, by contrast, involves the public sector: It requires the grant of a legislative charter in order to obtain such characteristics as perpetual life.[65] Modern corporations typically form under the state general or nonprofit corporation statute.[66]

Despite their similarities, charitable trusts and charitable corporations are governed by distinct legal regimes. The pure trustee standards are stricter than those imposed on corporate directors, although the standards have been conforming because of waiver by

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61. *See* Fishman, *Development of Nonprofit Law*, *supra* note 44, at 645-50 (explaining the great degree to which charity fiduciaries were controlled by donors at common law).

62. Aspects of modern trusts typically are regulated by statute. *See, e.g.*, UNIF. SUPERVISION OF TRUSTEES FOR CHARITABLE PURPOSES ACT, 7B U.L.A. 727 (1985).

63. *See* JESSE DUKEMINIER & STANLEY M. JOHANSON, WILLS, TRUSTS, AND ESTATES 565-67 (5th ed. 1995) (discussing the creation of a trust).

64. *See id.* at 672 (stating that a charitable trust is exempt from the rule against perpetuities).

65. BLACK'S LAW DICTIONARY 340 (6th ed. 1990) (defining "corporation" as "[a]n association of persons created by statute as a legal entity [that is] vested with the capacity of continuous succession").

66. From time to time, the state legislature might grant a specific corporate charter. The federal government can also grant charters; for example, Congress chartered the Boy Scouts, 36 U.S.C. § 28 (1994), the Girl Scouts of America, 36 U.S.C. § 6, and the American Red Cross, 36 U.S.C. § 1. *Cf.* Christine Maistrellis, American National Red Cross v. S.G. & A.E.: *An Open Door to the Federal Courts for Federally Chartered Corporations*, 45 EMORY L.J. 771, 771 (1996) (stating that Congress creates federally chartered corporations to perform services the government would not provide otherwise).

trust settlors, the enactment of modern statutes, and the increasing harmonization of enforcement styles.[67] For many years, numerous commentators have urged that instead of following organizational form, the law should follow function.[68] Otherwise, the well-advised charity founder's choice of form (as trust or corporation) bestows on or denies the public particular rights of state supervision and fiduciary obligations. The Delaware Supreme Court, however, recently declined to adopt a single legal standard for the two charitable forms. To this court, the donor's ability to choose the legal environment for his charity is an important aspect of the gift:

> The Attorney General argues that a charitable trust and a charitable corporation are created for the same purpose, and that to apply different standards to the two entities would elevate form over function. In this context, however, form is not an unimportant consideration. . . . [T]he creator of a charitable enterprise recognizes that different legal rules govern the operation of charitable trusts and charitable corporations and selects a form with those rules in mind. The founder of a charitable trust binds its funds by the express limitations and conditions of the trust document and imposes upon its trustees the strict and unyielding principles of trust law. By contrast, the founder of a charitable corporation makes a gift "outright to the corporation to be used for its corporate purposes," and invokes the far more flexible and adaptable principles of corporate law. Both forms are fully recognized by our law and each has its function. One of the cardinal principles of trust law is that the intention of the settlor is paramount. We believe that the decision of Fred M. Kirby to endow a corporation rather than a trust in 1931 is equally entitled to deference.[69]

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67. *See* MARION R. FREMONT-SMITH, FOUNDATIONS AND GOVERNMENT 154-57 (1965) (comparing the trust and the corporation as forms of organization).

68. *See id.* at 155 (noting a "need for developing a common set of fiduciary principles for directors and trustees alike"); Fishman, *Development of Nonprofit Law*, *supra* note 44, at 657 (describing difficulties created because "the 'trust-corporate standard' dichotomy has often centered on the label to be applied, rather than upon an analysis of the corporate problem involved"); Henry Hansmann, *Reforming Nonprofit Corporation Law*, 129 U. PA. L. REV. 497, 623 (1981) [hereinafter Hansmann, *Reforming Nonprofit Corporation Law*] (suggesting "that nonprofit corporation law should be both unitary and rigorous"); Kenneth L. Karst, *The Efficiency of the Charitable Dollar: An Unfulfilled State Responsibility*, 73 HARV. L. REV. 433, 436 (1960) ("[T]here is no good reason for making different rules for the managers of two large foundations simply because one is a corporation and the other a trust. . . . The important differences among charities relate not to their form but to their function.").

69. Oberly v. Kirby, 592 A.2d 445, 466-67 (Del. 1991) (citations omitted) (quoting Denckla v. Independence Found., 193 A.2d 538, 541 (Del. 1963)).

In practice, it must be admitted, rarely does the founder of a charity carefully consider the legal differences and make a choice based on the advantages of organizational form. The overwhelming American preference for the corporate form results from historical accident[70] and a combination of institutional forces.[71] First, "coercive isomorphism" (dictated conformity) arises from the similarity of state laws and practices.[72] Second, "mimetic processes" (imitation) induce start-up enterprises to model themselves on those to which society has already granted legitimacy.[73] Finally, and perhaps most important to the new modern charity, "normative pressures," stemming from the professional training of the charity advisor (particularly attorneys), lead to conformity of organizational form.[74] In choosing between legal forms today, advisors ordinarily recommend the nonprofit corporate form,[75] although the trust form might be appropriate for a charity limited to managing a fund of money and making designated distributions, such as a grant-making foundation whose purpose the donor narrowly defines.[76]

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70. *See* FREMONT-SMITH, *supra* note 67, at 37-40 (describing how, following the Revolution, some states repealed all English statutes—including the Elizabethan Statute of Charitable Uses—leading some courts to mistakenly believe that charitable trusts could not have been created at common law). For an extended discussion of the American development of charitable trusts, see ZOLLMAN, *supra* note 41, at 20-70.

71. *See* Paul J. DiMaggio & Walter W. Powell, *The Iron Cage Revisited: Institutional Isomorphism and Collective Rationality in Organizational Fields*, 48 AM. SOC. REV. 147 (1983), *reprinted in* THE NEW INSTITUTIONALISM IN ORGANIZATIONAL ANALYSIS 63, 65 (Walter W. Powell & Paul J. DiMaggio eds., 1991) ("Once disparate organizations in the same line of business are structured into an actual field (as we argue, by competition, the state, or the professions), powerful forces emerge that lead them to become more similar to one another.").

72. *Id.* at 67-69.

73. *Id.* at 69-70.

74. *Id.* at 70-74.

75. We are a nation not just of laws, but of lawyers. When I was a young associate, permitted my first pro bono case, I took on the task of formalizing and obtaining tax-exempt status for a fledgling community theater company. I'm fairly sure that the steps I took were the same as those that would have been taken by a lawyer in any state of the Union when asked to set up a new nonprofit enterprise. The complex set of documents I drafted quite baffled my client, an actress with little business experience. My supervisor, a senior associate who had brought in the matter, never discussed with me why this new theater company should be a corporation rather than a trust, or even, assuming a corporation, why a *nonprofit* corporation. *Cf.* Francie Ostrower, *The Role of Advisors to the Wealthy*, *in* AMERICA'S WEALTHY AND THE FUTURE OF FOUNDATIONS 247, 249 (Teresa Odendahl ed., 1987) ("Donors, attorneys, and personal advisors all believe that attorneys are the advisors who are the most influential participants in the donor's choice of a charitable instrument.").

76. *See, e.g.*, Bell & Bell, *supra* note 47, at 437 (noting that 80% of the 29,000 charities registered in California in 1980 were corporations, 14% were trusts, and 6% were unincorporated associations). Even most grant-making foundations are corporations. *See, e.g.*, *Duties of Charitable Trust Trustees and Charitable Corporation Directors*, 2 REAL PROP. PROB. & TR. J.

*B. The Function and Legal Obligations of Private and Charity Fiduciaries*

The concept of fiduciary permeates the law. The word derives from the Latin for trust.[77] For any fiduciary relationship, the law imposes on the fiduciary two primary duties, the duty of loyalty[78] and the duty of care[79]—to obey the dictates of the principal while exercising prudent judgment in good faith.

Recent academic analyses of firms ask, "What is the problem for which the firm is a solution?" Figuring out this question helps reveal whether the law is efficient and effective, and whether it needs reform.

*1. The Private Trust.*—The analysis that follows begins with the private trust. This arrangement tries to solve the problem of human mortality. A property owner cannot live long enough to control the disposition of property beyond the next couple of generations. Assume that this owner wants to devise a mechanism to provide equally for each descending generation. By placing the property in trust, the owner can create a structure in which the fiduciary (the trustee) will carry out the settlor's wishes in a way that treats succeeding genera-

545, 545 (1967) [hereinafter *Duties of Trustees*] (Report of the Committee on Charitable Trusts) (indicating that approximately three-fourths of foundations in the United States are corporations, including 10 of the 13 largest).

A donor who will be the sole funder of a charity might prefer to adopt the trust form. It is easier for one person to control a trust (for example, the donor can be the sole trustee). By contrast, the typical nonprofit corporation must have a minimum of three directors—although the founder could set it up as a membership corporation with herself as the sole member, the board of directors cannot be easily neutered. *See* Solomon v. Hall-Brooke Found. Inc., 619 A.2d 863, 866 (Conn. App. Ct. 1993) (holding that a donor's employment with an incorporated charitable foundation was at will and could be terminated with or without just cause); Carolyn C. Clark & Glenn M. Troost, *Forming a Foundation: Trust vs. Corporation*, PROB. & PROP., May-June 1989, at 32, 32-34 (describing the flexibility and controllability of a trust as a form of a charitable foundation). Moreover, as discussed in Part III.B *infra*, a corporate charity might more easily change its purposes than a charitable trust. *See also* Brigid McMenamin, *Donor Beware*, FORBES, Feb. 13, 1995, at 172, 174 ("[I]t's easier for future generations to tinker with articles of incorporation than with a trust instrument, which needs court approval to change."). *See generally* MARTIN MORSE WOOSTER, THE GREAT PHILANTHROPISTS AND THE PROBLEM OF "DONOR INTENT" (1994) (examining the problem of ensuring that the wishes of the creators of charitable foundations will be followed after their deaths). Independent of a role as trustee or director, the donor may impose her desires on a corporate charity through limitations in the gift instrument.

77. MERRIAM WEBSTER'S COLLEGIATE DICTIONARY 433 (10th ed. 1996).

78. *See* REVISED MODEL NONPROFIT CORP. ACT § 8.30 cmt. 4 (1987) ("The general duty of loyalty of directors of nonprofit corporations is set forth in the mandate of section 8.30 that directors act in good faith in a manner they reasonably believe to be in the best interests of the corporation.").

79. *See id.* § 8.30 cmt. 2 ("Section 8.30(a) requires that a director in discharging his or her duties act with the care of an ordinarily prudent person in a like position under similar circumstances.").

tions in the desired manner.[80] (However, the limit of the law's patience for control by the dead hand—known as the rule against perpetuities—is "lives in being plus 21 years."[81]) Legal title to the trust property normally resides in the trustee;[82] equitable title normally resides in the beneficiaries[83] (the "*cestui que trustent*," law French for "those who trust"[84]). The law requires the trustee to treat the beneficiaries impartially, in the absence of trust terms specifying otherwise.[85] In our example, the trust instrument allocates the trust's resources among all the beneficiaries in a way that gives "income" (as defined) to the life interests while preserving the "principal" for the remaindermen.[86] Anyone with a property interest in the trust (a beneficiary or a co-trustee) may sue a trustee for breach of fiduciary duty.[87]

Under the duty of loyalty, the trustee may not engage in any dealings with the trust, no matter how fair or even favorable to the trust.[88] By tradition, as Edward Halbach describes it, the only defense to

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80. *But see* Joel C. Dobris, *Why Trustee Investors Often Prefer Dividends to Capital Gain and Debt Investments to Equity—A Daunting Principal and Income Problem*, 32 REAL PROP. PROB. & TR. J. 255, 271 (1997) ("Indeed, the whole idea of a trust is, speaking rather loosely, a heuristic. Most clients have only a vague, rule-of-thumb idea of what they are doing when they put assets into a trust."). Professor Dobris is a co-reporter in the revision of the *Revised Uniform Principal and Income Act* and was a co-reporter of the *Uniform Principal and Income Act*.

81. DUKEMINIER & JOHANSON, *supra* note 63, at 833.

82. *Id.* at 563.

83. *Id.* at 563-64.

84. *See* BLACK'S LAW DICTIONARY, *supra* note 65, at 229 (defining "cestui que trust" as "[h]e who has a right to a beneficial interest in and out of an estate the legal title to which is vested in another").

85. DUKEMINIER & JOHANSON, *supra* note 63, at 568.

86. *Id.* Here and as noted below, this text benefited from comments received from Edward C. Halbach, Jr., the reporter for the American Law Institute's RESTATEMENT (THIRD) OF TRUSTS (THE PRUDENT INVESTOR RULE) (1992). Professor Halbach stated that it is increasingly common to distribute less than all of the income to the life interest, while granting the power to invade principal. That is, the trustee usually has the discretion to maintain the life tenant's standard of living. Telephone Interview with Edward Halbach, Professor Emeritus, University of California at Berkeley School of Law (Aug. 26, 1994); *see also* REVISED UNIF. PRINCIPAL AND INCOME ACT (Discussion Draft 1997).

87. *See* FREMONT-SMITH, *supra* note 67, at 197 ("[T]he existence of a beneficiary capable of looking after his own interests is, in fact, a prerequisite to the validity of a private trust."). To be precise, the beneficiaries need not become identifiable until the expiration of the rule against perpetuities (for example, because of the possibility of unborn children). DUKEMINIER & JOHANSON, *supra* note 63, at 599. However, usually somebody has to take when a trust fails. Current practice has been struggling with the doctrine against unascertainable beneficiaries, which has fallen into disrepute. Telephone Interview with Edward Halbach, *supra* note 86.

88. Telephone Interview with Edward Halbach, *supra* note 86.

trustee self-dealing is, "I didn't do it."[89] Such an absolute prohibition is an admission of legal impotence: Years could pass by the time the beneficiaries might even notice the breach, and the fact that trusts separate beneficiaries across time exacerbates their inability to police their interests.[90] A conflict-of-interest transaction may nevertheless take place under one of three circumstances. First, the settlor often waives these prohibitions in the trust instrument, permitting trustees to deal with the trust if the transaction is fair to the trust. Second, the trustee may obtain court permission. Third, because trustee self-dealing is not void, but rather voidable at the option of the beneficiaries, if the self-dealing transaction resulted in gain to the trust, the beneficiaries can let it stand. However, if a loss resulted, beneficiaries can obligate the trustee to make up the difference (or to disgorge the gain).[91] In addition, states permit the trustee to be paid reasonable compensation.[92]

The duty of care requires the trustee to behave as would a prudent person dealing with her own property.[93] The trust settlor has wide latitude to vary allocations, investments, and other obligations by setting forth specific instructions in the instrument, and settlors commonly do. Except in rare cases, the trustee must obey the settlor's instructions.[94]

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89. *Id.*

90. *Id.* Professor Halbach noted that multiple trustees watch over one another, but the policing problem otherwise remains. *Id.*

91. Unless the trust instrument provides otherwise, in all practicality only a court may authorize trustee self-dealing or remove a trustee (generally, only for cause or, possibly, because of friction or hostility between the trustee and the beneficiaries that seriously impedes trust performance). *See* 2 SCOTT & FRATCHER, *supra* note 46, § 107, at 102 ("A court that has supervision over the administration of trusts has power to remove a trustee for proper cause."). A given beneficiary who consents to, or knowingly acquiesces in, a breach will be estopped from complaining about trustee self-dealing. However, while beneficiaries may unanimously agree either to consent to a breach or to seek removal of a trustee, in most private trusts there are unborn beneficiaries whose consent cannot be obtained. A future project in the revision of the *Restatement of Trusts* deals with "vicarious consents"—when consent to a breach could be obtained vicariously from a guardian or someone similarly situated. Telephone Interview with Edward Halbach, *supra* note 86.

92. *See* Jeffrey N. Gordon, *The Puzzling Persistence of the Constrained Prudent Man Rule*, 62 N.Y.U. L. REV. 52, 82 & n.123 (1987) (noting state statutes that set fees to be paid to trustees).

93. DUKEMINIER & JOHANSON, *supra* note 63, at 930.

94. In narrow circumstances, a court can interfere. For example, if the trust provisions violate public policy, or circumstances change in ways not provided for by the settlor, and the change would defeat the purpose of the trust, a court may provide relief. The equitable doctrine of deviation permits the court to alter administrative provisions (for example, the designation of a bank trustee that no longer exists). Traditionally, the court cannot alter the substantive provisions, such as the beneficiaries who may receive distributions, but

2. *The Charitable Trust.*—A charitable trust solves a very different problem from a private trust. Indeed, much of charitable trust law looks backwards compared with ordinary trust law.[95] A private trust fails if it will not have beneficiaries identifiable within the period of the rule against perpetuities.[96] By contrast, a charitable trust must not have ascertainable beneficiaries.[97] A private trust fails if its corpus will not vest within the period of the rule against perpetuities.[98] By contrast, a charitable trust is permitted to be, and usually is, perpetual.[99] Courts generally refrain from interfering with the wishes of a private settlor, because of the term limits on the life of a private trust. By contrast, because the settlor of a charitable trust can dictate the use of trust assets for centuries, the courts retain a cy pres power to reform charitable trusts whose purposes have become impossible to carry out.[100]

The law of trusts makes little distinction between the legal obligations of those who manage charitable trusts and those who manage private trusts.[101] Thus, a strict fiduciary standard appears to apply,

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statutes are moving away from such restrictions. Telephone Interview with Edward Halbach, *supra* note 86.

95. This is why charitable trusts failed in those states that erroneously believed that the post-revolutionary repeal of the Statute of Charitable Uses also repealed charitable trusts. *See supra* note 70.

96. 4A SCOTT & FRATCHER, *supra* note 46, § 364, at 108.

97. *Id.*

98. *Id.*

99. *See id.* § 365, at 109 n.1 ("[I]ndeed, most charitable trusts are of indefinite duration.").

100. Cy pres relief becomes available when the settlor's purposes fail. *See* BLACK'S LAW DICTIONARY, *supra* note 65, at 387 (defining the cy pres doctrine as "a rule for the construction of instruments in equity, by which the intention of the party is carried out *as near as may be*, when it would be impossible or illegal to give it literal effect"). While only a court may apply the cy pres doctrine, charity trustees sometimes act on their own in applying trust assets to a purpose different from the one directed by the donor. If the trustee is called to account, and the court agrees that the trust has failed and approves the new application, no liability results. FISCH, *supra* note 46, § 586, at 461-62. Professor Fisch's treatise bemoans the millions of dollars languishing in neglected charitable trusts, particularly small ones or those enjoying a substantial surplus beyond what can be spent pursuant to the donor's directions. *Id.* § 585, at 460. English charity law imposes an affirmative duty on charity trustees to seek cy pres relief when the circumstances warrant, and the Fisch treatise urges that American courts should interpret the general fiduciary duty of care to include such an obligation. *Id.* § 521, at 403-04.

101. *See* RESTATEMENT (THIRD) OF TRUSTS (THE PRUDENT INVESTOR RULE) § 379 (1992) ("The duties of the trustee of a charitable trust are similar to the duties of the trustee of a private trust."); 4A SCOTT & FRATCHER, *supra* note 46, § 379 ("The duties of the trustee of a charitable trust are similar to those of trustees of a private trust."); GEORGE GLEASON BOGERT & GEORGE TAYLOR BOGERT, THE LAW OF TRUSTS AND TRUSTEES § 391 (rev. 2d ed. 1991) ("The powers, duties, and liabilities of trustees for charity are, with only a few exceptions, the same as in the case of trustees of private trusts.").

because, as just described, the trustee's duty of loyalty prohibits self-dealing transactions with the charitable trust. Under the duty of care, the trustee must exercise such attention as would a prudent person in managing his own affairs.[102] However, while settlors of testamentary charitable trusts often want their trustees to adhere to strict fiduciary standards, the living settlor of a charitable trust who also wants to act as trustee typically relieves the trustees of legal duties to the maximum extent permitted. This generally results in a lenient standard like that imposed on corporate directors.[103]

Again, the trustee must obey the specifications of the trust instrument. As long as the trust qualifies as charitable, courts will hold the trustee to these terms no matter how confident the parties are that a better use could be made of the funds.[104] Charitable trusts notorious for their founder's idiosyncracies abound—consider, for example, the Barnes Foundation,[105] the Isabella Stewart Gardner Museum,[106] and the Buck Trust.[107] Only should the donor's dictates become impossible to carry out will a court consider a cy pres petition, and then the court will endeavor to carry out the donor's wishes by departing as minimally as possible from the original instructions.[108]

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102. The *Restatement (Third) of Trusts* describes the duty of care as requiring a trustee to act "as a prudent investor would, in light of the purposes, terms, distribution requirements and other circumstances of the trust." RESTATEMENT (THIRD) OF TRUSTS (THE PRUDENT INVESTOR RULE) § 227. This language is used in order to "lessen the danger of unwarranted, excessive conservatism." Edward C. Halbach, Jr., *Trust Investment Law in the Third Restatement*, 77 IOWA L. REV. 1151, 1155 n.19 (1992).

103. *See infra* notes 114-121 and accompanying text (discussing the corporate fiduciary standards).

104. *See* FREMONT-SMITH, *supra* note 67, at 433 ("The courts look first to the terms of a trust instrument . . . supplying them from trust law only when the instrument is silent.").

105. *See* Mary Grace Blasko et al., *Standing to Sue in the Charitable Sector*, 28 U.S.F. L. REV. 37, 73-74 & n.285 (1993) (discussing the Barnes Foundation litigation).

106. *See, e.g.*, DOUGLASS SHAND-TUCCI, THE ART OF SCANDAL: THE LIFE AND TIMES OF ISABELLA STEWART GARDNER (1997); Holland Cotter, *A Legacy Thieves Could Not Steal; Despite Devastating Losses, the Gardner Museum Is Rebounding*, N.Y. TIMES, Mar. 31, 1997, at C11 (describing the terms of Gardner's "extraordinary will": Should Gardner's installation of artwork be altered in any way, the entire collection is to be "shipped to Paris and auctioned off, with the profits going to Harvard University"). The theft of 13 valuable paintings—perhaps the largest art heist in history—carries reminders in the form of small placards displayed where those works used to hang, reading "Stolen, March 18, 1990." *Id.* The pieces were not insured, "'since even if an insurance policy paid off, the museum could not use the money to replace the items lost.'" John Abell, *Stolen Masterpieces at Boston Museum Not Insured*, REUTER LIBRARY REPORT, Mar. 20, 1990, *available in* LEXIS, News Library (quoting museum spokesman Corey Cronin).

107. *See generally* John G. Simon, *American Philanthropy and the Buck Trust*, 21 U.S.F. L. REV. 641 (1987) (discussing the Buck Trust litigation and the public policy issues implicated thereby).

108. *See also infra* notes 140-141 and accompanying text.

While a settlor may not waive fiduciary obligations entirely,[109] a founder or major donor may impose obligations on the charity that raise serious concerns of dual loyalty and commingling of private and public purpose. For example, the founder might require the charity to retain a donation that consists of stock in the founder's company, even though an ordinary prudent investor would prefer to diversify.[110] Should the law privilege the donor to such a degree? This issue is discussed further in Part III.B, below.

Given that charities lack identifiable beneficiaries, typically only state attorneys general may sue to enforce a charitable trust and the fiduciaries' duties.

*3. Business Corporations.*—Why do corporations form? A business corporation reduces the transaction costs involved in operating a complex, joint capitalist enterprise in a framework of centralized management, limited liability for owners, perpetual life for the enterprise, and freely transferable interests.[111] However, separating ownership (the shareholders) from control (the directors) produces a "principal-

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109. *See* FREMONT-SMITH, *supra* note 67, at 434 (discussing a judicial attitude that some standards of conduct are so essential that they cannot be removed by agreement); *see also Duties of Trustees*, *supra* note 76, at 555 ("[P]ublic policy prevents any relaxation which would relieve a trustee from responsibility for wilful and deliberate breaches of fiduciary duty, for gross negligence or actions taken in bad faith or with fraud, or for acts from which he has profited personally."). As Professor Zollman observed, "A provision in a will that the trustee shall not be held accountable for the non-performance or ill-performance of the trust is . . . ineffective, and will have to give way to the statute which says that he shall account." ZOLLMAN, *supra* note 41, at 424 (footnote omitted). He continues: "'No testator can obtain for his bequests that support and permanence which the law gives to public charities only, and at the same time deprive the beneficiaries and the public of the safeguards which the law provides for their due and lawful administration.'" *Id.* (quoting Jackson v. Phillips, 96 Mass. (14 Allen) 539, 571 (1867)).

110. A similar problem exists in the family trust situation. Should the trustee be keeping the family business intact, or maximizing the security and returns of the beneficiaries? See John H. Langbein, *The Uniform Prudent Investor Act and the Future of Trust Investing*, 81 IOWA L. REV. 641, 665 (1996), which states:

> I am not saying that you can never have an underdiversified trust fund. It will remain common to place a family firm or a family farm in trust . . . . There's nothing wrong with using a trust as part of the succession arrangements for a family enterprise. . . . When, however, the trust assets are cash or cash-equivalent, in the sense that diversification can be achieved at little cost, I believe that the courts will come to view the advantages of diversification as so overwhelming that the settlor's interference with effective diversification will be found to be inconsistent with the requirement that a private trust must be for the benefit of the beneficiary.

111. *See generally* OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM (1985) (describing the transaction costs analysis of the corporation).

agent problem."[112] Accordingly, the directors' duties of loyalty and care represent an attempt to align the interests of the agents with the interests of the principals. However, as a legal matter, the directors owe these duties to the *corporation* rather than to shareholders (or any other constituent group).[113]

The duty of loyalty for corporate fiduciaries has evolved past absolute bans on self-dealing.[114] Rather, states look for a process in which the transaction with the interested director was approved by disinterested parties (directors or shareholders or both) after full disclosure of all material facts by the interested party.[115] While courts might still examine the transaction for fairness to the corporation, they apply a "much lighter level of scrutiny."[116]

In reviewing directors' duty of care, courts have developed a doctrine called the "business judgment rule."[117] Less a rule than an accumulation of case law statements, the business judgment rule insulates directors from liability for mistakes in judgment exercised in good faith and without divided loyalty.[118] As a result, a director

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112. For an extensive discussion of these issues, see generally Brody, *Agents Without Principals*, *supra* note 33.

113. *See* JAMES D. COX ET AL., CORPORATIONS § 10.1, at 10.2-10.7, § 10.11, at 10.38-10.40 (1995) (discussing directors' fiduciary duty).

114. Initially courts imposed trustee-type duties on directors of business corporations, but such punctiliousness could not survive the realities of the business world. *See* Fishman, *Standards of Conduct*, *supra* note 52, at 434-35 (noting that a combination of a need for the service of "men of experience and ability" on corporate boards as well as the advantages of transactions with corporations' own "directors and with other corporations" led to a relaxation of the strict rule). *See generally* Harold Marsh, Jr., *Are Directors Trustees? Conflict of Interest and Corporate Morality*, 22 BUS. LAW. 35 (1966) (describing the evolution from trustee standard to the fairness standard).

115. *See* MODEL BUS. CORP. ACT §§ 8.60-8.63 (1984); *see also infra* note 229 (discussing burden of proof in a duty-of-loyalty case); *infra* note 234 (discussing remedies in a duty-of-loyalty case).

116. ALI PRINCIPLES, *supra* note 59, § 5.01 reporter's note 3, at 207. "[L]ess intense scrutiny" applies to executive compensation because the corporation by definition cannot forgo the transaction. *Id.* § 5.03 cmt. c, at 246-47. Nevertheless, regulators of business corporations have recently required more rigorous procedures for approving compensation paid by publicly traded companies. *See* I.R.C. § 162(m) (West 1997) (placing limits on deduction of compensation over $1 million paid by companies that do not follow certain procedures); Executive Compensation Disclosure, Securities Act Release 33-6962, Exchange Act Release No. 31327 [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,056 (Nov. 12, 1992) (announcing the adoption of final rules on executive compensation disclosure). As to tax-exempt charities, see new I.R.C. § 4958, discussed *infra* Part II.

117. ALI PRINCIPLES, *supra* note 59, § 4.01(c), at 138-39.

118. *Id.* § 4.01(c) cmt., at 173. Section 4.01(a), which sets forth the duty of care, provides:

> A director or officer has a duty to the corporation to perform the director's or officer's functions in good faith, in a manner that he or she reasonably believes to be in the best interests of the corporation, and with the care that an ordinarily

breaches the duty of care only by committing "gross negligence" rather than ordinary negligence.[119]

The law requires the corporation to provide information to the shareholders to improve their ability to monitor the directors,[120] and grants shareholders the ability to sue (on behalf of the corporation) for harm caused by directors' breach of fiduciary duty.[121]

4. *Charitable Corporations.*—Like charitable trusts, charitable corporations seek to solve the problem of serving an indefinite public into (usually) perpetuity. However, perpetuity is not unique to the nonprofit corporate form; business corporations also have perpetual life. The primary legal distinction between the business corporation and the nonprofit is the absence of owners. Sometimes called "non-

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> prudent person would reasonably be expected to exercise in a like position and under similar circumstances.

*Id.* § 4.01(a), at 138. Section 4.01(c) states the business judgment rule:

> A director or officer who makes a business judgment in good faith fulfills the duty under this Section if the director or officer:
>
> (1) is not interested . . . in the subject of the business judgment;
>
> (2) is informed with respect to the subject of the business judgment to the extent the director or officer reasonably believes to be appropriate under the circumstances; and
>
> (3) rationally believes that the business judgment is in the best interests of the corporation.

*Id.* § 4.01(c), at 139.

The ABA's *Revised Model Business Corporation Act* (now called the *Model Business Corporation Act* (1984)) and its *Revised Model Nonprofit Corporation Act* both state that the business judgment rule need not be resorted to if the director satisfies the statutory duty of care. *See* MODEL BUS. CORP. ACT § 8.30(d) cmt. 4 (1984) ("The possible application of the business judgment rule need only be considered if compliance with the standard of conduct set forth in . . . section 8.30 is not established."); REVISED MODEL NONPROFIT CORP. ACT § 8.30 cmt. 3 (1987) ("If a director has met the standards of section 8.30, there is no need to apply the business judgment rule."). This formulation seems to me very unhelpful. The whole purpose of the business judgment rule is to preclude detailed inquiry. More useful is the approach taken in the ALI's *Principles of Corporate Governance*, which refers to the business judgment rule as a "safe harbor." *See* ALI PRINCIPLES, *supra* note 59, § 4.01(c) cmt., at 173 ("Although courts have not expressed it this way, the business judgment rule has offered a safe harbor for directors or officers who make honest, informed business decisions that they rationally believe are in the best interests of their corporations. Section 4.01(c) articulates this safe harbor concept.").

119. *See, e.g.*, Smith v. Van Gorkom, 488 A.2d 858, 873 (Del. 1985) (affirming gross negligence as the standard for director liability under the business judgment rule); *see also infra* Part III.A.

120. *See* MODEL BUS. CORP. ACT §§ 16.02 (Inspection of Records by Shareholders), 16.20 (Financial Statements for Shareholders) (1984).

121. *See id.* § 7.40 (Procedure in Derivative Proceedings).

stock" corporations for this reason,[122] nonprofit corporations may not have shareholders or otherwise distribute earnings.[123] However, nonprofit corporations may, but are not required to, have members with rights to elect the board of directors and to exercise other extraordinary powers set forth in the statute or the articles of incorporation.[124] For example, members might be granted the right to vote on the corporation's decision to sell substantially all of its assets, merge, or dissolve. This type of membership is more common in the "mutual" nonprofit, such as a labor organization, social club, or business league. Most charities have no members, or have only members in the ceremonial sense. A nonprofit corporation without members, by negative definition, has a self-perpetuating board of directors.[125]

The duties of directors of nonprofit corporations, particularly in recent years, have come to resemble those of directors of business corporations, because of the change in function of the typical charitable corporation.[126] As Bayless Manning observed of the basic difference

122. *See* 1 WILLIAM MEADE FLETCHER ET AL., FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 68, at 917 (perm. ed. rev. vol. 1990) (distinguishing stock and nonstock corporations).

123. *See id.* § 68.05, at 918-20 (discussing limitations on nonprofit or "nonstock" corporations).

124. *See* REVISED MODEL NONPROFIT CORP. ACT § 2.02 (stating that the articles of incorporation for a nonprofit corporation must state whether it will have members and may state the powers that its members will have).

125. To improve charity governance, California limits charity managers to 49% of the board positions. CAL. CORP. CODE § 5227 (West 1990 & Supp. 1998). One wonders, however, whether this simply leads to dummy outside directors. *See* Fishman, *Standards of Conduct*, *supra* note 52, at 448 n.252 ("This provision encourages the naming of dummy directors."). The ABA's *Revised Model Nonprofit Corporation Act* also offers such a provision, as optional section 8.13 (Financially Disinterested Majority—Public Benefit Corporations). The official comment states:

> This section is optional as many members of the Subcommittee . . . felt that its provisions would be ineffective in preventing intentional abuses, while presenting a burdensome or inconvenient requirement. . . . Legitimate public benefit corporations might have difficulty in finding active and competent directors who had no financial interest in the corporation.

REVISED MODEL NONPROFIT CORP. ACT § 8.13 cmt. For a proposal on expanding charity membership—and its legal significance—see Avner Ben-Ner & Theresa Van Hoomissen, *The Governance of Nonprofit Organizations: Law and Public Policy*, 4 NONPROFIT MGMT. & LEADERSHIP 393, 408-12 (1994).

126. *See* Stern v. Lucy Webb Hayes Nat'l Training Sch. for Deaconesses & Missionaries, 381 F. Supp. 1003, 1013 (D.D.C. 1974) (mem.). Judge Gesell stated:

> [T]he modern trend is to apply corporate rather than trust principles in determining the liability of the directors of charitable corporations, because their functions are virtually indistinguishable from those of their "pure" corporate counterparts.
>
> . . . A trustee is uniformly held to a high standard of care and will be held liable for simple negligence, while a director must often have committed "gross negligence" or otherwise be guilty of more than mere mistakes of judgment.

between a trustee and a director: "[T]he concept of the prudent investor was created precisely to differentiate a trustee from the wider universe of business risk-taking, the very universe in which the board of directors is expected to live and operate."[127] The ABA's *Revised Model Nonprofit Corporation Act* explicitly rejects the approach that corporate charities are trusts and that directors are trustees.[128]

A conflict-of-interest transaction between the organization and a director can invoke both the duty of loyalty and the duty of care: generally, the loyalty of the conflicted director and the care exercised by the other directors in approving the transaction. State nonprofit statutes typically deal with director conflicts of interest. For example, section 8.31 of the ABA's *Revised Model Nonprofit Corporation Act* blesses an interested transaction that either was fair when entered into or was approved in advance, after full disclosure of the material facts and of the director's interest, by the board acting in good faith on the reasonable belief that the transaction is fair to the charity.[129] Alterna-

> . . . Since the board members of most large charitable corporations fall within the corporate rather than the trust model, being charged with the operation of ongoing businesses [as opposed to merely the management of the trust funds], it has been said that they should only be held to the less stringent corporate standard of care.

*Id.* (citations omitted); *accord* Oberly v. Kirby, 592 A.2d 445, 462 (Del. 1991) (stating that a member of a charitable corporation owes a fiduciary duty to act with "fairness and loyalty, devoid of considerations of self-interest"); Johnson v. Johnson, 515 A.2d 255, 264 (N.J. Super. Ct. Ch. Div. 1986) (stating that the standard of care for investments by a director of a charitable corporation is one of ordinary business care and prudence rather than the stricter standard of a trust fiduciary). However, the *Restatement (Second) of Trusts* comments: "In the case of a charitable corporation duties of a somewhat similar character [to the trustees of a charitable trust] rest upon the members of the controlling board . . . ." RESTATEMENT (SECOND) OF TRUSTS § 379 cmt. b (1959).

127. Bayless Manning, *The Business Judgment Rule and the Director's Duty of Attention: A Time for Reality*, 39 BUS. LAW. 1477, 1493 (1984).

128. *See* REVISED MODEL NONPROFIT CORP. ACT § 8.30(e) ("A director shall not be deemed to be a trustee with respect to the corporation or with respect to any property held or administered by the corporation, including without limit, property that may be subject to restrictions imposed by the donor or transferor of such property.").

129. *See id.* § 8.31. Some states always require the transaction to be fair to the charity; other states use the fairness test as an alternative to disinterested approval. *See, e.g.*, Gilbert v. McLeod Infirmary, 64 S.E.2d 524, 529 (S.C. 1951) (applying the fairness test and voiding a transaction despite the absence of actual fraud or fraudulent intent on the part of the director); *see also* Fishman, *Standards of Conduct*, *supra* note 52, at 443 (discussing the statutory provisions of New York, California, and Ohio). Even the *Revised Model Nonprofit Corporation Act* follows the common trend to bar loans to directors and officers. *See* REVISED MODEL NONPROFIT CORP. ACT § 8.32 (Loans to or Guaranties for Directors and Officers). On the general question of compensation, the Model Act provides: "Unless the articles or bylaws provide otherwise, a board of directors may fix the compensation of directors." *Id.* § 8.12. (The official comment emphasizes that the directors must still comply with their duties of loyalty and care. *Id.* § 8.12 cmt.) As a practical matter, most directors of nonprofits serve without compensation (other than expenses); executive compensation is the

trustees and directors. Thus, while most American charities are corporations and most charitable trust instruments grant trustee discretion,[134] we may fairly ask what those standards *should* be. When, for example, commentators urge the adoption of trust standards, they yearn for a structure of strict fiduciary duties for all charity managers, be they legally trustees or directors.[135] To their dismay, however, the trend, while indeed towards conformity, is in the direction of the corporate standard. As discussed below, courts prefer to defer to the business judgment of charity managers, legislatures relax the investment duties of institutional fund managers, and Congress bows to the determination of independent board members of public charities in setting compensation and other benefits.

### C. *Monitoring and Enforcement*

Contrasting the charitable forms with their proprietary analogues presents the dilemma of charity fiduciary law in its brightest light: In the case of an entity having no owners and established for the benefit of indefinite beneficiaries, who is the principal on whom the law can rely to monitor the agents and enforce the charitable purposes? The way the law answers this question makes enforcement of charity fiduciary duties difficult.

Beginning with self-dealing, if regulators and courts want an easy life, the state can adopt prohibitions on any conduct between a charity and its fiduciaries that is hard for an outsider to monitor and judge for fairness. This explains the strict trust standard.[136] No solution this simple, however, comes without cost. Per se prohibitions sweep too broadly, and void too many transactions that would benefit the charity and thus benefit the public. As a compromise, self-dealing transac-

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134. For example, Marion Fremont-Smith observes: "It is the rare trust instrument which does not include some, if not all, of the provisions whereby these differences between trustees and directors are removed." FREMONT-SMITH, *supra* note 67, at 155.

135. *See, e.g.*, Deborah A. DeMott, *Self-Dealing Transactions in Nonprofit Corporations*, 59 BROOK. L. REV. 131, 145-47 (1993) (criticizing the application of corporate fiduciary standards to the nonprofit sector).

136. See, for example, *In re* Taylor Orphan Asylum, 36 Wis. 534, 552 (1875), discussing the ban on trustees' buying the charity's property:

> [This is the rule] not because they might not in many instances make fair and honest disposition of it to themselves, but because the probability is so great that they would frequently do otherwise, without danger of detection, that the law considers it better policy to prohibit such purchases entirely, than to assume them to be valid except where they can be proved to be fraudulent.

*Id.* (internal quotation marks omitted). As discussed in Part II, the federal tax laws impose blanket prohibitions on self-dealing by private foundation managers, regardless of whether the foundation takes the trust or corporate form.

tions with a corporate charity will be reviewed for substantive fairness only in the absence of a private process requiring decisionmaking by disinterested fiduciaries (under the tax laws, for example, all private foundations are subject to the strict standard).[137]

Some commentators criticize such deference to charity managers.[138] After all, the nonprofit structure cannot be equated with the business corporation in which shareholders having a direct financial interest ultimately decide the fate of the board.[139] Initially, one might think that the law should privilege the trust settlor or donors with oversight powers. However, American law does not work this way. A donor cannot reclaim funds if she is displeased with their use;[140] more generally, the donor cannot bring suit to enforce the purposes of the charity.[141] Nor, except in rare cases, do beneficiaries have standing to

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137. *See infra* Part II (discussing restrictions on self-dealing).

138. *Cf.* DeMott, *supra* note 135, at 131 ("[I]t is neither justifiable nor wise to import criteria that legitimize self-dealing from the for-profit setting to the nonprofit context.").

139. *See* Hansmann, *The Evolving Law*, *supra* note 29, at 820 ("[I]t is not appropriate to hold the managers of . . . a nonprofit only to the fiduciary standards appropriate for a for-profit.").

140. If the charity fails to adhere to a restriction on a donation, and the donor retains a reversion to a private person or fails to express a general charitable intent, the property will revert (even if the breach occurs beyond the dead-hand period). *See, e.g.*, Evans v. Abney, 396 U.S. 435, 447 (1970) (holding that property donated for a municipal park for whites reverted to the family only because the will did not express a general charitable intent, and thus a cy pres modification was not available); *cf.* Solomon v. Hall-Brooke Found., Inc., 619 A.2d 863, 866 (Conn. App. Ct. 1993) (holding that a donor's gift to a foundation, a gift conditioned upon a lifetime employment contract, was unenforceable as a matter of public policy, and thus the donor's employment was at will).

141. When a donor conditions the use of a gift, the charity must adhere to that restriction, but generally only the attorney general may bring an enforcement action. *See* Carl J. Herzog Found., Inc. v. University of Bridgeport, 699 A.2d 995, 1002 (Conn. 1997) (holding that an objecting donor has no standing under the Connecticut Uniform Management of Institutional Funds Act); *see also infra* Part III.C. English charity law still embraces a founder's right of "visitation" over gifts made to charitable corporations. FREMONT-SMITH, *supra* note 67, at 206. This practice has largely fallen into disuse in the United States. *Id.* at 206-07. That the English right is hereditary makes it less appealing here. See BOGERT & BOGERT, *supra* note 101, § 416, at 62, which states:

> In a country such as the United States, where primogeniture is obsolete, the vesting of a power of visitation in the heirs of the donor is not desirable. . . . [I]n many cases they would be either wholly uninterested in exercising the right of visitation, or would be openly hostile to the institution which had deprived them of a part or all of the fortune of their relative.

*Accord* Wier v. Howard Hughes Med. Inst., 407 A.2d 1051, 1057 (Del. Ch. 1979) (holding the common law right of visitation no longer applicable). *But cf.* N.Y. EST. POWERS & TRUSTS LAW § 8-1.3(a) (McKinney 1992) (allowing anyone "founding, endowing and maintaining" a public library, museum, or educational institution in trust to exercise complete control over administration of the trust during his or her lifetime, and, if granted, to pass on these rights to the surviving spouse, without any obligation to account). At a recent conference, one attorney suggested a contractual remedy, whereby the instrument grant-sue charity trustees or directors, either directly or derivatively on behalf of the charity, because "the human beings who are favorably affected by the execution of the trust are merely the media through whom the social advantages flow to the public."[142] Instead, the state attorney general, acting as *parens patriae*, can enforce society's interests in the proper operation of the charity.[143] The attorneys general enjoy a wide variety of powers, including "enjoining wrongful conduct, rescinding or cancelling a transfer of property, appointment of a receiver, replacement of a fiduciary, compelling an accounting, redress of a breach or performance of fiduciary duties."[144]

In practice, however, attorneys general rarely pursue their rights with the same zeal that private parties exhibit. What if the attorney general will not act, cannot act, or does not present the "right" arguments (whether for political or other reasons)? Critics of limited standing rules urge greater powers in the hands of some outside party.[145] To defend such a position, however, they must believe that

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ing the gift would provide for a "gift over to another charity" in the event of default, so that an independent charity would have a private right of action (as well as an interest in monitoring the first charity's use of the gift). Victoria B. Bjorkland, Partner, Simpson, Thatcher & Bartlett, Comments at a Conference on "Governance of Nonprofit Organizations: Standards and Enforcement," National Center on Philanthropy and the Law, New York University School of Law (Oct. 30-31, 1997) (author's notes).

142. George Gleason Bogert, *Proposed Legislation Regarding State Supervision of Charities*, 52 MICH. L. REV. 633, 633 (1954). *See generally* Blasko et al., *supra* note 105, at 37 (examining "private parties' standing to initiate litigation against charitable organizations for mismanagement, fraud or corruption"). But see *infra* notes 291-294 and accompanying text for a discussion of whether donors have standing under the *Uniform Management of Institutional Funds Act*.

143. *See* Blasko et al., *supra* note 105, at 43-47 (discussing the authority of attorneys general to bring suit to enforce the charitable purposes of an organization).

144. FISCH, *supra* note 46, § 711, at 549-50 (footnotes omitted). The judicial power to remove a trustee, and the causes that justify removal, are the same for charitable and private trusts. BOGERT & BOGERT, *supra* note 101, § 398, at 343.

145. *Compare* Marion R. Fremont-Smith, Enforceability and Sanctions, paper presented at a Conference on "Governance of Nonprofit Organizations: Standards and Enforcement," National Center on Philanthropy and the Law, New York University School of Law (Oct. 1997) (manuscript at 4, on file with author) ("It is this author's view that the overriding factor in almost every case in which standing has been granted to individuals has been lack of effective enforcement by the attorney general or another government official.") *with* Rob Atkinson, *Unsettled Standing: Who (Else) Should Enforce the Duties of Charitable Fiduciaries?*, 23 J. CORP. L. (forthcoming 1998) (manuscript at 94-95) (questioning whether attorney general supervision really is too low). Moreover, Atkinson would prefer that charities be treated as "radically independent, self-sustaining" communities, leading to a "sectarian model" of altruism in which "charitable fiduciaries would enjoy maximum independence from all external controls, both private and public." *Id.* at 109. Under such a view,

> [T]he state would have no say in the use of resources in the hands of charitable fiduciaries, beyond ensuring that they do not transgress the outer limits of care and loyalty. This model, in effect, would abolish the duty of obedience entirely

the gains in preventing charity abuses outweigh the additional cost in administration, interference in decisionmaking, and the possibility of getting the wrong result.

To minimize the risk of vexatious and multiple lawsuits but to take advantage of the oversight provided by those with a special interest in the charity, a few recent statutes set forth an expanded class of private persons with standing rights. The 1980 California nonprofit statute permits any of the following to "bring an action to enjoin, correct, obtain damages for or to otherwise remedy a breach of a charitable trust": (1) the corporation, derivatively; (2) an officer; (3) a director; (4) a "person with a reversionary, contractual, or property interest in the assets subject to such charitable trust" [but note, not donors generally]; and (5) the Attorney General, or any person granted relator status by the Attorney General.[146] New York's 1970 statutory revision grants standing in suits for breach of fiduciary duty to the attorney general, the corporation, a director, an officer, members holding five percent of voting power, and, if the certificate of incorporation or the bylaws so provide, to any contributor of at least $1000.[147] The 1987 *Revised Model Nonprofit Corporation Act* permits derivative suits by fifty members or, if the nonprofit corporation has fewer than fifty members, members holding five percent of voting power. (In such a case, notice must be given to the attorney general, who has the right to join in the action.)[148] Even without statutory authorization, courts will, on rare occasion, grant standing to those with a "special interest."[149] One commentary also found that "[i]f a

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> and leave the attorney general alone with standing to enforce the remaining duties of care and loyalty.

*Id.*

146. CAL. CORP. CODE § 5142(a) (West 1990). The attorney general must be given notice of any action brought by the other persons specified, and the attorney general may intervene. "In a suit by a relator, the relator generally takes an active part in the proceeding and is responsible for court costs, but the attorney general retains control of the action and can withdraw, dismiss or compromise it at any time." Blasko et al., *supra* note 105, at 49 (footnote omitted); *accord* Fishman, *Development of Nonprofit Law*, *supra* note 44, at 674 (urging that relators, if successful, should be granted reimbursement for costs and attorneys' fees).

147. N.Y. NOT-FOR-PROFIT CORP. LAW § 720(b) (McKinney 1970 & Supp. 1997). The statute also grants standing to a receiver, a trustee in bankruptcy, or a judgment creditor. *See id.*

148. REVISED MODEL NONPROFIT CORP. ACT § 6.30(a), (f) (1987) (Derivative Suits).

149. *See, e.g.*, Jones v. Grant, 344 So. 2d 1210, 1212 (Ala. 1977) (holding that "beneficiaries with a sufficient special interest in the enforcement of a charitable trust can institute a suit as to that trust," and granting standing to the faculty, staff, and student body to sue where grants and loans made to upgrade the college had allegedly been misused); Hooker v. Edes Home, 579 A.2d 608, 614 (D.C. 1990) (holding that "a particular class of potential beneficiaries has a special interest in enforcing a trust if the class is sharply de-

court determines that the attorney general is substantially ineffective, the probability increases that a private party will be allowed to represent, in litigation, the public's beneficial interest in a charity."[150] On the other hand, a recent Connecticut case suggests that those who hope for a liberalizing trend in interpreting standing rights will have a long wait.[151]

Granting standing to any director of the charity raises a circularity problem.[152] To allow suit by a disappointed director of a charitable corporation confounds the general principle that the corporation is to be governed by the majority of the board.[153] Henry Henn and Jef-

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fined and its members are limited in number," and, in addition, that plaintiffs can show an immediate threat of injury); Alco Gravure, Inc. v. Knapp Found., 479 N.E.2d 752, 755 (N.Y. 1985) (holding that where a company foundation amended its articles of incorporation to permit distributing income and principal to another charity, individuals from the class of intended beneficiaries—the employees of a particular corporation—had standing to sue for equitable relief). For an extreme example of standing granted to a large, indefinite class, see *Stern v. Lucy Webb Hayes National Training School for Deaconesses & Missionaries*, 367 F. Supp. 536, 540-41 (D.D.C. 1973) (mem.), which certified 10,000 patients of a hospital as a class to sue derivatively for an injunction against director mismanagement and self-dealing, but did not permit direct suit for treble damages under the antitrust laws.

150. Blasko et al., *supra* note 105, at 69.

151. *See* Steeneck v. University of Bridgeport, 668 A.2d 688 (Conn. 1995). *Steeneck* dealt with a University "life trustee" who lacked voting privileges, who could not serve as an officer or member of the executive committee or chair corporate committees, and who could not be counted toward a quorum. *Id.* at 690. The court held that the trustee had no standing, either as a "director," *id.* at 695, or as someone with a "special interest," to challenge as ultra vires the University's contract to affiliate with the Professors World Peace Academy, founded by the Reverend Sun Myung Moon. *Id.* at 696-97. The *Steeneck* court declined to decide whether voting rights alone were a necessary prerequisite to director status, but instead concluded that the bylaws contemplated that "the life trustee position is largely an honorary one, to which genuine and substantial management functions do not attach." *Id.* at 694. A strong dissent argued: "It is . . . clear that, in granting standing to a mere 'member' of a nonstock corporation who has no role in the management of the affairs of the corporation[,] the legislature could not have intended to deny a nonvoting trustee statutory standing . . . ." *Id.* at 698 (Berdon, J., dissenting) (citation omitted). Moreover, the dissent viewed the position of life trustee as analogous to that of a co-trustee, who, under the common law, is "'in the best position to learn about breaches of trust and to bring the relevant facts to a court's attention.'" *Id.* at 699 (quoting Holt v. College of Osteopathic Physicians & Surgeons, 394 P.2d 932, 936 (Cal. 1964)).

152. Supporters of such a right include Karst, *supra* note 68, at 443-44, and Bogert, *supra* note 142, at 633-36. In the reverse situation, the corporation, acting through a majority of the board, may clearly bring suit against a wrongdoing director for breach of fiduciary duty. *See* FREMONT-SMITH, *supra* note 67, at 151 (noting that "[i]n the case of a charitable corporation, the right to bring suit to enforce the duties of directors is available to the corporation").

153. *See, e.g.*, *Holt*, 394 P.2d at 939-41 (McComb, J., dissenting) (explaining that "[t]he affairs of either a private corporation or a charitable corporation are managed by a majority of the board of directors or board of trustees of the corporation"); Nugent *ex rel.* Lingard v. Harris, 184 A.2d 783, 785-86 (R.I. 1962) (affirming the trial judge's finding that a minority of directors may not secure removal of the majority in the absence of mismanage-

frey Boyd thus observe: "Analogous New York case law probably would bar the derivative action if a disinterested quorum or committee of directors exercises its business judgment and determines that the maintenance of the action is against the best interests of the corporation";[154] accordingly, by contrast, "[d]emand might be unnecessary if plaintiff shows, for example, that the demand would be futile because the complaint implicates a majority of the board."[155] A California court permitting a charity's directors to sue noted: "We do not reach the question whether minority directors of a private [business] corporation can bring an action in behalf of the corporation. The differences between private and charitable corporations make the consideration of such an analogy valueless."[156]

What happens to the errant fiduciary once someone with standing complains? As discussed in Part III.A, even in the rare case when a breach is established, under state law, a finding of liability almost never results in a punishment more severe than admonishment or, at worst, removal of the fiduciary. As discussed immediately below, recent federal tax law could provide a different answer.

## II. FEDERAL REGULATION OF CHARITY FIDUCIARIES THROUGH TAX LAWS

Overlaid on the state law variations in the law of charities is the uniform layer of federal tax law. In order for a charity to qualify for federal income tax exemption under section 501(c)(3) of the Internal

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ment as opposed to a difference of opinion). A similar problem can arise in a charitable trust, whose trustees (unlike the trustees of a private trust) may act by majority rather than unanimous decision. *See* RESTATEMENT (SECOND) OF TRUSTS § 383 (1959) (explaining that if there are several trustees of a charitable trust, their powers may be exercised by a majority of the trustees unless otherwise directed by the terms of the trust); FREMONT-SMITH, *supra* note 67, at 107 ("In a private trust powers can be exercised only with the concurrence of all the trustees; whereas in a charitable trust, the affirmation of a majority is sufficient unless there is a provision . . . requiring unanimity.").

154. Henry G. Henn & Jeffrey H. Boyd, *Statutory Trends in the Law of Nonprofit Organizations: California, Here We Come!*, 66 CORNELL L. REV. 1103, 1123-24 (1981).

155. *Id.* at 1123 n.159; *accord* REVISED MODEL NONPROFIT CORP. ACT § 6.30 cmt. 2, at 119 (1987) (noting that a demand on the board prior to bringing suit "would be useless, for example, if the suit was against all the directors for entering into a conflict of interest transaction").

156. *Holt*, 394 P.2d at 936 n.4 (citation omitted). Even granting standing to a co-trustee, however, does not guarantee that the co-trustee will bring suit. Charles Berry and Gerald Buchwald tell the story of how John Hancock, elected treasurer of the Harvard Corporation in the 1770s, moved the treasury to Philadelphia and refused to settle the amount or resign as treasurer. Charles R. Berry & Gerald J. Buchwald, *Enforcement of College Trustees' Fiduciary Duties: Students and the Problem of Standing*, 9 U.S.F. L. REV. 1, 13 n.50 (1974). Hancock later became governor of Massachusetts and thus president of the Harvard Board of Overseers. *Id.* His estate made restitution after his death, still without any litigation. *Id.*

Revenue Code, it must be organized and operated exclusively for a religious, educational, or charitable purpose.[157] In addition, the Code prohibits the "inurement" of charity profits to "any private shareholder or individual."[158] Federal income tax law applies the same organizational and operational constraints on charities regardless of organizational form—that is, whether organized as trusts or corporations.[159]

Additional restrictions apply to that subset of section 501(c)(3) organizations known as "private foundations,"[160] generally defined as charities (other than churches, hospitals, or educational institutions) funded by a small group of donors.[161] In 1969, amendments to the Internal Revenue Code effectively adopted the strict trust standard of loyalty by imposing an absolute ban on most self-dealing transactions between a private foundation insider and the foundation.[162] Before 1950, the tax laws were silent on the extent to which self-dealing transactions by charity managers amounted to prohibited private inurement. In 1950, spurred by complaints about abuses in the private foundation subsector,[163] Congress passed a statute imposing an arm's-

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157. I.R.C. § 501(c)(3) (West 1997).

158. *Id.*

159. *See id.* (including in its definition of exempt organizations "[c]orporations" and "any community chest, fund, or foundation" that meets the forementioned requirements).

160. *See* I.R.C. ch. 42 ("Private Foundations and Certain Other Tax-Exempt Organizations").

161. *See* I.R.C. § 509 (defining the term "private foundation").

162. Henry Hansmann disagrees with Congress's decision to use the Internal Revenue Code to impose strict fiduciary standards on private foundation managers, and less strict standards on managers of publicly supported charities. Hansmann, *The Evolving Law*, *supra* note 29, at 837-38. To Hansmann, this is exactly backwards: As a principal-agent matter, donors to foundations can look out for their own interests, while donors to public charities need the extra protection of the ban on self-dealing. *Id.* As Hansmann explains:

> I think the tax code's private foundation rules are a bad model upon which to base corporate-law fiduciary duties for officers of private foundations. . . . The stricter standard is unnecessary because the only person that a private foundation can defraud is the federal government. . . . Most of us are not donating to private foundations unless we control them. . . . We are very interested in the fiduciary duties imposed upon other kinds of nonprofits. In short, the federal tax code places the strictest fiduciary standards upon the class of organizations for which such standards are least appropriate from the point of view of corporation law. I think it is regrettable that we have defaulted to the federal tax law to establish fiduciary standards. But there may be no alternative.

*Id.* at 838. However, the reason Congress imposed self-dealing prohibitions on substantial contributors to and managers of private foundations was not to protect the donors, but rather to protect the *taxpayers*: Congress was concerned precisely with "defraud[ing] the federal government." *Id.*

163. *See* Consuelo Lauda Kertz, *Executive Compensation Dilemmas in Tax-Exempt Organizations: Reasonableness, Comparability, and Disclosure*, 71 TUL. L. REV. 819, 822 (1997) (explaining how the new legislation resulted from reports of misappropriations). Technically,

length standard on loans, payments of compensation, preferential availability of goods or services, and other transactions with creators, substantial contributors, and their families and controlled businesses.[164] The Internal Revenue Service, however, found it nearly impossible to enforce an arm's-length standard. Moreover, the penalty—i.e., loss of tax exemption—was so great that the Service only reluctantly found violations.[165] In response, in 1969 Congress replaced the arm's-length standard with an absolute prohibition, violations of which attract penalty taxes to the benefiting disqualified person and to a participating foundation manager.[166] Unless corrected, serious prohibited transactions can also cause loss of tax exemption to the private foundation.

For nearly thirty years, transactions between non-private foundations—that is, the "public charities"—and their insiders continued to be governed only by the facts-and-circumstances private-inurement test.[167] A finding of private inurement would theoretically cause loss of the public charity's tax exemption.[168] In practice, this death sentence was avoided if the Service and the charity could work out a closing agreement in which the insiders agreed to modify their conduct and make the charity whole.[169]

A few years ago, congressional tax law writers became captivated by the sorry facts of management buyouts of nonprofit health maintenance organizations at reportedly phenomenal bargain prices to the insiders.[170] The federal tax rules were helpless to punish this type of

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these charities were not called private foundations until the Tax Reform Act of 1969. *See* I.R.C. § 509(a) (West 1997).

164. I.R.C. § 503 (1954) (subsections dealing with the arm's-length standard were repealed in 1969).

165. *See* Kertz, *supra* note 163, at 827-28 (noting that the IRS has been reluctant to use the harsh remedy of loss of exemption except in egregious cases).

166. Code section 4941 contains exceptions for, among other things, the payment of compensation "for personal services which are reasonable and necessary to carrying out the exempt purpose of the private foundation." I.R.C. § 4941(d). Nevertheless, the per se bar on self-dealing transactions occasionally caused severe dislocations. For example, section 4941 "forced the Rockefeller Foundation to spend two million dollars to move out of Rockefeller Center in order to avoid a conflict of interest, even though it was paying regular commercial rent." Hone, *supra* note 37 (discussant remarks), at 770 (comments of Professor John Simon).

167. JAMES J. FISHMAN & STEPHEN SCHWARZ, NONPROFIT ORGANIZATIONS 496 (1995).

168. *Id.*

169. *Id.*

170. *See, e.g.*, Theresa McMahon, *Fair* Value? *The Conversion of Nonprofit HMOs*, 30 U.S.F. L. REV. 355, 388 (1996) (discussing the interest taken by United States Representative Peter Stark of California when news of the proposed management buyout of Health Net, a nonprofit public benefit social welfare organization, became public); Lee A. Sheppard, *HMO Conversions and Self-Dealing*, 61 TAX NOTES 15, 15 (1993) (same). Another notorious

wrongdoing. A charity selling all its assets and distributing the sale proceeds to other charities in liquidation doesn't care about losing its tax exemption.[171] But why did this become a *federal tax* problem? Should it be reason enough that, in some of these cases, controversy raged locally over whether the state regulatory agency had the expertise, the time, or, perhaps, the political will to ensure the fairness of the transaction to the nonprofit?[172]

Congressional interest in this and other types of "excess benefit" transactions intensified. Reformers sought a legal structure that would penalize the wrongdoers rather than the injured charity and its beneficiaries, without imposing an absolute ban on self-dealing.[173] Thus, both congressional and administration proposals urged a variety of "intermediate sanctions"—penalty taxes on the excess benefits obtained by misbehaving insiders rather than the death sentence of revoking the organization's tax exemption.[174] A set of intermediate sanctions was signed into law on July 30, 1996.[175]

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case, involving the sale of Anclote Psychiatric Hospital in Florida, also inspired Congressman Stark to propose inserting self-dealing taxes into the Clinton administration's health care reform bill. Michael W. Peregrine & Bernadette M. Broccolo, *Stark Introduces Exempt Organizations "Intermediate Sanctions" Legislation*, 9 EXEMPT ORG. TAX REV. 131, 132 (1994). Stark's proposal extended the inurement prohibition to HMOs and other organizations exempt under Internal Revenue Code section 501(c)(4). *See* Peregrine & Broccolo, *supra*, at 132. The Internal Revenue Service retroactively revoked Anclote's exemption in order to tax the sale; the Tax Court upheld the Service in finding the below-market terms of the sale resulted in private inurement. *See* Anclote Psychiatric Ctr., Inc. v. Commissioner, 76 T.C.M. (CCH) 175 (1998).

171. *See* Sheppard, *supra* note 170, at 17 (noting that if an organization no longer exists, the fact that it is no longer exempt is unimportant); *cf. id.* at 16-17 (describing Letter Ruling 9130002, a "rare" case in which the Internal Revenue Service retroactively revoked a hospital's exemption to "enable[ ] the IRS to tax the sale proceeds"); *see supra* note 170 (describing Anclote Psychiatric Center). Moreover, in many of the nonprofit hospital conversions the charity retains the sale proceeds and operates as a grant-making foundation, in which case continued tax-exempt status would be important. See extended discussion in Part III.B, *infra*.

172. *See, e.g.*, Harris Meyer, *Selling . . . Or Selling Out*, TRUSTEE, Sept. 1996, at 12, 14 ("In the 1980s, a number of not-for-profit California HMOs were purchased in leveraged buyouts by insiders, then sold for far larger sums. . . . State regulators were widely criticized for being asleep at the wheel.").

173. *See* Kertz, *supra* note 163, at 828 (explaining that the loss of exemption by a university would affect the students, faculty, staff, and general community, without necessarily punishing the wrongdoers).

174. The Internal Revenue Service has also set forth guidelines specifically addressed to health care organizations. *See supra* note 131.

175. Taxpayer Bill of Rights 2, Pub. L. 104-168, 110 Stat. 1452 (1996), § 1311(a) (codified at I.R.C. § 4958 (West 1997)) (adding to the Internal Revenue Code new section 4958 ("Taxes on Excess Benefit Transactions")). *See generally* Kertz, *supra* note 163 (analyzing recently enacted intermediate-sanctions legislation that deals with excessive compensation abuses). The new law also extends the "private inurement" prohibition to section 501(c)(4) organizations. *See* I.R.C. §§ 501(c)(4)(B), 4958(e)(1).

Under the new rules, if a "disqualified person"—anyone in a position to exercise substantial influence over the affairs of the charity (or a related person)[176]—receives a financial benefit from the charity greater than the value of goods or services she provided, then the benefited insider must pay a tax equal to twenty-five percent of this excess.[177] (A second-tier, confiscatory tax applies if the charity is not made whole.[178]) In addition, a tax applies to any charity manager who "knowingly" approved the transaction.[179] Under the legislative history, charity fiduciaries may rely on a rebuttable presumption of reasonableness if the following conditions are met: (1) the transaction was approved by the trustees or directors (or a committee thereof), who were individuals unrelated to and not controlled by the disqualified person; (2) this independent body obtained and relied on appropriate data for functionally comparable positions; and (3) the body adequately documented the basis for its determination.[180] In all other cases, the burden of proof will be on the fiduciaries, although the Internal Revenue Service has hinted that it will not pursue "minor" transgressions[181] and that it is considering safe harbors for charities (such as churches) that lack independent boards.[182]

Indeed, these new rules are only the latest in a series of federal tax laws that impose tighter restrictions on charity behavior than do state rules. While state law generally permits a nonprofit organization to have broad purposes—such as "any lawful purpose"[183]—a charity that hopes to obtain federal income-tax exemption under section 501(c)(3) must have only religious, educational, or charitable purposes. Federal tax rules regarding unrelated business income (starting in 1950),[184] private foundation status (1946, 1950, and particularly 1969),[185] and political and lobbying activities (1969 and 1987)[186] have profoundly influenced operations of the charitable sector. The infor-

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176. I.R.C. § 4958(f)(1)(A)-(B).

177. I.R.C. § 4958(a)(1), (c)(1)(A).

178. I.R.C. § 4958(b).

179. I.R.C. § 4958(a)(2).

180. H.R. REP. NO. 104-506, at 56-57 (1996). See also the American Law Institute's discussion of "duty of fair dealing" in *infra* note 229.

181. *See supra* note 165.

182. Fred Stokeld, *IRS Considering Alternatives to Rebuttable Presumption Rule*, 74 TAX NOTES 1505, 1506 (1997).

183. *See* Hansmann, *Reforming Nonprofit Corporation Law*, *supra* note 68, at 509-38 (discussing "the varying approaches taken in the state statutes toward the purposes for which nonprofit corporations may be formed").

184. *See* I.R.C. §§ 511-515.

185. *See* I.R.C. §§ 507-509(a).

186. *See* I.R.C. §§ 501(c)(3), 501(h), 4911.

mation returns that charities must file with the IRS, and make available to the public, contain the most comprehensive and current data on the sector.[187] Meanwhile, lax or overburdened state attorneys general have come to rely more and more on the Internal Revenue Service to police charities.[188]

As a result, we have been moving to a system of federalizing oversight of charities. De facto, and against its core competency (and likely preference), the Internal Revenue Service comes to operate, at least in part, as a uniform, super-regulatory board.[189] One can debate the merits of increased federal powers and their effect on state enforcement.[190] However, even the best laws lose their salutary benefits

187. Generally, all charities with annual gross receipts of over $25,000, except churches, must file a Form 990 (or, if small, a Form 990-EZ). Private foundations must file a Form 990-PF. I.R.C. § 6033(a). Unfortunately, the IRS does not have an easily accessible centralized source for returns. Legislation enacted in 1996 also requires Form 990 filers to disclose their most recent form on the spot (for an in-person request) or within 30 days (for a mail-in request). I.R.C. § 6104(e).

188. This is not to say that the states have complete confidence in the adequacy of the IRS Form 990. *See, e.g.*, Robert Franklin, *Charity Information Easier to Come by, but Is It Reliable?*, STAR TRIB. (Minneapolis), Oct. 7, 1996, at 3B, *available in* LEXIS, News Library, Strib File (quoting Sheila Fishman, the director of the Minnesota's Attorney General's charity division, as saying she has "very little trust in" the Form 990).

189. See, for example, Marion R. Fremont-Smith, *Trends in Accountability and Regulation of Nonprofits*, *in* THE FUTURE OF THE NONPROFIT SECTOR 75, 86 (Virginia A. Hodgkinson et al. eds., 1989), which states:

> [T]he Internal Revenue Service is not the most appropriate agency to regulate the independent sector. It lacks the more refined tools for compelling compliance available to state equity courts. It is not well placed to police disclosure provisions. Even if granted equity-type powers, its staff is neither by training nor by inclination suited to enforcement that is not designed to raise revenue.

190. In an analogous context, Justice Black lamented the prosecuting of local crimes through federal tax laws; specifically, he argued that the power shift to Washington harmed both the central government and the states. *See* Rutkin v. United States, 343 U.S. 130, 141-43 (1952) (Black, J., dissenting).

Under Internal Revenue Code section 6104(c), the Internal Revenue Service must notify appropriate state officials of a *final* determination to deny or revoke tax exemption of a charity under section 501(c)(3). *Accord* James B. Lyon, *The Supervision of Charities in the United States by the State Attorneys General (and Other State Agencies) and the Internal Revenue Service*, N.Y.U. 24TH CONF. ON TAX PLANNING FOR 501(c)(3) ORGANIZATIONS, § 5.04[2], at 5-27 (1996). It might improve the administration of state monitoring and enforcement if Congress permitted the Service to share information about an *ongoing* investigation with the appropriate state. *See id.* § 5.04[1], at 5-25 to 5-26 (discussing the relationship between the state attorneys general and the Internal Revenue Service in general). Lyon describes the frustration resulting from the Service's inability to reciprocate the flow of information that attorneys general currently provide to the Service. *See id.* § 5.04[3], at 5-28 & n.71 ("'We provide information to the IRS and we don't know what the IRS does with it because they are prohibited by law from telling us what they are doing with it.'" (quoting testimony by the Connecticut Assistant Attorney General)). The Oversight Subcommittee of the House Ways and Means Committee recently recommended that "'[the] IRS study and make recommendations to the Committee on Ways and Means on whether certain State if they are not backed up with authority, and the exempt-organization function at the Service suffers from its own inadequate resources.[191]

## III. DUTY OF CARE: CORE QUESTIONS AND CASE STUDIES

Legal disputes involving nonprofit fiduciaries generally deal with breaches of the duty of *loyalty* rather than of the duty of *care*. Self-dealing and other conflicts of interest go to the heart of the fiduciary relationship. In the charitable sector, such violations of the public trust attract the most press coverage and public disdain, and thus win the greatest share of attorney general attention.[192] Yet, important as is fiduciary malfeasance, the remainder of this Article will focus on fiduciary misfeasance, precisely because the law is so bad at addressing

officers, such as the attorney general and other officials charged with overseeing public charities, should be provided additional access to Federal tax information.'" *Id.* § 5.04[3], at 5-29 (quoting HOUSE SUBCOMM. ON OVERSIGHT OF THE COMM. ON WAYS AND MEANS, 103D CONG., REPORT ON REFORMS TO IMPROVE THE TAX RULES GOVERNING PUBLIC CHARITIES 23 (Comm. Print 1994)).

191. *See, e.g.*, Wright, *supra* note 48 (citing Exempt Organizations Director Marcus Owens to the effect that the 800 IRS employees who work on exempt organizations (and municipal bonds) audit 10,000 organizations "in a good year," but that fewer than 100 of these are comprehensive reviews).

192. *See, e.g.*, Jim Witty, *Attorney General Turns up the Heat*, HONOLULU STAR-BULL., Sept. 11, 1997, at A1 (reporting on a preliminary attorney general investigation of the trustees of the $10-billion Bishop Estate charitable trust, particularly instances of self-dealing and co-investing in projects in which trustees also personally invested); Op. N.M. Att'y Gen., No. 90-17, 1990 N.M. AG LEXIS 15, at *12-13 (Sept. 20, 1990) (concluding that the state conflict-of-interest statute bars the state from entering into a contract with a nonprofit having a state legislator on the board); M.A. Farber, *Abrams to Investigate Covenant House Loans*, N.Y. TIMES, Mar. 2, 1990, at B1, *available in* LEXIS, News Library, Nyt File (citing a former head of the Attorney General's Charities Bureau who emphasized that it is a violation of state law for any officer or director of a nonprofit to receive a loan from the institution); William C. Lhotka, *Designer Gowns Helped Oust Sisters from Foundation*, ST. LOUIS POST-DISPATCH, Sept. 22, 1996, at 5D, *available in* LEXIS, News Library, Mwest File (noting that the Missouri Attorney General "called the [David B. Lichtenstein] foundation a 'financial playground' for [the removed directors]"); Selwyn Raab, *Judge Ousts Operators at Mental Center*, N.Y. TIMES, Oct. 21, 1986, at B3, *available in* LEXIS, News Library, Nyt File (noting a situation in which a nonprofit paid $2.5 million in excessive rents to corporation owned by the family of the nonprofit's founder and medical director); Kathleen Teltsch, *Abrams Says Head of Foundation Lived Well on Charity's Millions*, N.Y. TIMES, Dec. 18, 1988, § 1, pt. 3, at 75, *available in* LEXIS, News Library, Nyt File ("'Since I've been Attorney General, I do not recall seeing another case of such extreme personal greed . . . .'" (quoting the New York Attorney General)); Kathleen Teltsch, *State Says Levitt Diverted $5 Million from Family Foundation*, N.Y. TIMES, June 11, 1983, § 1, at 27, *available in* LEXIS, News Library, Nyt File (reporting on the charges brought by the New York State Attorney General against William J. Levitt for diverting foundation funds for "personal use and benefit"). *See generally* DeMott, *supra* note 135 (addressing whether directors of nonprofits should be as free to self-deal as their counterparts are in for-profit business corporations, and arguing that norms in the for-profit context should not be imported into the nonprofit context).

it.[193] The discussion is divided into four topics, based on the cases introduced in this Article: (A) the near abdication of director oversight (Adelphi University); (B) fundamental changes in the charity's purposes or activities (Timken Mercy hospital); (C) investment policy (the *Reader's Digest* foundations); and (D) the cozy world of charity fundraising (Foundation for New Era Philanthropy).

The law largely ignores the "business" side of charity: decisions as to what activities the charity should engage in go unreviewed and undisturbed by public authorities, be they attorneys general or judges.[194] All matters of judgment fall under the fiduciary's duty of care, governed by general principles of prudence and good faith.[195] Even here, again for practical reasons, we find more specific guidance and review for investment activities than for spending policies. After all, one can measure the success of an investment portfolio by referring to objective indices, but who can second-guess a decision to build a new physics lab instead of raise salaries for the business school faculty?

In practice, of course, it is not always so easy to separate the twin obligations of loyalty and care. Peter Swords and Harriet Bograd have found a consensus among the more experienced state charity officials: "Inadequate board governance also creates the conditions that make embezzlement, misappropriation of funds and self-dealing possible. The case of the domineering executive director and the weak board seems to be quite typical across the country."[196]

Moreover, courts seem more willing to listen to duty-of-care complaints if the transaction is tainted by duty-of-loyalty implications. For

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193. For a rare example of the attorney general stepping in to remedy gross mismanagement, see Randy Kennedy, *New Board Puts Garden Back on Feet*, N.Y. TIMES, Nov. 7, 1993, § 13, at 9, *available in* LEXIS, News Library, Nyt File (describing the New York Attorney General's investigation of the directors and officers of the Queens Botanical Garden Society for waste and mismanagement, the removal or resignation of 20 directors, and the operation of the Society by the New York City Department of Cultural Affairs until the Society's members elected new directors); *see also supra* note 47 (describing the California Attorney General's actions against charity fiduciaries who breached their duty of care).

194. *See* REVISED MODEL NONPROFIT CORP. ACT § 8.01(b) (1987) ("Except as provided in this Act . . . , all corporate powers shall be exercised by or under the authority of, and the affairs of the corporation managed under the direction of, its board.").

195. *See* Henry Ridgely Horsey, *The Duty of Care Component of the Delaware Business Judgment Rule*, 19 DEL. J. CORP. L. 971, 977-78 (1994) (discussing the "business judgment" rule as according deference to directors in their duty to govern in good faith).

196. Peter Swords & Harriet Bograd, *Accountability in the Nonprofit Sector: What Problems Are Addressed by State Regulators?* (visited Mar. 19, 1998) <ftp://nonprofits.org/pub/cyb-acc/npcc/AG_PROB.WP5>. The state charity officials also expressed familiarity with the "'self-employment syndrome,'" in which a charity "was created primarily for the benefit of its formerly unemployed executive, and the board, staff, vendors, and contractors include many friends and relatives of the executive." *Id.*

example, in the "Sibley Hospital case,"[197] the directors completely failed to supervise the investment of funds, leaving millions of dollars on deposit in non-interest-bearing bank accounts.[198] The court, though, appeared at least as influenced by concerns of loyalty.[199] One wonders whether Judge Gesell would have found any duty-of-care breach—or, more important, even granted standing to the plaintiff patients—had the funds been deposited at banks where the hospitals' directors were *not* also directors.[200] Indeed, Judge Gesell's application of the business-corporation fiduciary rules to charitable corporations had even greater impact on the duty-of-loyalty side: The directors did not face the absolute ban on self-dealing found in trust law, but only the disclosure-fairness test of the corporate law.[201] Nor did breach lead to liability.[202] In the end, no director was removed or fined; rather, each was required only to read the court's opinion![203]

The first and last of our case studies—Adelphi University and the Foundation for New Era Philanthropy—deal with director judgment unconstrained by donor direction. The middle two case studies raise issues of donor control and the degree to which society should give continuing authority to the donor's wishes. The drop in value of the Wallace foundations can be traced directly to their holdings of stock in their founders' company, Reader's Digest Associates.[204] In the Timken Hospital case study, donors gave unrestricted funds to a charitable corporation formed for a specified purpose, raising a more subtle, unself-interested type of divided loyalty—what Daniel Kurtz and

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197. Stern v. Lucy Webb Hayes Nat'l Training Sch. for Deaconesses & Missionaries, 381 F. Supp. 1003 (D.D.C. 1974) (mem.) (*Sibley Hospital*).

198. *See id.* at 1010 & tbl.II (illustrating the directors' maintenance of funds in accounts earning little or no interest).

199. *See id.* at 1016 (discussing instances in which defendant trustees engaged in self-dealing); *see also* Scheuer Family Found., Inc. v. 61 Assocs., 582 N.Y.S.2d 662, 664 (App. Div. 1992) ("[I]f plaintiff has made a prima facie showing of a lack of such disinterested independence or such dual relation, the complaint may not be dismissed for failure to state a cause of action solely upon application of the business judgment rule.").

200. *But see* Lynch v. Redfield Found., 88 Cal. Rptr. 86, 92 (Ct. App. 1970). In *Lynch*, the court surcharged squabbling directors for permitting funds to accumulate in a non-interest-bearing account for five years. *Id.* The Attorney General charged:

> "[A]ll three directors in concentrating on their feud left the Foundation in a state of suspended animation for several years ignoring their obligations to carry on its charitable purposes and to manage its assets with the degree of care and diligence which a prudent man would exercise in the management of his own affairs."

*Id.* (alteration in original) (quoting a statement of the Attorney General).

201. *Sibley Hospital*, 381 F. Supp. at 1015.

202. *See id.* at 1017.

203. *See id.* at 1021.

204. *Cf.* Barshay, *supra* note 17.

other commentators call the duty of obedience.[205] When may the charity sell the donated property or alter the purposes to which that donation is put? Does organizational form matter, and should it? That is, should cy pres relief from a court be required for charitable trusts while charitable corporate boards are granted plenary authority to amend "outdated" restrictions and charitable purposes?

### A. *Adelphi University: Directors Fail to Exercise Judgment*

*1. The Standard of Care.*—Only a handful of cases—in the proprietary sector as well as the nonprofit—deal with the fiduciary's duty of care unadorned by concerns of the duty of loyalty. In 1891, the United States Supreme Court first recognized a duty of care in industrial-corporation directors to act as would "ordinarily prudent and diligent men";[206] in this five-four decision the business world learned what a difficult standard this is to flunk.[207] The Delaware high court did not even recognize a duty to act in an informed and prudent manner until 1963.[208]

Plaintiffs' lack of success in duty-of-care claims has been blamed on a misapplied business judgment rule.[209] Commented Henry Horsey, a former justice of the Delaware Supreme Court:

> Those who surveyed the duty of care case law in this country before the mid-[nineteen-]eighties found an infertile field and were in nearly unanimous agreement as to their findings: the business judgment rule had been applied in such a manner as to constitute an almost per se bar to share-

205. *See* KURTZ, *supra* note 30, at 84-90.

206. Briggs v. Spaulding, 141 U.S. 132, 152 (1891).

207. *See id.* at 165-66 (holding that the defendants were not liable for not preventing loss by putting the bank into liquidation within 90 days after they became directors). Nineteenth-century courts initially applied fiduciary duties only to directors of corporations that were banks, invoking a quasi-trustee theory. *See* Hun v. Cary, 82 N.Y. 65, 70 (1880) (stating the question under consideration as the measure of fidelity, care, and diligence the trustees of the bank owed to the bank and its depositors).

208. *See* Horsey, *supra* note 195, at 985-87 (discussing *Graham v. Allis-Chalmers Manufacturing Co.*, 188 A.2d 125 (Del. 1963), in which a Delaware court first recognized the existence of a director's fiduciary duty to act in an informed and prudent manner). Justice Horsey authored the controversial opinions for the court in both *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985), and *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345 (Del. 1993), *modified*, 636 A.2d 956 (Del. 1994). *See infra* notes 216-217, 228-230 and accompanying text.

209. *See* Franklin A. Gevurtz, *The Business Judgment Rule: Meaningless Verbiage or Misguided Notion?*, 67 S. CAL. L. REV. 287, 298-300, 304-12 (1994) (arguing that a gross negligence standard does not appear to have affected the outcome in any case where the defendant lost, and questioning why directors should enjoy more protection against a charge of negligence than other professionals).

holder claims of directors' breach of their fiduciary duty of care.[210]

Indeed, in 1942, the highest court of New York declared: "[E]rrors of judgment by directors do not alone suffice to demonstrate lack of fidelity[,] . . . . even though the errors may be so gross that they may demonstrate the unfitness of the directors to manage the corporate affairs."[211]

The business judgment rule (if not the name) dates back to a 1742 English case, *Charitable Corp. v. Sutton*,[212] in which the Lord Chancellor declared: "For it is by no means just in a judge, after bad consequences have arisen from such executions of [directors'] power, to say that they foresaw at the time what must necessarily happen; and therefore were guilty of a breach of trust."[213] Declared one modern trial judge, in rejecting a rule that directors are chargeable with ordinary negligence: "Courts have more than enough to do in adjudicating legal rights and devising remedies for wrongs. The directors' room rather than the courtroom is the appropriate forum for thrashing out purely business questions . . . ."[214] No wonder, then, that the corporate bar was so stunned by the Delaware Supreme Court's 1985 decision in *Smith v. Van Gorkom*,[215] holding directors personally liable for gross negligence in arranging the sale of their company.[216] This highly criticized decision helped inspire state statutes, discussed below, that permit shareholders to limit or eliminate the monetary liability of directors for most breaches of the duty of care.[217]

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210. Horsey, *supra* note 195, at 977-78 (citing, among other articles, George W. Dent, Jr., *The Revolution in Corporate Governance, the Monitoring Board, and the Director's Duty of Care*, 61 B.U. L. REV. 623 (1981), and S. Samuel Arsht, *The Business Judgment Rule Revisited*, 8 HOFSTRA L. REV. 93 (1979)).

211. Everett v. Phillips, 43 N.E.2d 18, 19-20 (N.Y. 1942).

212. 26 Eng. Rep. 642 (Ch. 1742).

213. *Id.* at 644. Horsey, *supra* note 195, at 975, describes *Charitable Corp.* as the "father" of the "business judgment rule."

214. Kamin v. American Express Co., 383 N.Y.S.2d 807, 810-11 (Sup. Ct.), *aff'd*, 387 N.Y.S.2d 993 (App. Div. 1976). The author of the trial decision, Judge Edward J. Greenfield, also commented, "To allege that a director 'negligently permitted the [action]' . . . without alleging fraud, dishonesty or nonfeasance, is to state merely that a decision was taken with which one disagrees." *Id.* at 811.

215. 488 A.2d 858 (Del. 1985).

216. *See id.* at 884 (holding board members personally liable for gross negligence in failing to disclose all material facts before securing stockholders' approval of merger). The defendants subsequently settled for $23.5 million, of which $10 million (the policy limit) was covered by the company's directors' and officers' liability policy. Bayless Manning, *Reflections and Practical Tips on Life in the Boardroom After* Van Gorkom, 41 BUS. LAW. 1, 1 editor's note (1985).

217. *See, e.g.*, DEL. CODE ANN. tit. 8, § 102(b)(7) (Supp. 1996) (providing that a certificate of incorporation may include a provision limiting monetary liability of directors for

2. *The Business Judgment Rule.*—The business judgment rule, by definition, requires the exercise of judgment; thus, it is not available in cases of nonfeasance.[218] The American Law Institute found that the "business judgment rule provides special protection to informed business decisions as distinguished, for example, from continued inattention to directorial obligations."[219] Critics contend that a distinction between misfeasance and nonfeasance fails to reflect life in the boardroom. Complains Bayless Manning: "[A]stonishingly, . . . given the realities of the way boards operate, the business judgment rule would not operate at all in respect of fully ninety percent of what directors are actually engaged in."[220] Nonprofit directors devote even less time and attention to their positions. Such affirmative board duties as selecting the chief officer, preparing the budget, and reviewing

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most breaches of the duty of care). *Compare* ALI PRINCIPLES, *supra* note 59, § 7.19 (Limitation on Damages for Certain Violations of the Duty of Care).

> [I]t is contemplated that the outside directors who were held liable in Smith v. Van Gorkom would have been entitled to the protection of a limitation on damages adopted pursuant to this Section. (No assumption is here made that these directors would have been liable to any extent if § 4.01 [Duty of Care] had been applicable.).

*Id.* § 7.19 cmt. f, at 248 (citation omitted); *accord infra* Part III.A.3 (discussing monetary caps or waivers).

218. In *Charitable Corp.*, the Lord Chancellor held the directors liable for the loss resulting from their gross failure to attend to the business, resulting in breaches of trust by others. 26 Eng. Rep. at 644-45.

219. ALI PRINCIPLES, *supra* note 59, introductory note to part IV, at 135 (Duty of Care and the Business Judgment Rule). The ALI acknowledges the difficulty in distinguishing between "a conscious decision or inexcusable inattentiveness." *Id.* § 4.01(c) cmt., at 175 (discussing the safe harbor provided by the business judgment rule). Section 8.30(d) of the *Revised Model Nonprofit Corporation Act* states that a director is not liable "for any action taken or not taken as a director" if the director complies with the duty-of-care standards. REVISED MODEL NONPROFIT CORP. ACT § 8.30, at 212 (1987) (General Standards for Directors). Again, though, this covers only conscious board decisions of whether to act or not. *See id.* § 8.30 cmt. 9, at 219 ("'Section 8.30(d) . . . also applies to the determination by the board of directors of which matters to address and which not to address. Section 8.30(d) does not apply only when the director has failed to consider taking action which under the circumstances he is obliged to consider taking.'" (quoting MODEL BUS. CORP. ACT § 8.30(d) cmt. 4, at 225 (1984))).

220. Manning, *supra* note 127, at 1494. Manning begins his analysis by taking "as axiomatic that a director should not be held liable for having failed in his duty of attention unless his conduct departs significantly from normal expectations of proper conduct." *Id.* at 1480. To Manning, the central problem of life as a director is that "the universe of all actions not taken is *always* far greater than the roster of actions taken." *Id.* Because agenda setting is the most important thing a board does, the distinction between commission and omission of specific acts is meaningless and unhelpful. *See id.* at 1485-86. Manning concludes hopefully: "The courts will somehow find a way to alter the interpretation of the business judgment rule in such a way as to make it produce commonsense results in the case of reasonably diligent citizens who have been in good faith generally attentive to their duties as directors over a period of time." *Id.* at 1495.

operations are likely to be carried out haphazardly or by only a few of the board members. Moreover, it is no legal defense that a director was an uncompensated volunteer.[221]

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221. *See Charitable Corp.*, 26 Eng. Rep. at 645 ("By accepting a trust of this sort, a person is obligated to execute it with fidelity and reasonable diligence; and it is no excuse to say that they had no benefit from it, but that it was merely *honorary* . . . ."); Lynch v. Redfield Found., 88 Cal. Rptr. 86, 91 (Ct. App. 1970) ("By pointing out that they served without compensation, defendant directors imply that such fact might subject them to a lesser fiduciary obligation than a compensated trustee. No authority has been cited and we have found none. We see no basis for such conclusion."). The *Revised Model Nonprofit Corporation Act*, however, states cryptically:

> Two distinguishing factors of nonprofit corporations are that their directors may be serving without compensation and are attempting to promote the public good. Courts may take these factors into consideration in determining whether directors are liable with respect to performance of their duties. This does not mean that directors can ignore their responsibilities because they are volunteers or have no economic interest in the corporation or its operations.

REVISED MODEL NONPROFIT CORP. ACT § 8.30 cmt., at 215.

Many states have adopted mandatory or permissible statutory protections for volunteer directors of charities as a response to the liability crisis of the mid-1980s. *See generally* REVISED MODEL NONPROFIT CORP. ACT, ch. 8, subch. E (Indemnification), §§ 8.50-8.58. These statutes do not, however, extend to trustees of charitable *trusts*. *See* BOGERT & BOGERT, *supra* note 101, § 394, at 279; *see also* KURTZ, *supra* note 30, at 37 ("[P]rudence dictates that directors' and officers' (D & O) liability insurance be procured; it protects both the organization's obligation to indemnify . . . and it independently protects directors in many cases when the corporation cannot provide indemnification under the prevailing law."). *See generally id.* ch. 6 ("Protection: Indemnification and Insurance"). After reviewing the data, Kurtz expresses skepticism of "an actual liability crisis" for nonprofit directors and officers (although there has been an increase in tort claims against them). *See id.* at 95, 99. *But see* John v. John, 450 N.W.2d 795, 798 (Wis. Ct. App. 1989). In *John*, the trial court found that the director was entitled to neither an advance for defense costs nor indemnification where he "had committed gross misconduct and breached his fiduciary duties as a director and trustee" of his foundation. *Id.* The trial court also found that he "had engaged in a pervasive pattern of abuse of office including securities fraud, tax fraud, perjury, self-dealing, conflicts of interest, corporate fraud, lying to the board of directors, breach of fiduciary duties, deception and disobedience of the board of directors, waste, and mismanagement." *Id.*; *see also infra* Part II.A.3 (discussing monetary shields for directors who breach their fiduciary duty of care).

Alfred Conard is credited for first proposing a monetary cap:

> In order to be effective but not catastrophic, the measure of liability must stand in a proper relation to what a director gains from his position. . . . Perhaps it should be twice this amount, or perhaps one-half, but it should vary depending upon the director's compensation. . . .
>
> . . . . .
>
> . . . At the same time, the statute would forbid indemnification of such liabilities, as well as prohibit insurance coverage against them.

Alfred F. Conard, *A Behavioral Analysis of Directors' Liability for Negligence*, 1972 DUKE L.J. 895, 914.

*3. Remedies.*—Traditionally, breach of a fiduciary duty has been a tort.[222] Thus, plaintiffs charging a breach of duty of care in the business corporation context must show both a harm caused to the organization and the measure of that harm.[223] Consider the 1924 case of a director who failed to pay attention while the business corporation slid into bankruptcy.[224] Judge Learned Hand declared, "Having accepted a post of confidence, [the director] was charged with an active duty to learn . . . ."[225] Nevertheless, the plaintiff had the burden of demonstrating under the ordinary rules of tort that "the performance of the defendant's duties would have avoided loss, and what loss it would have avoided."[226] If this means that no remedy might be available, Hand saw no alternative:

> [W]hen a business fails from general mismanagement, business incapacity, or bad judgment, how is it possible to say that a single director could have made the company successful, or how much in dollars he could have saved? . . .
>
> . . . [Were the burden instead on the defendant,] if a director were once shown slack in his duties, he would stand charged prima facie with the difference between the corporate treasury as it was, and as it would be, judged by a hypothetical standard of success. How could such a standard be determined? . . . Men's fortunes may not be subjected to such uncertain and speculative conjectures. . . . No men of sense would take the office, if the law imposed upon them a guaranty of the general success of their companies as a penalty for any negligence.[227]

Recently, however, the Delaware Supreme Court rejected Hand's analysis: "The tort principles of *Barnes* have no place in a business judgment rule standard of review analysis."[228] The court further held:

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222. *See* Barnes v. Andrews, 298 F. 614, 616 (S.D.N.Y. 1924) (stating that a director's breach of fiduciary duty "rests upon a tort").

223. *See id.* at 620 (explaining that the director's "disbursement may have been a wrong to the company, but no damage followed it, and without damage there can be no recovery").

224. *Id.* at 614-15.

225. *Id.* at 616.

226. *Id.* However, a particular director cannot escape liability by claiming that his or her conduct was less significant than the conduct of the others. *See* ALI PRINCIPLES, *supra* note 59, § 7.19, at 238 (providing that if the board as a whole has violated its duty of care, either by commission or omission, the directors bear joint and several liability).

227. *Barnes*, 298 F. at 616-17.

228. Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 370 (Del. 1993), *modified*, 636 A.2d 956 (Del. 1994). Asked one commentator: "[I]f a breach of fiduciary duty is not a tort action, what is it? A contract action?" Charles Hansen, *The* Technicolor *Case: A Lost Opportunity*, 19 DEL. J. CORP. L. 617, 637 n.152 (1994). Even in a contract case, the plaintiff has

"A breach of either the duty of loyalty or the duty of care rebuts the presumption that the directors have acted in the best interests of the shareholders, and requires the directors to prove that the transaction was entirely fair."[229] The court declared that "[b]urden shifting does

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the burden of establishing the elements of the claim, including causation and injury. The court's approach in *Technicolor* appears to conflict with an earlier holding that "the party attacking a board decision as uninformed must rebut the presumption that its business judgment was an informed one." Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985).

229. *Technicolor*, 634 A.2d at 371. It is not easy to parse the issues of causation, damage, and burden of proof under the traditional tort approach. To start with, the ALI's *Principles of Corporate Governance* emphasize that just because a director might have committed a breach of the duty of care, "no implication is intended that liability will be imposed. That question depends on whether the acts or omissions were the legal cause of any damage to the corporation." ALI PRINCIPLES, *supra* note 59, introductory note to pt. IV, at 136; *see also id.* § 7.18, at 222-23 (Recovery Resulting from a Breach of Duty: General Rules).

The ALI's restatement of the duty of care concludes: "A person challenging the conduct of a director . . . has the burden of proving a breach of the duty of care, . . . and, in a damage action, the burden of proving that the breach was the legal cause of damage suffered by the corporation." *Id.* § 4.01(d), at 139. If, however, the challenging party can prove that the director was not acting in good faith or with disinterest with respect to a business judgment, then the director's conduct will be judged without recourse to the protection of the business judgment rule. If the challenger can prove that the director did not (or did not rationally) believe that the decision was in the best interests of the corporation, then the director has breached the duty of care. Next, the challenger must prove that the breach of duty-of-care standards was the legal cause of loss to the corporation. *See id.* § 4.01(d) cmt. d, at 142; *see also id.* § 7.18 (providing general rules regarding recovery for breach of duty).

A different burden of proof applies in cases involving the duty of loyalty, which the ALI calls the "duty of fair dealing." *See id.*, introductory note to pt. V, at 199. In general, if the interested director makes a disclosure in advance and obtains approval from disinterested directors (or shareholders), then the business judgment rule applies, and the burden of proof is on the challenger. The ALI suggests that even when disinterested directors have approved a transaction, the transaction should be scrutinized more closely than under the business judgment rule, because these transactions "need not be entered into (in the sense that alternative transactions can usually be effected with third parties)." *Id.* § 5.02(a)(2) cmt., at 218; *cf.* Gearhart Indus., Inc. v. Smith Int'l, Inc., 741 F.2d 707, 720 (5th Cir. 1984) (explaining that under Texas business corporation law, the burden of proof is on the interested director, but a transaction unfair to the corporation is still upheld if ratified by a majority of disinterested directors or the shareholders). If the interested director does not make a disclosure or obtain approval, the more stringent standard of fairness applies, and the burden of proof falls on the interested director. ALI PRINCIPLES, *supra* note 59, introductory note to pt. V, at 202-03; *see also id.* § 5.02 (Transactions with the Corporation); *id.* § 5.02 & cmt. a, at 211 (discussing requirements of section 5.02 in comparison with existing law).

The ALI principles for advance approval of conflict-of-interest transactions apply in some cases to ratification after the fact by disinterested directors (or shareholders). The ABA's *Revised Model Nonprofit Corporation Act*, however, provides that if the interested director of a public benefit corporation did not disclose and obtain board approval in advance, then only the court or the attorney general may ratify the transaction (they may also approve it in advance). Of course, the interested director can always defend by proving that the transaction was fair. REVISED MODEL NONPROFIT CORP. ACT § 8.31 cmt. 2 (Ways to Comply with Section 8.31), at 224-25 (1987).

not create *per se* liability on the part of the directors; rather, it is a procedure by which Delaware courts of equity determine under what standard of review director liability is to be judged."[230] Similarly, Illinois rejects the *Restatement (Second) of Torts*' view of breach of fiduciary duty as a tort, applying instead "the substantive laws of agency, contract and equity."[231]

The type of remedy affects how concerned we should be about the level of care. Judge Gesell in the Sibley Hospital case observed that the "function of equity is not to punish but merely to take such action as the Court in its discretion deems necessary to prevent the recurrence of improper conduct."[232] If directors face monetary damages, then society might be loath to impose high fiduciary obligations on charity managers.[233] By contrast, if wrong-doing directors face only removal or other injunction (as embarrassing as this may be), then perhaps society should not be so fearful. Of course, in framing such a solution we should remember that courts (and attorneys general) have enough to do without trying to run charities.[234] Moreover, charity board service generally is a voluntary and often time-consuming undertaking, and removing one director does not ensure that a better one will step forward to take his place.[235] No wonder former

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230. *Technicolor*, 634 A.2d at 371.

231. Kinzer v. City of Chicago, 539 N.E.2d 1216, 1220 (Ill. 1989).

232. Stern v. Lucy Webb Hayes Nat'l Training Sch. for Deaconesses & Missionaries, 381 F. Supp. 1003, 1018 (D.D.C. 1974) (mem.).

233. Compare ALI PRINCIPLES, *supra* note 59, § 7.19 reporter's note 5, at 258-59, which states that limitations on liability for breach of duty of care will "tend to inhibit re-characterization of duty of fair dealing cases as duty of care cases so as to enable the defendant to pass on the loss to the insurer. . . . Such a fictitious characterization undercuts the deterrent threat by which the duty of loyalty should be enforced . . . ." *But see* Macaluso v. Jenkins, 420 N.E.2d 251, 257 (Ill. App. Ct. 1981) (holding that a director exercising such control over a corporation justifies piercing the nonprofit corporate veil).

234. The *Model Business Corporation Act* does not specify remedies for breach of the duty of loyalty or the duty of care. The ABA suggests:

> A court should enter an order that provides an equitable and fair remedy to the corporation taking into account any benefits the corporation received. A court should determine whether the breach of section 8.31 [duty of loyalty] was technical or substantive, whether there was an attempt to deal openly and fairly with the corporation and to act in good faith in furthering the corporation's best interests. In particularly egregious cases involving fraudulent or malicious conduct, a court may grant exemplary damages.

MODEL BUS. CORP. ACT § 8.31 cmt. 6, at 227 (1984).

235. See, for example, David G. Samuels, *Obligations of Fiduciaries of Charitable Foundations*, N.Y. L.J., Feb. 5, 1997, at 1, 4:

> [A]s a technical matter, the Attorney General [of New York] can ordinarily initiate court action seeking the removal of board members who authorize, or acquiesce in, the payment of excessive compensation to officers or insiders or other actions which result in the waste of corporate assets. The Attorney General also

New York State charity director Daniel Kurtz concluded: "In light of the consistently generous holdings concerning directors' conduct, the rare case in which breaching directors appear to suffer genuine sanctions seems truly aberrational . . . ."[236]

Not that recovery against negligent directors is much more likely on the stock corporation side. Indeed, realizing that the risk of large judgments dissuades good directors from service and encourages them to be overly cautious in making decisions, legislatures across the country have moved to permit business corporations to indemnify directors and—usually only upon shareholder approval—even to adopt a shield against monetary damages for directors who act in good faith and not out of self-interest.[237] A monetary shield does not alter the

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> can seek to surcharge individual board members who have arguably squandered or wasted corporate assets, requesting a court to order one or more board members to pay restitution to the charitable organization and thereby make it whole.
>
> However, as a practical matter, an attorney general will be less able to obtain drastic relief against board members who are not shown to have been active participants in, or beneficiaries of, illegal payments of charitable assets.
>
> The courts do not tend to view passive or negligent conduct with as jaundiced an eye as active misconduct, and board members (who are often volunteers serving without compensation, and often individuals of modest means) are not likely to be required to repay funds which they never personally received, particularly if they act promptly to seek relief from the active wrongdoer.

*Accord* Bell & Bell, *supra* note 47, at 451 ("[The California Attorney General] rarely seeks to remove trustees from office. Courts require a strong likelihood of future misconduct by the trustees, and often trustees against whom actions are brought will resign their office." (footnote omitted)).

Note that the federal Volunteer Protection Act of 1997, which generally relieves volunteers of nonprofit or governmental organizations from liability, does not extend to "any civil action brought by any nonprofit organization or any governmental entity against any volunteer of such organization or entity." Volunteer Protection Act of 1997, Pub. L. No. 105-19, 111 Stat. 218 (to be codified at 42 U.S.C. § 14503(b)). It is not clear whether this exception applies to attorney general enforcement action or derivative suits against wrongdoing voluntary directors and trustees. *See* Fremont-Smith, *supra* note 145, at 11 ("However, it is not certain whether this exception will apply to enforcement actions by the attorney general or individuals to whom the courts have granted standing to bring suit.").

236. KURTZ, *supra* note 30, at 156 n.20.

237. *See generally* E. Norman Veasey et al., *Delaware Supports Directors with a Three-Legged Stool of Limited Liability, Indemnification, and Insurance*, 42 BUS. LAW. 399 (1987) (discussing how the July 1986 amendments to the Delaware General Corporation Law expanded protection for directors). In 1986, Delaware added to its Corporation Code new section 102(b)(7), which, as discussed below, is also available to nonprofit corporations. This statute permits the certificate of incorporation to contain:

> (7) A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director: (i) For any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) under § 174 of this title [dealing with distributions]; or (iv) for any transaction from

standard of care, but rather limits the corporation to nonmonetary remedies, such as injunction or removal of the offending director.[238]

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> which the director derived an improper personal benefit. . . . All references in this paragraph to a director shall also be deemed to refer (x) to a member of the governing body of a corporation which is not authorized to issue capital stock.

DEL. CODE ANN. tit. 8, § 102(b)(7) (Supp. 1996).

In a survey conducted shortly after enactment, 75% of responding Delaware business corporations declared an intent to seek stockholder approval for the amendments authorized by section 102(b)(7). R. Franklin Balotti & Mark J. Gentile, *Elimination or Limitation of Director Liability for Delaware Corporations*, 12 DEL. J. CORP. L. 5, 5 n.1 (1987); *see also* Zirn v. VLI Corp., 681 A.2d 1050, 1053 (Del. 1996) ("We . . . hold that the directors are exempt from liability for monetary damages for good-faith disclosure violations by virtue of the company's certificate of incorporation adopting the exemption authorized . . . ."); Arnold v. Society for Sav. Bancorp, Inc., 678 A.2d 533, 541 (Del. 1996) (*Arnold II*) ("*Arnold I* can be read only as a holding that the directors are free from personal financial liability whether monetary damages arise out of legal or equitable theories."); Arnold v. Society for Sav. Bancorp, Inc., 650 A.2d 1270, 1286 (Del. 1994) (*Arnold I*) ("We hold that Section 102(b)(7), as adopted by Bancorp, shields the individual defendants from liability, and that the shield was not waived."), *aff'd*, 678 A.2d 533 (Del. 1996); *In re* Dataproducts Corp. Shareholders Litig., [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,227, at 91,183 (Del. Ch. Aug. 22, 1991) (noting that because of the corporation's certificate of incorporation, "the directors cannot be held liable for monetary damages except for (*inter alia*) acts amounting to a breach of their duty of loyalty, or involving intentional misconduct, a knowing violation of law, or an improper personal benefit").

In 1990, after 35 state legislatures had already acted, the ABA adopted an amendment to the MODEL BUS. CORP. ACT (1984). New section 2.02(b)(4) permits the following:

> [A charter provision] eliminating or limiting the liability of a director to the corporation or its shareholders for money damages for any action taken, or any failure to take any action, as a director, except liability for (A) the amount of a financial benefit received by a director to which he is not entitled; (B) an intentional infliction of harm on the corporation or the shareholders; (C) a violation of section 8.33 [unlawful distributions]; or (D) an intentional violation of criminal law.

Committee I, *supra* note 55, at 700 (emphasis omitted).

The ABA adopted the opt-in charter-amendment approach favored (with various exceptions) by most of the states to the self-executing approach adopted by five states: "So long as any such liability-limitation provision does not extend to liability to third parties," the ABA comments, "shareholders should be permitted—except when important societal values are at stake—to decide how to allocate the economic risk of the directors' conduct between the corporation and the directors." *Id.*; *see also* 2 MODEL BUS. CORP. ACT ANN. § 2.02 cmt. i, at 109 (Director Liability) (3d ed. 1984 & Supp. 1992). One state (Virginia) combines an opt-in with a self-executing rule, capping a director's liability at the *lesser of* (a) the amount specified in the charter or bylaws, or (b) the greater of $100,000 or the cash compensation received by the director in the preceding 12 months; and two states (Indiana and Ohio) statutorily reduced the standard of the duty of care. *Id.* § 8.50 statutory comparison, at *1093-1094.3*; Committee I, *supra* note 55, at 698.

238. *See, e.g.*, ALI PRINCIPLES, *supra* note 59, § 7.19, at 255 ("Nonfinancial penalties, such as injunctions or disqualifications from office, which are not addressed by § 7.19, have only limited applications in the duty of care area, in part because due care suits typically arise well after the event."); Deborah A. DeMott, *Limiting Directors' Liability*, 66 WASH. U. L.Q. 295, 299 (1988) ("Other types of remedies—such as injunctions— . . . are outside the scope of authorized provisions."). Monetary caps avoid the circularity of having the corporation indemnify a director who was found liable for damages, and they reduce the costs of

Limiting the potential cost for duty-of-care breaches to the compensation received might make courts more inclined to uphold standards of care,[239] and can be reconciled with a restitutionary measure of damages.[240]

The legal question remains whether shareholders of corporations in those few states without enabling statutes might nevertheless adopt such charter amendments.[241] The ALI's *Principles of Corporate Governance* suggest that, in the absence of a statute, the ability to limit a director's monetary exposure for breaches of the duty of care to the corporation is a matter of shareholder right.[242] However, the ALI would not sanction a cap of less than one year's compensation of a director (or officer) breaching the duty of care. Moreover, the ALI would not protect behavior involving illicit self-dealing, conscious disregard of duty, or violation of the law, nor would it protect "a sustained and unexcused pattern of inattention that amounted to an abdication of the defendant's duty to the corporation."[243]

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insurance. The unavailability of a monetary recovery, for better or worse, also makes a shareholder derivative suit less desirable to the shareholders' plaintiffs bar (whose contingent fees are generally a percentage of the award). *See* ALI PRINCIPLES, *supra* note 59, § 7.19 & cmt. c (Policy considerations), at 241-42.

239. *See* ALI PRINCIPLES, *supra* note 59, § 7.19, at 255 ("Commentators have also argued that the disproportion between the potentially enormous damages for a due care violation and the often limited culpability of the defendant disposes courts to decline to find liability in cases where the defendant's behavior should not be protected.").

240. *See* AMERICAN LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 7.16 cmt. h, pt. 2, at 206-07 (Discussion Draft No. 1, 1985) (noting that a restitution measure "could justify return of compensation received by an officer or director who breached his duty of care on the theory that he had implicitly promised to use due care but had not so performed and thus was required to make restitution of his allocable salary and related benefits over the relevant period"). This draft admits that such a theory would not be accepted by a court faced with a case of medical malpractice!

241. The ALI Reporter's comment acknowledges the absence of American case law, but analogizes the shareholders' waiver to the ability of "a trustee to relieve itself by contract from liability for negligence, but not for liability from breaches that were in bad faith, intentional, or recklessly indifferent to the interests of a beneficiary." ALI PRINCIPLES, *supra* note 59, § 7.19 cmt. a (Comparison with Existing Law), at 240.

242. *See id.* § 7.19 (Limitation on Damages for Certain Violations of the Duty of Care). Commentary to drafts of this section reveal a split in opinion among the reporters for various portions of the project. *See, e.g.*, AMERICAN LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 7.17 reporter's notes 2 & 3, at 268-71 (Tentative Draft No. 8, 1988) (contrasting opinions of the Chief Reporter and the Reporter for Part IV, with those of the Reporter for Part VII). The final language deletes an earlier clause that also would have permitted a charter provision that entirely "precludes damages against a director acting in such capacity for such a failure." *See* AMERICAN LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 7.17, at 116 (Tentative Draft No. 9, 1989).

243. ALI PRINCIPLES, *supra* note 59, § 7.19(3), at 238. The ALI gives the following example of the abdication provision, suggesting that abdication will rarely be found:

Does a contractarian view of corporations also permit shareholders to waive a director's monetary liability for breaches of the duty of *loyalty*?[244] The policy judgment underlying the ALI's monetary cap provision "is that, with respect to the goal of assuring the quality of business decisionmaking," less reliance should be placed on litigation and greater reliance should be placed on "alternative mechanisms, such as an independent board, the market for corporate control, peer pressure, and public disclosure."[245] Accordingly, the ALI Reporter argues against a suggestion that shareholders could waive the duty of loyalty, observing that "market and social forces seem more likely to be able to deal with the official who is merely lazy than with one who is dishonest or self-interested."[246]

The contractarian view of corporate charter amendments is hard to apply to the "principal-less" model of a memberless nonprofit corporation (unless we view prospective donors as basing their decision to contribute on the existence of such an amendment to the articles). However, society might wish to enact such a monetary cap for nonprofit directors under the theory that better management will result. Because of the absence of shareholders, though, it seems unnecessary to require nonprofit corporations without members to adopt such a charter amendment. Nevertheless, alternative paragraph (d) to section 8.30 of the *Revised Model Nonprofit Corporation Act* tracks Delaware's opt-in approach, and so whether the shield applies depends, first, on the state's enabling legislation, and second, on each charity's

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> Director Jones has been recurrently ill for over a year and during this period has missed all meetings of the board of directors of Industrial Co. Industrial Co. experienced a severe business crisis during this period, and the board took an action that violated § 4.01 [duty of care] in an area in which it usually relied on Jones's expertise. Jones would have successfully opposed the action if present. If Jones incurs liability on these facts (for example, on the theory that a director in such circumstances should have resigned), a certificate provision limiting liability in compliance with § 7.19 should be effective. Although a sustained and unexcused absence might otherwise have amounted to an "abdication," Jones's nonattendance under these circumstances would not amount to an abdication.

*Id.* § 7.19 cmt. f, illus. 7, at 250.

244. *See, e.g.*, *id.* § 7.19 cmt. d, at 243 ("Here, case law provides a clear answer that a charter amendment will not be given effect by a court when it infringes on [the] duty [of loyalty]."). Comment d to section 7.19 states further:

> If corporate managers were to ask shareholders to approve a charter provision that limits or exculpates them from liability for duty of loyalty violations, a fundamental problem of asymmetric information would arise because investors would face substantial uncertainty and could not accurately price the cost to them of this discretionary power.

*Id.* § 7.19 cmt. d, at 244.

245. *Id.* § 7.19 cmt. c, at 242 (Policy Considerations).

246. *Id.* § 7.19 reporter's note 5, at 258.

articles of incorporation.[247] A few state statutes permit charter amendments by their nonprofit corporations,[248] although Arkansas's

247. REVISED MODEL NONPROFIT CORP. ACT § 8.30(d) (1987) (alternative provision). Alternative section 2.02(b)(5) to the *Revised Model Nonprofit Corporation Act* would permit the articles to include the following:

> (5) provisions eliminating or limiting the personal liability of a director to the corporation or members of the corporation for monetary damages for breach of any such director's duties to the corporation and its members, provided that such a provision may not eliminate or limit the liability of a director:
>
> (i) for any breach of the director's duty of loyalty to the corporation or its members;
>
> (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law;
>
> (iii) for any transaction from which a director derived an improper personal economic benefit; or
>
> (iv) under sections 8.31-8.33 [dealing with distributions].
>
> No such provisions shall eliminate or limit the liability of a director for any act or omission occurring prior to the date when such provision becomes effective.

*Id.* § 2.02(b)(5) (alternative provision). Correspondingly, alternative section 8.30(d) adds a second sentence, to read in its entirety as follows:

> (d) A director is not liable to the corporation, any member, or other person for any action taken or not taken as a director, if the director acted in compliance with this section. The liability of a director for monetary damages to the corporation and its members may be eliminated or limited in the corporation's articles to the extent provided in section 2.02(b)(5).

*Id.* § 8.30(d) (alternative provision). The commentary states: "This alternative section is derived from section 102(b)7 [sic] of the Delaware General Corporation law. It does not change the duty of care. Rather subdivision (d) allows a corporation to limit directors' liability for monetary damages for breaching their duty of care." *Id.* § 8.30(d) cmt. (alternative provision).

248. *See* ALASKA STAT. § 10.20.151(d) (Michie 1996) (providing for amendments changing the number of directors and eliminating or limiting the personal liability of the directors); ARIZ. REV. STAT. ANN. § 10-2342.A.8 (West 1996) (providing that articles of incorporation shall state a provision eliminating or limiting personal liability of director excepting certain circumstances); COLO. REV. STAT. § 7-22-101(r) (West 1996) (same); DEL. CODE ANN., tit. 8, § 102(b)(7) (Supp. 1996) (allowing for provisions to limit personal liability of directors of both stock and nonstock corporations); KAN. STAT. ANN. § 17-6002(b)(8) (1996) (allowing limitations on personal liability in both stock and nonstock corporations); MASS. GEN. LAWS ANN. ch. 180, § 3 (West 1987 & Supp. 1997) (providing that articles of incorporation may include provisions eliminating or limiting personal liability of director); MICH. COMP. LAWS § 450.2209 (West 1994 & Supp. 1997) (applying to a "volunteer director" and excepting an "act or omission that is grossly negligent," severely diminishing the value of the monetary waiver); N.H. REV. STAT. ANN. § 420-A:4-a (Supp. 1997) (creating provisions for directors of nonprofit health service corporations); TENN. CODE ANN. § 48-52-102(b)(3) (1995) (setting forth requirements for stating provisions that regulate the powers and rights of a corporation). The California Nonprofit Corporation Law protects *uncompensated* directors of *charities* from personal liability for the following:

> any negligent act or omission occurring (1) within the scope of that person's duties as a director acting as a board member . . . ; (2) in good faith; (3) in a manner that the person believes to be in the best interest of the corporation; and (4) is in the exercise of his or her policymaking judgment.

revision of its nonprofit law rejected the proposal.[249] We have yet to see any state impose a mandatory minimum monetary floor (as Virginia does for business corporations, in the absence of a charter amendment[250]). In all cases, moreover, directors remain at risk for breaches of their duty of loyalty. In addition, nonmonetary remedies, such as removal, remain.[251]

*4. Adelphi University.*—The New York State Board of Regents Report in the Adelphi University case never reached the business judgment rule: "For the rule to pertain, trustees [of an educational corporation] must affirmatively exercise discretion and make a deliberate judgment."[252] Thus, "the rule does not shield from scrutiny irrational decisions that are based on inadequate information or

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CAL. CORP. CODE § 5047.5 (West 1990). This statute does not apply, among other situations, to self-dealing, gross negligence, or in any action brought by the attorney general. Moreover, the statute applies only if the charity maintains general liability insurance. *Id.*

249. *See* James Edward Harris, *The Nonprofit Corporation Act of 1993: Considering the Election to Apply the New Law to Old Corporations*, 16 U. ARK. LITTLE ROCK L.J. 1, 19 (1994) (discussing the rejection of a liability shield for directors under the new Arkansas nonprofit corporation act). While the Arkansas legislature enacted the monetary shield in its business corporation act, the bar committee developing the nonprofit statute "believed that it would be bad policy to permit the exculpation of directors from fulfilling the basic corporate duty of care. For that reason, the Committee decided not to include an exculpation clause in the legislative proposal." *Id.*

250. *See* VA. CODE ANN. § 13.1-692.1 (Michie 1993) (Limitation on liability of officers and directors; exception).

251. *See* Craig W. Hammond, Note, *Limiting Directors' Duty of Care Liability: An Analysis of Delaware's Charter Amendment Approach*, 20 U. MICH. J.L. REFORM 543, 561-62 (1987) ("Those states that wish to follow the charter amendment approach but do not want to remove all potential sanctions on directors might couple the sunset provision proposal with nonmonetary sanctions."). Regulators and courts could put some teeth into removal by also barring the breaching director from serving as a director, officer, or consultant for *any* nonprofit organization for some period of time. One commentator observes:

> The advantages of the "suspension" provision . . . are that it is not so easy to get around (notice the "or consultant" proviso); it is not so severe that, like potential multi-million-dollar personal liability, it would strike courts as unthinkable to impose; but at the same time it would still have some effective "bite" to it—the suspendees would be removed from the most prestigious and cushy positions ordinarily available to men of their rank, and would, I suspect, be objects of some shame among their peers.

*Id.* at 562 n.73 (proposing temporary suspension from serving as an officer in any corporation for directors found liable for breaching their duty of care (citing CHRISTOPHER D. STONE, WHERE THE LAW ENDS: THE SOCIAL CONTROL OF CORPORATE BEHAVIOR 148, 149 (1975) (proposing three-year suspension of directors found to have committed gross negligence from stock corporations doing business in interstate commerce))).

252. Panel, *supra* note 4, at 16. The Report elaborates: "Although the trustees have not cited any case law in which a New York court has specifically applied the business judgment rule to trustees of education corporations, presumptively the rule would apply to an educational corporation just as to any other not-for-profit corporation." *Id.*

consideration."[253] The Report found that the board failed to make an informed decision about the university president's compensation: "This is evidenced by the board's failure to review or approve the terms of Diamandopoulos' compensation, gather comparable salary data, engage in any meaningful evaluation of Diamandopoulos' performance or educate itself about the specific terms of Diamandopoulos' package."[254] The Regents declared: "When directors act blindly, recklessly and heedlessly, as these trustees have in setting Diamandopoulos' compensation, they cannot escape responsibility for their conduct."[255] The Report concluded: "The totality of the record before us demonstrates that, in setting Diamandopoulos' compensation, the trustees failed to exercise the degree of care and skill that ordinarily prudent persons would have exercised in like circumstances. They must therefore be removed from office."[256]

One can't help but get a sense from reading the Regents' report of how restricted the regulator's role is. In concluding that Diamandopoulos's compensation was excessive, the Report reviews his achievements (or lack thereof) in detail. We find such statements as the following: "[T]he first academic plan was not in place until 1990—five years into Diamandopoulos' tenure";[257] "Despite this plan, enrollment started to fall";[258] "While we do not take issue with the board's decision to create an Honors College, we note that it did not prove a panacea for Adelphi's ailments";[259] "During this time, Diamandopoulos often expressed concern about the enrollment decline, but seemed helpless against it";[260] "[To the faculty he] admitted a 'downward slide' in admissions standards for several years [and] stated that 5,535 FTE's [full-time equivalent students] for 1995 'represents a number below which we cannot fall without as yet unimagined' consequences, [while the 1995 numbers] fell to 4,603";[261] "While Diamandopoulos and the trustees often lamented this situation, they never implemented any strategy to address it, [and] [y]ear after year, annual fundraising targets were missed";[262] "In fact, during Dia-

253. *Id.* at 33.

254. *Id.* at 17.

255. *Id.* at 33. Given this finding, it would not have mattered whether the Adelphi trustees were held to an ordinary negligence standard or a gross negligence standard.

256. *Id.* at 16-17.

257. *Id.* at 27.

258. *Id.* at 28.

259. *Id.* at 29.

260. *Id.*

261. *Id.*

262. *Id.* at 30.

mandopoulos' presidency, Adelphi's Barron's ratings have sunk from 'very competitive' in 1986 to 'competitive' in 1991 to 'less competitive' in 1994";[263] and "After eight years in office . . . [he] had presided over a complete breakdown in relations between faculty and administration."[264] In 1993-1994, of presidents of doctoral institutions, his pay was second only to that of Boston University's John Silber (who also sat on Adelphi's board).[265]

What might the Attorney General of New York add to the Regents' sanction of removal?[266] New York not-for-profit law does not authorize charter amendments limiting a director's liability for monetary damages. Upon the request of the Regents, the Attorney General filed suit against the former trustees[267] for, among other forms of relief, an accounting of "all University assets lost or wasted for the benefit of the President" and assets "misdirected" to the self-dealing trustees, as well as "directing defendant trustees be surcharged for any loss or waste of University assets which are a result of their misconduct, with appropriate interest."[268] As a separate matter, the Internal

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263. *Id.* at 31-32.

264. *Id.* at 32.

265. *Id.*; *cf.* JOHN S. GLASER, THE UNITED WAY SCANDAL: AN INSIDER'S ACCOUNT OF WHAT WENT WRONG AND WHY 114 (1994) (noting that William Aramony, the disgraced former United Way president whose generous compensation shocked the public, once advised, "'A cardinal rule . . . is that you never put anyone on your Board who makes less than you do.'").

266. *See* N.Y. EDUC. LAW § 216-a(4)(d)(9) (McKinney 1988) (providing that the Regents may request the Attorney General to bring suit against the trustees of a New York university).

267. Plaintiff's Complaint at 9, Vacco v. Diamandopoulos, No. 97401253 (N.Y. Sup. Ct. Mar. 24, 1997) (noting the Attorney General's authority to commence action against a corporation at the request of the Regents).

268. *Id.* at 43-44. At a news conference, New York Attorney General Dennis Vacco quantified the amount sought in restitution for the University at $6 million. Jack Sirica, *Adelphi Fallout: Vacco Sues Ex-Board Trustees for Misappropriation*, NEWSDAY, Mar. 25, 1997, at A5, *available in* LEXIS, News Library, Majpap File. In early June 1997, the defendants moved to dismiss some of the causes of action, and to force Adelphi to advance funds for legal fees. Jack Sirica, *Adelphi in Fight Over Law Fees*, NEWSDAY, June 7, 1997, at A8, *available in* LEXIS, News Library, Majpap File. According to a news story, "both the attorney general and the university's current board members remain sharply opposed to the former trustees' argument that, if anything, the Regents [sic] decision that resulted in their ouster found them guilty only of 'negligence.'" *Id.*; *accord* Jack Sirica, *Ousted Trustees Renew Fight: Petitioner Challenges Regents on Adelphi*, NEWSDAY, June 6, 1997, at A28, *available in* LEXIS, News Library, Majpap File (reporting on a petition filed by former trustees to overturn the Regents' findings that resulted in their removal, and stating that "the outcome of the petition would appear to have the greatest bearing on several lawsuits the former trustees are now fighting"). It appears that even if the university's directors' and officers' liability policy covers deliberate misconduct (which would be unusual), the trustees' legal fees might already have reached the policy's $3.1 million limit. Accordingly, the trustees would need to justify entitlement to indemnification from the university. *See* Emily Bass, *Legal Fight Does*

Revenue Service might be able to seek to impose "excess benefit" sanctions on both Diamandopoulos and the directors who approved his excess compensation.[269]

5. *Summary.*—To summarize this subpart, we examined the aspect of a fiduciary's duty of care that relates to the business judgment rule. We saw that this rule—which is more of a safe harbor—cannot be invoked unless the director actually exercised judgment. Accordingly, it fails to assist directors who do not make themselves aware of the issue involved. Even without the operation of the business judgment rule, however, the reluctance of attorneys general and courts to sanction directors personally often leads to a finding of lack of liability. Rather than degrade the standard of care, a (low) maximum monetary sanction should be imposed on nonprofit directors; injunctive remedies, such as removal, would remain. More certain and less severe potential penalties would make board service more attractive, while alerting fiduciaries that charities are entitled to a real level of care.

### B. *Timken Mercy Medical Center: Fundamental Change in Purpose*

1. *General Principles of Director Authority.*—In the early years of corporate governance, a corporation could engage only in those activities specified in its charter or otherwise permitted by statute.[270] In the modern era, corporations have broad powers, and so the doctrine of ultra vires has atrophied.[271] Similarly, because a proprietary corporation's primary purpose is to make a profit, the courts will not review the directors' decisions to make even drastic changes in business activ-

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*Adelphi an Injustice*, NEWSDAY, May 9, 1997, at A41, *available in* LEXIS, News Library, Majpap File.

269. *See supra* note 6. An organization manager who knowingly and willfully participated in an excess-benefit transaction (but did not personally benefit) faces a maximum exposure of $10,000 for each such transaction. *See* I.R.C. § 4958(d)(2) (West 1997).

270. *See* 7A WILLIAM MEADE FLETCHER & STEPHEN M. FLANAGAN, FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 3399, at 6 (perm. ed. rev. vol. 1997) (describing the doctrine of ultra vires as an act beyond the powers of a corporation as fixed by its charter).

271. *Id.* § 3405, at 17; *see, e.g.*, MODEL BUS. CORP. ACT § 3.04(b) (1984) (providing that only a shareholder, the corporation acting against an incumbent or former director, officer, employee or agent, or the attorney general may challenge the validity of corporate action on the ground that the corporation lacked the power to act). One scholar notes:

> Indeed, it is difficult to formulate a justification for retention of the *ultra vires* concept in a business context where, after all, there is only a single objective into which a multitude of activities may be translated, *i.e.*, corporate profit and shareholder gain. At the same time, it is impossible to assimilate the multifarious activities pursued by charities to a single objective.

KURTZ, *supra* note 30, at 149 n.107 (citation omitted).

ities—in theory, if the shareholders disapprove, they can always remove and replace the board.[272]

As a basic principle of corporate governance, directors have the authority to amend the articles of incorporation and bylaws.[273] However, in the case of fundamental changes such as merger or dissolution, corporation law usually requires shareholder approval. Specifically, the common law required shareholder approval for a sale of substantially all of the corporation's assets, and corporate statutes continue this rule.[274] In addition, the board of directors owes the shareholders a duty to consider bona fide offers for corporate assets.[275]

Nonprofit law often substitutes the approval of members for the approval of shareholders.[276] This leaves the obvious question whether any check applies to such a fundamental decision by the board of a

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272. *See, e.g.*, ALI PRINCIPLES, *supra* note 59, § 3.02, at 86-87 ("Except as otherwise provided by statute . . . a board of directors also has the power to: . . . [i]nitiate and adopt corporate plans, . . . [m]anage the business of the corporation[,] . . . [and] [a]ct as to all other corporate matters not requiring shareholder approval.").

273. *See, e.g.*, MODEL BUS. CORP. ACT § 10.02 (1984) ("Unless the articles of incorporation provide otherwise, a corporation's board of directors may adopt one or more amendments to the corporation's articles of incorporation without shareholder action . . . ."). Delaware, however, requires shareholder approval of a certificate of incorporation amendment, and grants the shareholders exclusive power to amend the bylaws unless, generally, that power is reserved to the board in the charter. *See* DEL. CODE ANN. tit. 8, § 109 (1991).

274. See MODEL BUS. CORP. ACT § 12.02(a) (1984):

> A corporation may sell, lease, exchange, or otherwise dispose of all, or substantially all, of its property . . . , otherwise than in the usual and regular course of business, on the terms and conditions and for the consideration determined by the corporation's board of directors, if the board of directors proposes and its shareholders approve the proposed transaction.

275. But even here the board has a great amount of discretion. *Cf.* ALI PRINCIPLES, *supra* note 59, § 6.01, at 389 ("The board of directors in the exercise of its business judgment, may approve, reject, or decline to consider a proposal to the corporation to engage in a transaction in control," but approval by the shareholders is required if the corporation is a party (citation omitted)). Moreover, section 6.02 provides: "The board of directors may take an action that has the forseeable effect of blocking an unsolicited tender offer, if the action is a reasonable response to the offer." *Id.* § 6.02(a), at 405 (citation omitted). This section permits the board to consider "whether the offer, if successful, would threaten the corporation's essential economic prospects." *Id.* § 6.02(b)(1), at 405. In addition, the board may "have regard for interests or groups (other than shareholders) with respect to which the corporation has a legitimate concern if to do so would not significantly disfavor the long-term interests of shareholders." *Id.* § 6.02(b)(2), at 405. If a shareholder can prove that the board's action was an unreasonable response to the offer, the action "may be enjoined or set aside, but directors who authorize such an action are not subject to liability for damages if their conduct meets the standard of the business judgment rule." *Id.* § 6.02(d), at 405.

276. Such a pattern emerges clearly in the law of Delaware, which has no separate nonprofit corporation statute. See DEL. CODE ANN. tit. 8, § 271(a) (1991), which provides, in pertinent part:

charity that lacks members. State statutes commonly permit attorneys general to become involved in extraordinary events in the life of a charity, such as when it wishes to merge, sell substantially all of its assets, or dissolve, as well as to appeal to a court to alter the restricted use of assets under the cy pres doctrine.[277] As discussed below, a trend has begun to develop in which states adopt specific legislation tailored to the sale of nonprofit hospital assets (particularly to for-profit entities).[278]

Drafters of the ABA's revision of the *Model Nonprofit Corporation Act* worried about whether a corporate charity can alter its purposes without applying to court for cy pres relief:[279] "'Those who give to a

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> Every corporation may at any meeting of its board of directors or governing body sell, lease or exchange all or substantially all of its property and assets, . . . upon such terms and conditions and for such consideration, . . . as its board of directors or governing body deems expedient and for the best interests of the corporation, when and as authorized by a resolution adopted by the holders of a majority of the outstanding stock of the corporation entitled to vote thereon or, if the corporation is a nonstock corporation, by a majority of the members having the right to vote for the election of the members of the governing body, at a meeting duly called upon at least 20 days' notice.

277. Different states have different models. *See* Daniel W. Coyne & Kathleen Russell Kas, *The Not-for-Profit Hospital as a Charitable Trust: To Whom Does Its Value Belong?*, 24 J. HEALTH & HOSP. L. 48, 52 (1991) (describing Illinois's "trust the trustees to do their duty" method without any immediate review or supervision, the New York "judicial approval" method, which requires court approval prior to the effectiveness of trustee action, and the ABA *Revised Model Nonprofit Corporation Act*'s intermediate course of requiring notice to the attorney general but not prior approval). For news coverage, see, for example, Lisa W. Foderaro, *Harvard Will Sell a Forest, a Legacy from an Alumnus*, N.Y. TIMES, Aug. 25, 1989, at B1, *available in* LEXIS, News Library, Nyt File (reporting the approval of trustee action by a court after review by the attorney general); Vivien Kellerman, *Antiquities Group Delays Land Sale*, N.Y. TIMES, Feb. 18, 1990, § 12, at 4, *available in* LEXIS, News Library, Nyt File (explaining that one needs attorney general and court approval to sell bequeathed property); Andrew H. Malcolm, *2 Right-to-Die Groups Merging for Unified Voice*, N.Y. TIMES, Apr. 12, 1990, at B4, *available in* LEXIS, News Library, Nyt File (describing how the proposed merger of the two largest right-to-die nonprofit groups would need the approval of the New York State Attorney General); Douglas C. McGill, *Historical Society Is Planning Cuts to Meet Crisis*, N.Y. TIMES, June 28, 1988, at C15 (describing the New-York Historical Society's discussions with the attorney general about receiving court permission to sell 40 paintings).

278. *See infra* Part III.B.3.

279. For a particular gift, "the corporation, as distinguished from its directors, may hold or be deemed to hold property in trust or subject to restrictions." REVISED MODEL NONPROFIT CORP. ACT § 8.30 cmt. 1 (1987). However, applying a literal trust approach to an outright gift to the nonprofit corporation would then make the corporation both the trustee and the beneficiary. Some courts circumvented this long-standing conundrum by treating the charitable class served by the corporation as the beneficiaries of the trust. *Duties of Trustees*, *supra* note 76, at 547. A trust approach makes monetary judgments for breach meaningless—the corporation would have to sue itself on behalf of its indefinite beneficiaries, and hence recover from itself. *Id.* However, equitable remedies would still be available. *Id.* Moreover, where the nonprofit organization itself serves as trustee of

home for abandoned animals do not anticipate a future board amending the charity's purpose to become research vivisectionists.'"[280] Some states apply "quasi-*cy pres* principles" to a charitable corporation's amendment of its purposes; such a court proceeding accords deference to the board's determination instead of permitting the judge to substitute her own judgment.[281] The new-purposes problem could obviously be avoided by including in the initial articles of incorporation a statement that the charity is formed "for any charitable purpose."[282] Indeed, the ABA cautions against an overly restrictive purposes clause in the articles of incorporation: "By irrevocably dedicating assets when such dedication is not required, the incorporators may inadvertently impress the assets of a corporation with unintended restrictions and obligations."[283] On the other hand, of course, charities fear that prospective donors might not be so willing to donate on such an open-ended basis.

2. *The Effect of Donor Restrictions on Efficient Use of Charitable Assets.*—Not only do donors have market power, but the law also looks

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restricted donated property, the charity must make a cy pres application to the court to modify the use. *Id.* at 548. Presumably, directors who alter the use of restricted property without following the proper procedures have committed a breach of fiduciary duty, albeit one measured under the corporate standard.

280. Lizabeth A. Moody, *The Who, What, and How of the Revised Model Nonprofit Corporation Act*, 16 N. KY. L. REV. 251, 264 & n.69 (1988) (quoting Letter from Kevin A. Suffern to Project Reporter Michael C. Hone (Oct. 2, 1986)). Suffern, as Assistant Attorney General of Massachusetts, also used this colorful language in litigation. *See* Attorney Gen. v. Hahnemann Hosp., 494 N.E.2d 1011, 1021 n.18 (Mass. 1986).

281. *See In re* Multiple Sclerosis Serv. Org. of N.Y., Inc., 496 N.E.2d 861, 861-62 (N.Y. 1986) (describing "[t]he standard governing distribution of the assets of a charitable corporation being dissolved under the Not-For-Profit Corporation Law . . . [as] less restrictive and accord[ing] greater authority to the corporation's board of directors . . . than was the *cy pres* standard at common law"); Alco Gravure, Inc. v. Knapp Found., 479 N.E.2d 752, 753 (N.Y. 1985) (holding that "quasi-*cy pres* principles" apply to a purposes clause amendment in articles of incorporation); *cf.* Queen of Angels Hosp. v. Younger, 136 Cal. Rptr. 36, 40-41 (Ct. App. 1977) (applying a strict cy pres standard by requiring sale proceeds to be used to carry out a charity's original purpose, which was the operation of a hospital); Town of Brookline v. Barnes, 97 N.E.2d 651, 655 (Mass. 1951) (noting that "the application of funds *cy pres* is a judicial function" and that the court may choose among many methods in arriving at an appropriate scheme).

282. *See* REVISED MODEL NONPROFIT CORP. ACT § 2.02(b)(1) ("The articles of incorporation may set forth . . . the purpose or purposes for which the corporation is organized, which may be, either alone or in combination with other purposes, the transaction of any lawful activity . . . .").

283. *Id.* § 2.02 cmt. 3(a); *cf.* Op. Miss. Att'y Gen., 1995 Miss. AG LEXIS 843, at *3 (Dec. 6, 1995) (explaining that where articles of incorporation broadly define a charity's tax-exempt purpose, it may sell its assets to a for-profit health care corporation and "redirect its focus to provide funding for research grants, patient education, support for organ donation and transplants and other charitable activities").

primarily to their wishes in determining what a charity may do.[284] However, it makes less sense to overprivilege donors in light of the actual functioning of the typical modern charity.[285] Few nonprofits actually rely on donations for the bulk of their support: In 1992, for the nonprofit sector as a whole, less than twenty percent of gross receipts came from donations.[286] In many cases, then, no donor or group of donors effectively influences nonprofit policy.[287] At the other extreme, in nonprofits where donations dominate, privileging donors with accountability rights loops back into another market failure, the "separation of supply from demand"—if by "demand" we mean the beneficiary's demand rather than the donor's.[288] A nonprofit organization dependent on a concentrated or organized donor base might be forced to make poor choices, behaving more paternalistically and conservatively. Because donors often do not consume the services they donate, donor control can lead to inefficient overproduction of what particular donors want to support and underproduction of services unpopular in donors' eyes.[289]

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284. *See* Evelyn Brody, *Charitable Endowments and the Democratization of Dynasty*, 39 ARIZ. L. REV. 873, 877 (1997) [hereinafter Brody, *Charitable Endowments*] (discussing the deference the law pays to donors).

285. *See generally* Brody, *Agents Without Principals*, *supra* note 33, at 519-22 (describing the hazards of deferring to donors).

286. In 1992, private contributions from individuals, foundations, and corporations came to $111 billion, accounting for 18% of total receipts of the nonprofit sector, down from 26% in 1982. *See* VIRGINIA ANN HODGKINSON ET AL., NONPROFIT ALMANAC 1996-1997: DIMENSIONS OF THE INDEPENDENT SECTOR 5, 86 tbl. 2.1 (1996) ("Private contributions grew at a rate higher than that of government only between the years of 1982 and 1987 . . . ."). These researchers additionally estimated that the value of volunteer services in 1994 was $116 billion, which represented a gradual decline in hours volunteered after 1992. *Id.* at 28. Averages mask enormous variations by subsector. However, "[t]he education/research subsector was the only subsector in which private contributions increased as a proportion of total funds, from 9 percent in 1977 to 13 percent in 1992." *Id.* at 11. Internal Revenue Service data for 1992 indicate that for tax-exempt hospitals, only 2.3% of total revenues came from contributions, gifts, and grants. *See* Cecelia Hilgert, *Charities and Other Tax-Exempt Organizations, 1992*, 16 STAT. INCOME BULL. 112, 113 fig.B (1996) (reporting that contributions, gifts, and grants amounted to only $5.6 billion out of a total revenue for hospitals of $242.8 billion). The percentage of contributions, gifts, and grants for "[h]ospital research organization[s]" was 25%, or $760 million out of $3.09 billion. *Id.*

287. *See* Brody, *Institutional Dissonance*, *supra* note 25, at 467 ("A nonprofit must accommodate the institutional expectations of its industry, its donors, its volunteers, its members, its beneficiaries, its clientele, its corporate sponsors, its government granting agencies and the taxpaying public.").

288. *See* LESTER M. SALAMON, PARTNERS IN PUBLIC SERVICE: GOVERNMENT-NONPROFIT RELATIONS IN THE MODERN WELFARE STATE 47-48 (1995) (discussing the problem of philanthropic paternalism and noting that it places the power to make a determination of community needs in the hands of the individuals with the greatest resources).

289. *See id.*

Moreover, until fairly recently, the law did not accommodate a donor who later regretted or was willing to alter restrictions made at the time of the gift.[290] Now, the *Uniform Management of Institutional Funds Act* (discussed in Part III.C, below) provides a mechanism for releasing donor restrictions.[291] With the donor's written consent, the charity's "governing board may release, in whole or in part, a restriction imposed by the applicable gift instrument on the use or investment of an institutional fund."[292] If, however, written consent cannot be obtained because of the donor's "death, disability, unavailability, or impossibility of identification, [then] the governing board may apply . . . to the [appropriate] court for release of a restriction."[293] By negative implication, the charity apparently may not apply for a judicial reformation over a living donor's objections. Furthermore, the charity and the donor may not collude to injure the public interest, and the charity must notify the attorney general, who may intervene. The court may release any restriction, in whole or in part, that it finds to be "obsolete, inappropriate, or impracticable,"[294] a much more flexible test than the cy pres requirement of impossibility.

To illustrate the difference in these standards, consider the most celebrated cy pres case in American philanthropy, the Buck Trust.[295] In 1975, Beryl Buck bequeathed $10 million worth of stock in an oil company to a trust for the benefit of Marin County, California, one of the richest counties in the country.[296] Ten years later, when the stock had ballooned in value to $400 million, the trustee possessing distribution powers sought court approval to spend some of the income to benefit the greater San Francisco Bay area.[297] The attorney general

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290. *See, e.g.*, UNIF. MANAGEMENT OF INST. FUNDS ACT prefatory note, para. 1 (1972), 7A U.L.A. 706 (1985) [hereinafter UMIFA] (explaining the desire among nonprofit institutions for "more effective use of endowment and other investment funds").

291. *See id.* The Act defines an "institution" as an incorporated or unincorporated organization formed and operated exclusively for educational, religious, charitable, or other eleemosynary purposes. *Id.* § 1(1), 7A U.L.A. 712.

292. *Id.* § 7(a), 7A U.L.A. 723. If a donor refuses to consent to change a restriction and the charity alters the use anyway, does the donor have standing under UMIFA to sue? A Connecticut appeals court ruled yes, but the Connecticut Supreme Court reversed. *See* Carl J. Herzog Found., Inc. v. University of Bridgeport, 677 A.2d 1378, 1385 (Conn. App. Ct. 1996), *rev'd*, 699 A.2d 995 (Conn. 1997).

293. UMIFA § 7(b), 7A U.L.A. 723 (1985) (second alteration in original).

294. *Id.*

295. *See* Ronald Hayes Malone et al., *The Buck Trust Trial: A Litigator's Perspective*, 21 U.S.F. L. REV. 585, 586 (1987) (describing the Buck Trust case as "the largest cy pres case in history").

296. *See* Brody, *Charitable Endowments*, *supra* note 284, at 880 (describing the history of the Buck Trust litigation).

297. *Id.*

opposed on the ground that the original restriction was not impossible to carry out.[298] The court agreed, and denied cy pres relief; the trustee was replaced.[299]

A second, less obvious question relating to a change in fundamental purpose applies to all charities, membership or nonmembership. As will be discussed in Part III.C below, a fiduciary has an obligation to make the charity's investments "productive." Does this obligation extend to its operating assets as well? Henry Manne suggests, in the business context, that only the "market for corporate control" induces managerial efficiency.[300] Under this theory, we would expect to find conservatism, in the sense of lack-of-change (if not complacency), to the extent that the nonprofit form shields charity managers from the threat of takeover.[301] Recently, for example, Henry Hansmann lamented how capital gets locked into the nonprofit hospital industry beyond its efficient use.[302] He proposed requiring nonprofit hospitals to respond to every serious bid to buy their assets, giving bidders standing to sue to enforce that duty.[303]

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298. *Id.* at 880-81.

299. *Id.* at 881; *see also* Simon, *supra* note 107 at 643 (arguing that the cy pres doctrine—which attempts to "avoid a frustration of donor intention arising out of changed circumstances" and to "avoid charitable waste"—could have accommodated the desired changes). The plaintiff opposed using any Trust funds for the petitioner trustee's attorneys fees, and sought to surcharge the petitioner for them. *See* Malone et al., *supra* note 295, at 634. There can be no doubt that the petitioner's resignation was conditioned on eliminating this possibility. *Id.* UMIFA cryptically states: "This section does not limit the application of the doctrine of *cy pres*." UMIFA § 7(d), 7A U.L.A. 723 (1985). The interaction between these two standards is unclear.

300. To Professor Manne, "[o]nly the take-over scheme provides some assurance of competitive efficiency among corporate managers and thereby affords strong protection to the interests of vast numbers of small, non-controlling shareholders." Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 113 (1965).

301. A consultant to nonprofit hospitals recently wrote:

> Most industry participants could cite several examples of institutions that have been ill served in the long run by a board's determination to resist market pressures. When the reluctant board finally seeks a partner, the hospital's financial value, strategic options, and negotiating clout have often diminished. . . . Despite this, I am unaware of a challenge to any community hospital board's fiduciary role because of delayed action.

Steven R. Hollis, *Strategic and Economic Factors in the Hospital Conversion Process*, HEALTH AFF., Mar.-Apr. 1997, at 131, 133.

302. Henry Hansmann, *The Changing Roles of Public, Private, and Nonprofit Enterprise in Education, Health Care, and Other Human Services*, *in* INDIVIDUAL AND SOCIAL RESPONSIBILITY 245, 255-56 (Victor R. Fuchs, ed. 1996).

303. *Id.* at 256. One senior administrator of the Good Samaritan Health System at the time of its sale to Columbia/HCA described how the nonprofit form held back the hospital:

> There also was a "shadow motivation," unspoken but always present: The board and the administration were increasingly convinced that Good Samaritan's ex-

3. *Nonprofit Hospital Conversions and Alteration of Purposes.*—Far from embracing such an approach, the legal structure in which donor wishes are privileged severely constricts the recently proliferating, and highly emotional, transactions in which nonprofit hospitals seek to convert to for-profit form. The board of a nonprofit hospital faces two independent questions in deciding whether to convert: what the Massachusetts Deputy Attorney General calls the "front-end cy pres issue" and the "back-end cy pres issue."[304]

The first question is whether the board, without attorney general or court approval, has the authority to decide to sell the assets (as well as to decide the terms of the deal and the identity of the buyer, fiduciary obligations being higher if the sale is to insiders). Second, if the sale takes place, who decides what to do with the resulting sale proceeds? Even though donations account for only a small portion of the resources of a modern nonprofit corporate hospital, should cy pres-type judicial approval nevertheless be required if the nonprofit board wants to devote the sale proceeds to non-hospital health care purposes—or, indeed, to any charitable purpose?[305] While several state regulators have filed suit to prevent such transactions,[306] the dis-

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> isting local, nonprofit structure would continue to make it difficult for them to undertake bold actions necessary for future survival. In the past year, for example, they had been unable to reach agreement on several key proposals, including the consolidation of cardiac surgery services, in large part because of the broad constituencies involved and the slow public decision-making process.

Molly Joel Coye, *The Sale of Good Samaritan: A View from the Trenches*, HEALTH AFF., Mar.-Apr. 1997, at 102, 103.

304. Richard Allen, Massachusetts Deputy Attorney General, Comments at a Conference on "Nonprofit Conversions," Program on Philanthropy and the Law, New York University School of Law (Oct. 18, 1996) (author's notes). *See generally* Coyne & Kas, *supra* note 277, at 50-51 (recounting state court cases that illustrate the hurdles that some nonprofit hospitals must overcome when they try to sell their assets).

305. The question of who decides was hotly debated by the participants in the N.Y.U. conference, *see supra* notes 54 and 304, who included the top charity regulators of California, New York, and Massachusetts. One participant, practitioner Victoria Bjorkland, asked whether a charity that had received 5000 perpetual donations would be required to undergo 5000 cy pres proceedings. Victoria Bjorkland, Partner, Simpson, Thatcher & Bartlett, Comments at a Conference on "Nonprofit Conversions," Program on Philanthropy and the Law, New York University School of Law (Oct. 18, 1996) (author's notes). For a discussion of these issues in the university context, see Harriet M. King, *The Voluntary Closing of a Private College: A Decision for the Board of Trustees?*, 32 S.C. L. REV. 547 (1981).

306. *See, e.g.*, Verified Complaint for Injunctive Relief ¶ 15, Kelley v. Michigan Affiliated Healthcare Sys., Inc., 96 TNT 187-16 (Mich. Civ. Ct. June 17, 1996), *available in* LEXIS, Fedtax Library, Tnt File ("This deal will abrogate a heritage of nonprofit, community-based health care grounded in principles of charity and benevolence, in exchange for a delivery system driven by shareholder greed and motivated by profit and return on investment."); Rex Dalton, *Sharp, State End Columbia Dispute; HealthCare System Adds 3 to Its Board*, SAN DIEGO UNION-TRIB., Mar. 27, 1998, at B1 (reporting that California Attorney General's Office—which had termed "imprudent and improper" the nonprofit Sharp Healthcare's at-

cussion below assumes that these transactions are lawful.[307]

If a donation to the nonprofit hospital was impressed with an actual trust, and if the trust forbids the sale, then the charity must obtain court approval to sell the assets. Regardless of the source of authority for selling, the charity must continue to use the sale proceeds for the purposes specified or to obtain court approval to alter the use.[308]

By contrast, the existence of *unrestricted* donations to a corporate charity does not bar the board from making decisions dealing with

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tempt (later abandoned) to sell a half interest with management control to Columbia/HCA—has closed its investigation after Sharp agreed to add three new board members); Jay Greene, *Minn. Becomes 1st State to Fight Not-for-Profit Hospital Merger*, MOD. HEALTHCARE, June 29, 1992, at 8, 8 (describing how the State of Minnesota filed suit against the merger of two Minneapolis-based healthcare systems); Monica Langley, *Sell the Local Hospital? The Very Idea Splits a Usually Placid Town*, WALL ST. J., Mar. 18, 1997, at A1 (describing how the public outrage among many Boca Raton, Florida citizens delayed indefinitely the sale of a local nonprofit hospital).

307. As a separate matter, if the nonprofit hospital transfers its assets to a partnership with for-profit investors, the Internal Revenue Service could challenge the continuing tax exemption of the nonprofit hospital. *See* Rev. Rul. 98-15, 1998-12 I.R.B. 6 (holding that whether the nonprofit hospital will be operating exclusively for a charitable purpose depends, among other factors, on whether it controls the partnership).

308. These issues arose in the cy pres proceeding involving the Massachusetts hospital MetroWest Health, Inc., whose affiliate formed a partnership with a subsidiary of the proprietary Columbia/HCA. In addition, the parties asked for court approval of a provision in the transfer agreement reciting:

> Because the Partnership is not a public charity and therefore cannot hold property subject to charitable trust, it is the intention of the parties that the Covenant shall be binding on the Partnership as a contractual obligation only and cannot and shall not impose any charitable trust on any property of the Partnership.

Contribution and Sale Agreement § 12.18.4, *reprinted in* Plaintiff's Complaint ¶ 77, MetroWest Health, Inc. v. Harshbarger, No. SJ 96-177 (Mass. Sup. Jud. Ct., Suffolk County, Apr. 5, 1996). (Note that because of Columbia/HCA's recent financial difficulties, it has put MetroWest up for bid; MetroWest Health, the nonprofit partner, has a right of first refusal. Alex Pham, *Firm Offers MetroWest up to $80m; Bidding War Ablaze as For-Profits, Nonprofits Vie*, BOSTON GLOBE, Mar. 19, 1998, at D1, *available in* LEXIS, News Library, Bglobe File.) Incidentally, not everyone agrees that the buying proprietary hospital should commit to a specified level of charity care. The economist Burton A. Weisbrod observes:

> [P]ublic policy should strive to maximize the bid price by minimizing or eliminating the obligation of the for-profit firm to provide charitable health services. Sound heartless? On the contrary, the resulting increased price would permit the foundation receiving the sale proceeds to finance charitable obligations. If, by contrast, the bids include obligations to provide community health education, care for the uninsured, research and other unprofitable but socially desirable services, the resulting contractual agreement will be difficult to enforce.

Burton A. Weisbrod & Elizabeth Selvin, *Hospitals & Profits; Fortunes, and Services, Are at Stake as Institutions Are Converted*, SAN DIEGO UNION-TRIB., Feb. 11, 1998, at B7, *available in* LEXIS, News Library, Sdut File (concluding that the resulting foundation should be required to provide these types of socially desirable services).

charity assets, including sale.[309] However, some courts hold corporate charities to the purposes stated in their articles of incorporation at the time the donations were made. If the charity desires to alter its purposes, at least in some states, the amendment may not apply retroactively. Thus, the Supreme Court of Massachusetts held that a hospital could not use sale proceeds attributable to pre-amendment donations for the new charitable purpose:

> [Otherwise, b]y simply amending its charter purposes, a charitable corporation would itself be able to exercise the power to devote funds to new charitable purposes whenever the trustees decided to do so, without any requirement that the new purposes be similar and not contradictory. . . . Such an interpretation also might eviscerate the Attorney General's power and responsibility to "enforce the due application of [charitable] funds . . . and prevent breaches of trust in the administration thereof."[310]

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309. *See Duties of Trustees*, *supra* note 76, at 548-54 (discussing, under the general heading "Duty to Comply with Donor's Directions," the following topics: (1) "Amendment of Charter," (2) "Merger or Consolidation," (3) "Dissolution," and (4) "Restricted Purpose"). For example, a federal appeals court (construing the law of North Carolina) refused to limit the use of donated funds to the specific solicited purpose:

> Campaign publicity [for the annual March of Dimes campaign] . . . furnishes no basis for an inference that the donors, by their response, manifested an intention to so restrict their gifts that plans of operation and administrative practices might not be altered to increase the effectiveness of The National Foundation's service of its objectives. At least, so long as victims of poliomyelitis in Catawba County received adequate and proper care and assistance, as they did . . . .

National Found. v. First Nat'l Bank, 288 F.2d 831, 836 (4th Cir. 1961).

310. Attorney Gen. v. Hahnemann Hosp., 494 N.E.2d 1011, 1021 (Mass. 1986) (alteration and second ellipsis in original). Upon a sale of its assets, Hahnemann Hospital amended its bylaws to add the following new purpose to its original purpose of operating a homeopathic hospital (and, secondarily, a convalescent home): "(3) Participating in any activity that promotes the health of the general public, including making distributions to organizations that qualify as exempt organizations under Section 501(c)(3) of the Internal Revenue Code." *Id.* at 1016 (internal quotation marks omitted). The court held that the hospital trustees did not violate their fiduciary duty to the hospital by so amending their bylaws. *Id.* at 1018. The court next considered the effects of the Converse trust agreement (governing a large donation) and of the existence of unrestricted donations. The court found that the hospital's intent to become a grant-making institution amounted to an "abandonment of Hahnemann's principal activity for the past four decades, the sole purpose for which it was first organized in 1892 and for which it accepted gifts," and that this abandonment violated the Converse trust. *Id.* at 1018. The court did not, accordingly, reach the Attorney General's argument that "the board also would violate its fiduciary duty to donors of unrestricted gifts by abandoning the purpose for which it was organized and had held itself out to the public." *Id.* at 1019 n.15. The court, in addition, rejected the Attorney General's argument "that trust law must be read into [the statute permitting the board to amend its articles] to limit amendments to those that further the 'dominant charitable purpose.'" *Id.* at 1020. However, the court found that the Converse trust instrument prevented the articles from being amended in a way inconsistent with the trust. "Conse-

If a charitable hospital sells its operating assets and now holds only the sale proceeds, the California Attorney General's office applies a strict cy pres approach, on the belief that the fiduciaries must continue to devote the proceeds to primary and hospital care.[311] Perhaps a court proceeding does best protect all affected interests. However, applying the cy pres standard—holding the charity to its original incarnation unless it becomes "impossible" to carry it out—makes no sense. To the extent economic forces have been dictating the shift of nonprofit hospital operating assets to the proprietary sector in the

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quently," the court concluded, "otherwise unrestricted donations made to Hahnemann before the September 18, 1985, amendment are subject to the same restrictions as Converse trust contributions." *Id.* In addition, "Hahnemann and the board will violate their fiduciary duties to those donors if they apply to the third, new purpose any proceeds of the sale attributable to donations from the Converse trust and from unrestricted donations made prior to September 18, 1985." *Id.* at 1021.

311. *See* Greg Jaffe & Monica Langley, *Fledgling Charities Get Billions from the Sale of Nonprofit Hospitals*, WALL ST. J., Nov. 6, 1996, at A1 ("'Foundation assets must be used for *real* health care—hospitalization, physician care to the sick, particularly indigents. . . . Wellness and prevention may be worthwhile, but they're not part of the trust for which the money was originally raised.'" (quoting Jim Schwartz, Deputy Attorney General of California)). For another account, see Meyer, *supra* note 172, at 15, which states:

> Deputy attorney general Jim Schwartz insists that both law and social policy require the Good Samaritan Charitable Trust to spend its money exclusively for the same purpose as the old not-for-profit—medical and hospital care, particularly for needy residents of the areas served by the system's four facilities.

To be precise regarding the sale proceeds of the Good Samaritan transaction, Mr. Schwartz wrote to me:

> Simply put, because non-profit and for-profit hospitals look fairly similar to us (excluding teaching or academic institutions), we attempted to identify those activities of the non-profit that made up its "charitable", as distinguished from "commercial" activities, i.e., its charitable components. The most obvious example of this is traditional charity care. Having identified those charitable components, we then created separate endowment funds for each component on a proportional basis reflecting its historic funding.
>
> Our thought was that this approach provides the directors with a reasonable level of discretion, insures that the sale proceeds will be utilized in a manner consistent with the articles of incorporation and historic uses, and guarantees that the community will continue to receive the substantive benefits which it has come to rely upon.

Letter to Brody, *supra* note 50, at 2. See also *Letter from James R. Schwartz, Deputy Attorney General of California, to California Senator Kenneth L. Maddy* 3-4 (Apr. 21, 1997) (on file with author), which describes the allocation of the $71.8 million in net assets from the Good Samaritan sale into separate trusts: $6.9 million for "community benefit" and other general health programs; $10.3 million for "school health centers . . . [that] provide[ ] preventive and primary health services to children and adolescents in the Santa Clara County public school system"; and $54.6 million into two trusts for "hospital care and outpatient medical care to the medically indigent" in that county.

first place,[312] it is not obvious that the state should prefer the nonprofit form to deliver hospital services.[313] Moreover, one study esti-

312. *See* David A. Hyman, *Hospital Conversions: Fact, Fantasy, and Regulatory Follies*, 23 J. CORP. L. (forthcoming 1998). As the General Accounting Office observed in a recent study of nonprofit hospital conversions:

> Market and institutional factors, such as the growth of managed care and the need for capital, are often cited as primary reasons for conversions. To be successful in a managed care environment, not-for-profit hospitals must be in a competitive position. This position can be achieved by building networks that guarantee patient flow and increase bargaining power with managed care plans and physician groups.

GENERAL ACCOUNTING OFFICE, NOT-FOR-PROFIT HOSPITALS: CONVERSION ISSUES PROMPT INCREASED STATE OVERSIGHT (GAO/HEHS-98-24) (Jan. 5, 1998) [hereinafter GAO REPORT]. Of course, market power can be exercised wholly within the nonprofit sector. *See, e.g.*, Judith Graham, *Columbia/HCA Came, Saw and Suffered; Health Firm Met Resistance from Not-for-Profits*, CHI. TRIB., Nov. 16, 1997, at C1 (describing the difficulty of proprietary hospitals in making inroads in Chicago, whose "hospital community . . . is proud, independent, overwhelmingly not-for-profit and mostly financially secure"); Bruce Japsen & Lisa Scott, *System Growth a Close Race: 1997 Multi-Unit Providers Survey Finds Not-for-Profits Ahead by a Nose*, MOD. HEALTHCARE, May 26, 1997, at 51, 51 (based on self-reported data, in 1996 "the two biggest acquirers of other hospitals were Catholic Healthcare West . . . and Sisters of the Sorrowful Mother-U.S. Health System"); Monica Langley, *Nuns' Zeal for Profits Shapes Hospital Chain, Wins Wall Street Fans*, WALL ST. J., Jan. 7, 1998, at A1 (describing the Daughters of Charity National Health System Inc.—owned by an order of Catholic nuns—as the "Daughters of Currency," and quoting their approach as "'[n]o margin, no mission'"; due in part to selling off 11 unprofitable hospitals, "their cash and investments have ballooned to about $2 billion, believed to be one of the largest reserves of any nonprofit hospital system in the country").

The March-April 1997 issue of *Health Affairs* magazine contains 22 articles on nonprofit hospital and HMO conversions. The term "conversion" embraces all manner of change of control over hospital assets—including asset sales, joint ventures, and long-term leases—but in all cases limited to change in sectoral ownership status. *See* Gary Claxton et al., *Public Policy Issues in Nonprofit Conversions: An Overview*, HEALTH AFF., Mar.-Apr. 1997, at 9, 10-11. Thus, a merger between two nonprofit hospitals, or a sale of assets from one for-profit hospital to another, would not count as a conversion. *See id.* (defining "conversion" as "any type of transaction that results in the shift of all or a substantial portion of the assets of nonprofit health care organizations to for-profit use"). This definition undercounts hospital restructuring activity, because "[m]ost mergers were between hospitals of the same ownership type." Jack Needleman et al., *Hospital Conversion Trends*, HEALTH AFF., Mar.-Apr. 1997, at 187, 188. Given this definition, one study found that about one percent of hospitals changed ownership status per year since 1980. *See id.* at 187. Most nonprofit hospitals that changed ownership status converted to for-profit, rather than public, status. *Id.* at 190. The biggest story, however, is what has been happening in the public hospital sector: Over half of the total conversions were from public hospital status, most to nonprofit status but a good number to for-profit. *Id.* at 189-90. Surprisingly, a significant percentage of conversions went from for-profit to nonprofit or public. *Id.* at 190.

313. Many nonprofit hospitals provide little charity care. The bulk of community benefits come from public facilities and major teaching hospitals. The "acquisition of nonprofit hospitals by investor-owned corporations does not lead uniformly to less uncompensated care." Gary J. Young et al., *Does the Sale of Nonprofit Hospitals Threaten Health Care for the Poor?*, HEALTH AFF., Jan.-Feb. 1997, at 137, 140. This result is consistent with other studies that find "that investor-owned hospitals provide no less uncompensated care than do nonprofits, given their locational choices, which typically are in relatively affluent commun-

mates that the new foundations already have resources of $8.5 billion.[314] Why should the wishes of the long-ago donors of what is now a small percentage of financial resources force the duplication of hospital services?[315]

A nonprofit hospital can be one of the largest charities in a community. Increasingly, communities worry about behind-closed-doors sales of nonprofit hospital assets—that the community might be shortchanged either in the amount paid for the assets (and hence the funds available for future charity) or in the quality and price of future, for-profit hospital services. Some also suspect conflicts of interest on the part of the nonprofit's trustees and officers, who might receive

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ties." *Id.* Moreover, the proprietary hospitals provide greater community benefits if the taxes they pay are taken into account. *See* Claxton et al., *supra* note 312, at 18 (suggesting, however, that it might be more appropriate "to count only those taxes that are specifically earmarked for health services" in the community benefit comparison).

Indeed, the desire to keep nonprofit hospital assets in the nonprofit sector might reduce community benefit. For example, the Massachusetts Attorney General requires a charity selling its assets to "receive fair value and fair transaction terms for its charitable assets." Richard C. Allen, *The Massachusetts Experience*, HEALTH AFF., Mar.-Apr. 1997, at 85, 87. (Assistant Attorney General Allen is the Director of Public Charities in the Attorney General's office. *Id.* at 85.) Moreover, "[t]he charity should be able to demonstrate that it obtained the best possible deal." *Id.* at 87. Yet, rather than sell its assets to the proprietary Columbia/HCA, the New England Medical Center (NEMC) decided to affiliate, for less money, with a Rhode Island nonprofit. The Attorney General approved the deal: "[A]ssuming that NEMC had followed a careful, prudent decision-making process, its choosing a viable nonprofit option instead of an apparently more lucrative for-profit alternative comported with the Massachusetts charities law requirement to select the least drastic viable alternative for the charity." *Id.* at 86.

314. *See* Jon Craig, *An $8.5-Billion Infusion for Philanthropy*, CHRON. PHILANTHROPY, Apr. 17, 1997, at 49 (describing a forthcoming study by the Henry J. Kaiser Family Foundation addressing nonprofit health care institution conversions). These figures also include conversion proceeds from health maintenance organizations, which were usually federally tax exempt as Internal Revenue Code section 501(c)(4) social-welfare organizations rather than as charities, and nonprofit health insurers (such as Blue Cross/Blue Shield), which lost their federal income tax exemption in 1986. *See also Conversion Foundations: A Listing*, HEALTH AFF., Mar.-Apr. 1997, at 238, 238-42. Columbia/HCA estimates that $2 billion in foundation assets can be attributed to its deals. *See* Tamar Lewin & Martin Gottlieb, *In Hospital Sales, an Overlooked Side Effect*, N.Y. TIMES, Apr. 27, 1997, at A1, *available in* LEXIS, News Library, Nyt File ("Though most of Columbia's hospitals were acquired in three huge corporate mergers, the hospitals now run by the company have spawned more than two dozen foundations.").

315. *See* Robert A. Boisture & Douglas N. Varley, *State Attorneys General's Legal Authority to Police the Sale of Nonprofit Hospitals and HMOs*, 13 EXEMPT ORG. TAX REV. 227, 227 (1996) (noting that hospitals must obtain court approval before making major changes in their charitable purposes); Thomas Silk, *Conversions of Tax-Exempt Nonprofit Organizations: Federal Tax Law and State Charitable Law Issues*, 13 EXEMPT ORG. TAX REV. 745, 746 (1996) (suggesting, hopefully, that "[t]he sector-shift is likely to encourage courts to take into account changed circumstances and thereby modify the original charitable purpose as warranted"). As to the wisdom of charitable perpetuities in general, see Brody, *Charitable Endowments*, *supra* note 284.

positions either in the new hospital management or in the resulting foundation.[316] In response, states have begun to adopt versions of a "Nonprofit Hospital Sale Act."[317] Such proposals attract a great deal of controversy; in April 1997, the governor of New Mexico vetoed his legislature's version on the ground that sufficient safeguards already exist.[318] Typically, these statutes require that the nonprofit hospital

316. *See generally* Lewin & Gottlieb, *supra* note 314 (describing conversion transactions, the resulting foundations, some suspicious deals, the "[l]ure" of "[l]anding [t]op [j]obs [i]n [p]hilanthropy," commingling of interests, and the legislative backlash). According to a state senator in Nebraska (and former board member of a rural hospital), the legislature "originally was going to outlaw all conflicts of interest but found that this was totally impractical and that the best protection for the public was to bring conflicts of interest out into the light of day by requiring public disclosure." Gerald E. Matzke, *A Road Map from Nebraska*, HEALTH AFF., Mar.-Apr. 1997, at 89, 90.

317. *See, e.g.*, CAL. CORP. CODE §§ 5914-5919 (West Supp. 1998) (enacted Sept. 29, 1996) (regulating transfers of assets by nonprofit "health facilities"); GA. CODE ANN. §§ 31-7-89.1, 31-7-400 to -412 (Supp. 1997) (enacted Apr. 22, 1997) (requiring notification of the Attorney General for certain transfers of assets from nonprofit corporations controlling hospitals); Nonprofit Hospital Sale Act, NEB. REV. STAT. §§ 71-20,102 to -20,109 (1996) (enacted Apr. 16, 1996) ("Since the effective date of this law, there have been no sales of nonprofit hospitals in Nebraska to for-profit commercial corporations." Matzke, *supra* note 316, at 91); VA. CODE ANN. §§ 55-531 to -533 (Michie Supp. 1997) (enacted Mar. 20, 1997) (requiring any nonprofit hospital or HMO to notify the attorney general of proposed sale so "that the Attorney General may exercise his common law and statutory authority" over the transaction). The Arizona nonprofit hospital sale law uniquely applies regardless of whether the buyer is for-profit or nonprofit. ARIZ. REV. STAT. §§ 10-11251 to -11254 (West Supp. 1997); *accord* Ron Shinkman, *No Secrets in Arizona: Law Means All Not-for-Profit Sales Will Face Public Hearings*, MOD. HEALTHCARE, Apr. 14, 1997, at 14, 14. *See generally* GAO REPORT, *supra* note 312, app. III (summarizing the laws of 25 states regarding conversion concerns, not all specific to hospitals). The Ohio proposal "has teeth": "Any organization or person who closes a transaction without adhering to the notification guidelines of the law is subject to a $10 million civil penalty or conviction for a felony of the third degree." Craig R. Mayton, *The View from Ohio*, HEALTH AFF., Mar.-Apr. 1997, at 92, 95; *accord* OHIO REV. CODE ANN. § 109.23 (Anderson 1994). (Assistant Attorney General Mayton is the section chief of the Charitable Foundations Section of the Ohio attorney general's office. *See* Mayton, *supra*, at 92.) While the Massachusetts legislature is debating such bills, the Massachusetts Attorney General, as part of his general authority, has been demanding participation in the terms of conversion deals (with appraisals paid for by the parties) and representation for the community on the board of the new foundation. Comments of Richard Allen at a Conference on "Nonprofit Conversions," Program on Philanthropy and the Law, New York University School of Law (Oct. 18, 1996) (author's notes).

In addition, at the federal level, California Congressman Pete Stark introduced H.R. 4433, "Medicare Non-profit Hospital Protection Act of 1997," on January 9, 1997, to ensure that "conversions are carried out in the sunshine of public information and debate" and produce fair prices. 143 CONG. REC. E82-83 (daily ed. Jan. 9, 1997) (statement of Pete Stark).

318. Governor of N. Mex., Veto Message (Apr. 11, 1997); *see also* Louis Lyons, *D.C. Lawmakers Critical of Nonprofit Hospital Conversion Bill*, TAX NOTES TODAY, Apr. 24, 1997, *available in* LEXIS, Taxana Library, Taxtxt File (reporting that proposed legislation imposing additional government review for conversions of nonprofit hospitals to for-profit enterprises in the District of Columbia came under intense criticism by city council members).

inform the attorney general of the terms of the proposed deal, and, after a public hearing, give the attorney general the right to disapprove it as against the public interest (disappointed parties may appeal to court).[319] The parties must usually pay for the attorney general's costs of investigating the fairness of the deal, including expert appraisers.[320] Legal problems remain because statutes define "conversion" differently, and political problems can arise if different state officials have overlapping jurisdictions.[321] No doubt Columbia/HCA's recent woes, leading to a retrenchment of hostile bids for nonprofit hospitals, will slow the momentum for legal change.[322]

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319. *See, e.g., supra* note 317 (citing state statutes regulating sales of nonprofit hospitals); *cf.* Tennessee *ex rel.* Adventist Health Care Sys. v. Nashville Mem'l Hosp., Inc., 914 S.W.2d 903, 908-09 (Tenn. Ct. App. 1995) (holding that plaintiffs lacked standing to challenge the sale of a not-for-profit hospital approved by the attorney general who had determined, after careful investigation, that the sale served the public interest, and who had obtained a consent decree from the Chancery Court approving the sale). The Tennessee appeals court quoted the attorney general's approval of the board actions, which could prove a model to nonprofit directors in sale-of-control situations:

> "The members of the boards themselves devoted substantial time, effort, and energy to analyzing, pondering, and considering the ramifications of the proposed sale. They thought about their constituents, about the implications of not selling the hospital's assets, about a sale to others, about other options such as networking, about continuing to stand alone, and other alternatives, and the affects [sic] upon the members of the public who utilize the hospital and the community itself. They reflected upon the consequences to the patients, the employees, the businesses in the community which encourage or direct employees to utilize the hospital, and to the continued availability of primary care and specialized physicians for the community."

*Id.* at 909 (quoting from an attorney general opinion). *But see* Shinkman, *supra* note 317, at 14 (the Arizona legislature eliminated the proposal to allow the attorney general veto power).

320. *See, e.g.,* CAL. CORP. CODE § 5919(b) (West 1997) ("The nonprofit public benefit corporation, upon request, shall pay the Attorney General promptly for all contract costs.").

321. *See, e.g.,* Patricia A. Butler, *State Policy Issues in Nonprofit Conversions,* HEALTH AFF., Mar.-Apr. 1997, at 69, 75 (comparing California's subjective standard for conversion with Nebraska's bright-line test); Donald Shriber, *State Experience in Regulating a Changing Health Care System,* HEALTH AFF., Mar.-Apr. 1997, at 48, 53 (explaining how state laws that focus on the form of the transaction rather than its function "provide an incentive for making transactions overly complex and confusing, since a conversion that is structured or labeled in a more straightforward manner may be easier to regulate"); *id.* at 59-60 (describing lack of clear regulatory authority, particularly in Blue Cross conversions, exacerbated by politics: "insurance commissioners and attorneys general may be elected officials who regard themselves as wholly independent of one another and even of the state's governor," and the attorney general might also have to represent the insurance department in litigation).

322. *See, e.g.,* Kurt Eichenwald, *A Makeover May Change More Than Columbia,* N.Y. TIMES, Aug. 8, 1997, at D1, *available in* LEXIS, News Library, Nyt File (stating that the new chairman of Columbia "said that Columbia would drop its adversarial approach to not-for-profit hospitals, and instead reach out to them, both for advice and for cooperative ventures"); *Mishap in the Operating Theatre,* ECONOMIST, Aug. 2, 1997, at 48, 49 (arguing that new man-

Should a nonprofit hospital conversion be allowed to proceed, under the typical nonprofit-hospital sale statute, the resulting funds must be used for "health care purposes" in the community that the hospital currently serves.[323] Moreover, some states are considering barring the old hospital trustees from controlling the board of the resulting foundation.[324] In any event, foundation leaders recommend

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agement will "tone down Columbia's high-pressure marketing tactics and limit the firm's expansion into communities where Columbia has met (and often steamrollered) local opposition"); Linda Sandler & George Anders, *Columbia/HCA Stock Lures Some Big Buyers Amid Bets That Company May Be Broken Up*, WALL ST. J., Oct. 6, 1997, at C2, *available in* 1997 WL-WSJ 14168823 (reporting that although Columbia/HCA is under government investigation for potential wrongdoing and there are reports of the company dumping some of its assets and taking the rest private, some investors have significantly increased their stakes in the company).

323. *See, e.g.*, NEB. REV. STAT. § 71-20,108 (1996) ("An acquisition is not in the public interest unless appropriate steps have been taken to safeguard the value of charitable assets and ensure that any proceeds of the transaction are used for appropriate charitable health care purposes as provided in subdivision (8) of this section."). Subdivision (8) asks:

> Whether the sale proceeds will be used for appropriate charitable health care purposes consistent with the seller's original purpose or for the support and promotion of health care in the affected community and whether the proceeds will be controlled as charitable funds independently of the purchaser or parties to the acquisition.

*Id.* Nebraska also requires the attorney general to consider whether the parties "have made a commitment to provide health care to the disadvantaged, the uninsured, and the underinsured and to provide benefits to the affected community to promote improved health care." NEB. REV. STAT. § 71-20,109(2) (1996).

The preamble to the California legislation declares: "Charitable, nonprofit health facilities, including nonprofit hospitals, hold all of their assets in trust, and those assets are irrevocably dedicated, as a condition of their tax-exempt status, to the specific charitable purposes set forth in the articles of incorporation of nonprofit entities." 1996 Cal. Legis. Serv., ch. 1105, § 1(a) (West). The California attorney general's office opposed a recent legislative proposal, now withdrawn, to liberalize the cy pres standard as it applies to hospital conversions. The bill would have permitted the use of hospital sale proceeds for any "community benefit," defined to include health prevention and promotion, adult and child day care, medical research and training, home-delivered meals to the housebound, and free food, shelter, and clothing to the homeless. *See* Letter to Brody, *supra* note 50, at 2; Letter from Peter K. Shack to California Senator Kenneth L. Maddy 2 (Mar. 27, 1997) (on file with author). In letters to the bill's sponsor, the attorney general's office objected to (and questioned the constitutionality of) the proposed "authorization to breach the trust and disavow the commitments made to those whose money, work, and efforts built these community hospitals." Letter from James R. Schwartz to California Senator Kenneth L. Maddy, *supra* note 311, at 4; *accord* Letter from Peter K. Shack to California Senator Kenneth L. Maddy, *supra*, at 5-7. *But see* Barbara Marsh, *Eyeing the Money Trail in Hospital Sale*, L.A. TIMES, Nov. 9, 1997, at D1, *available in* LEXIS, News Library, Lat File (describing the unhappiness of acceding to the attorney general's demand that the foundation adhere as closely as possible to the hospital's original mission). The chairman of this foundation complained: "'If we don't have hospitals anymore, how do we give money to in-patient care?' . . . 'That means we have to work with other not-for-profit hospitals. Why should we hand over money to people that used to be our competitors?'" *Id.*

324. *See, e.g.*, Ellen Hale, *Some States Taking Steps to Protect Not-for-Profit Hospitals*, GANNETT NEWS SERVICE, Nov. 20, 1996, at S12, *available in* 1996 WL 4391192. Hale notes that: "If

that new members be brought in to provide grant-making expertise and to help avoid potential conflicts of interest.[325]

Not all trustees hew to the original charity's path. Having determined that federal and state programs adequately meet the needs of most uninsured patients, one Tennessee foundation that resulted from the sale of hospital assets intends now to shift its focus from health care to education.[326] A foundation in Venice, Florida, makes

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passed, the Colorado legislation being drafted would be among the most comprehensive, requiring an independent new board of trustees for the new charity created by the sale of a not-for-profit hospital. In many conversions so far, the old hospital board simply moves to the new foundation." *Id.* However, Nancy Kane observed, "many boards feel that the charitable asset value of the conversion is a direct result of their stewardship and that it is their obligation to maintain the charitable mission of those assets in their new form." Nancy M. Kane, *Some Guidelines for Managing Charitable Assets from Conversions*, HEALTH AFF., Mar.-Apr. 1997, at 229, 234.

325. Indeed, Judith Bell, a lawyer at Consumers Union, suggests that more nonprofit hospitals might be maintained if the board members could not stay on with the foundation: "If the choice is to cut the nursing staff, lay people off, and do all the tough, unpopular things it would take to put the hospital back in shape, or, alternatively, to sell, get a glamorous new foundation and have lots of money to give away, it's clear which way they'll go." Lewin & Gottlieb, *supra* note 314 (internal quotation marks omitted).

In general, the old hospital trustees have no particular expertise in foundation management and grant-making. One commentator observes:

> The potential for misuse of the assets worries the traditional philanthropic community, which is racing to study the new foundations and educate newcomers about the elusive task of funding and operating effective charitable programs. Most foundation leaders are former hospital executives and trustees jumping into social programming that's far different from the health care delivery they know best. They usually lack experience in grant-making and managing large investment funds.

Meyer, *supra* note 172, at 14. For further support, see Craig Havighurst, *Solid Foundations*, HEALTH SYSTEMS REV., July-Aug. 1996, at 33, 37, commenting:

> Board members will have a bias towards protecting or subsidizing their former hospital and will be pressured to do so by the new investor. . . .
>
> Foundation leaders interviewed for this article acknowledged that this is perhaps the most real danger to an effective foundation. All recommended a complete severing of ties.

*See also* Harris Meyer, *From Giving Care to Giving Grants*, FOUND. NEWS & COMMENTARY, July-Aug. 1996, at 40, 43 (expressing skepticism over new foundations keeping the same board members or executives as the previous hospital or HMO).

326. *See* Jaffe & Langley, *supra* note 311; *see also* Meyer, *supra* note 172, at 17 (reporting that the Rose Foundation in Denver, in asking the community about its priorities, discovered that education and children and family programs ranked far higher than health care: "In the macro view," the foundation president said, "everything is health related. . . . If the kids aren't educated and aren't eating, what's more important for us to address than that?"); *accord* Meyer, *supra* note 325, at 42 (explaining that the Rose hospital's origin in the 1940s was "a place for Jewish doctors to practice at a time when they weren't allowed on staff anywhere else," and as a result, the Rose Foundation officials have also decided to focus "on preserving Jewish identity").

grants to arts organizations, to human service organizations, and for civic affairs.[327]

4. *Timken Mercy Medical Center.*—In the Timken hospital case described at the beginning of this Article, the $200 million proceeds of the sale of the nonprofit hospital assets will be held by grant-making foundations.[328] These foundations plan to redirect the purposes of the charity by using the proceeds, according to a news report, "to act on issues that affect the quality of life, change attitudes and structures that oppress people, provide direct relief to the poor and listen to the poor and educate others to their needs."[329] Such a broad construction of charitable purposes raises the issues just discussed.

The Timken story raises an additional fiduciary legal issue. News accounts described how, prior to the board vote on the sale, the twelve community members of the board were "removed," leaving the board with only the four members representing the Sisters of Charity of St. Augustine (CSA) Health System and the president/CEO.[330] Under nonprofit law, board members can be removed so easily only if they are appointed by, and serve at the pleasure of, one or more "members" of the nonprofit.[331] It appears that the CSA system was the sole member of the Timken hospital, akin to making Timken its subsidiary. This situation should not bother those who advocate for a strong membership role in charities, but it does raise concerns if other constituencies, such as the community, are to be entitled to independent representation.

5. *Summary.*—This subpart examined the aspect of a fiduciary's duty of care that relates to what some commentators call the duty of obedience, and which this Article argues is an aspect of the duty of care. In the absence of shareholders, and assuming no members, when can the directors on their own determine that the purposes of the charity may be changed? When must the directors receive approval from the attorney general or the courts, or both? The recent wave of nonprofit hospital conversions has led many state legislatures to enact statutes requiring attorney general—and in some cases community—involvement. Some states also involve the community in the "back end" cy pres issue: deciding how to use the resulting sale proceeds. The amount of deference to grant nonprofit directors requires

327. Havighurst, *supra* note 325, at 34.

328. McIntyre, *supra* note 13.

329. *Id.*

330. *See supra* notes 9-10 and accompanying text.

331. *See* REVISED MODEL NONPROFIT CORP. ACT § 8.09 (1987).

balancing the public interest against the desirability of an independent charitable sector. These issues, at least in the hospital context, are only beginning to be debated.

### C. *The* Reader's Digest *Foundations: Investment Duties and Commingled Purposes*

1. *Prudent Man Versus Legal List.*—A trustee's duty of care includes the duty to make trust assets productive. We owe the development of the "prudent man rule" to an 1830 Massachusetts Supreme Court case involving Harvard College.[332] Judge Putnam declared in dictum a standard of investment that most states, in court decisions or legislation, came to adopt for all trustees, private or charitable:

> [Trustees must] observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested.[333]

Dubbing this the "prudent-man rule," the *Second Restatement of the Law of Trusts* declared the trustee's duty "to make such investments and only such investments as a prudent man would make of his own property having in view the preservation of the estate and the amount and regularity of the income to be derived."[334]

Commentators hailed Judge Putnam's opinion in *Amory* as a model of flexibility regarding the trustee's investment powers. The authors of the various Restatements, too, believed that they had expressed the rule as one of trustee flexibility.[335] However, to Professor Lawrence Friedman, the prudent investor rule "presupposes a certain class of trustees: men of business ability, whose social and economic position allows them easily to observe how their peers manage large estates for themselves or others."[336] Moreover, the rule originated in Boston, in which a "special institution was developing, the so-called Boston trustee, a professional manager of other people's fortunes—

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332. *See* Harvard College v. Amory, 26 Mass. (9 Pick.) 446 (1830).

333. *Id.* at 461.

334. RESTATEMENT (SECOND) OF TRUSTS § 227 (1959).

335. *See, e.g.*, RESTATEMENT (THIRD) OF TRUSTS (THE PRUDENT INVESTOR RULE) § 227 general notes at 59 (1992) (stating that the rule lessens the dangers of unwarranted conservatism); RESTATEMENT (SECOND) OF TRUSTS § 227 cmt. a (indicating the flexibility of the rule based on the increased skill level of certain trustees).

336. Lawrence M. Friedman, *The Dynastic Trust*, 73 YALE L.J. 547, 554 (1964).

the living embodiment of the prudent investor."[337] Most states took many years to accept the prudent investor rule (for private as well as charitable trustees).[338] The legislative and judicial quest to distinguish permissible "investing" from impermissible "speculating" led to extreme conservatism. Courts and legislatures often relied instead on "legal lists"—generally consisting of government bonds and usually excluding as too risky both equities and debt issued by corporations.[339] This approach continued until, by the turn of the nineteenth century, trust companies had developed to provide "a rational, institutional base for legal and business experience in drafting, forming, managing and perpetuating long-term trusts."[340] Other court decisions second-guessed trustees by examining the losing investment in isolation from the entire portfolio, so that losses on hedging instruments suddenly appeared speculative.[341] Finally, trustees were barred from delegating their duties (unlike corporations, which by definition act through others), lending further encouragement to buying and holding "safe" assets.[342]

We continue to find examples of the disgraceful inefficiencies that these narrow interpretations can produce. For over fifty years, a

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337. *Id.* In a footnote, Professor Friedman argued that there was a division of trustee labor in Massachusetts: "[P]rivate trustees for dynastic trusts, and corporate trustees and savings banks for small depositors (roughly equivalent to caretaker trusts)." *Id.* n.27.

338. *See id.* at 554 (stating in 1964 that although the prudent investor standard was more than 130 years old, it had not become generally accepted in the majority of jurisdictions until the last 20 years).

339. *See* John H. Langbein & Richard A. Posner, *Market Funds and Trust-Investment Law*, 1976 AM. B. FOUND. RES. J. 1, 3-4. In restricting investments to government bonds, states conveniently provided a source of funds for the public sector. *See id.* at 5 n.18 (comparing the English chancellor's concern for providing a broad market for government securities with American state legislatures' statutory lists authorizing state and local obligations); *see also* Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795, 799-820 (1993) (analyzing the problems of political influences over public pension funds). Describing the hazards of relying on the legislature to authorize particular investments, Professor Friedman observed: "It must have been clear to all where the impetus for these laws arose. This was not a plain and narrow path but an invitation to corruption. The power to prescribe 'legals' was a power to control or at least influence the flow of investment money." Friedman, *supra* note 336, at 562. Professor Friedman concluded that the Depression provided the spur to final repeal of legal lists: "One might seriously question . . . the social utility of rules which kept funds out of channels which might conceivably restore business confidence, enhance stock prices, and help get the country back on its feet." *Id.* at 571.

340. Friedman, *supra* note 336, at 563.

341. *See, e.g.*, *id.* at 566-67 (discussing *Simmons v. Oliver*, 43 N.W. 561 (Wis. 1889), where a trustee invested a portion of the trust in a business that failed and the court imposed its own strict standards to govern investment policy for trustees).

342. *See* BEVIS LONGSTRETH, MODERN INVESTMENT MANAGEMENT AND THE PRUDENT MAN RULE 72-73 (1986) (discussing the rule against delegation).

1945 testamentary devise by the progressive Macon newspaper publisher W.T. Anderson had yet to result in the formation of the stipulated charitable foundation for the health needs of poor local blacks.[343] Because living heirs were still entitled to small stipends, the trust's bank trustees, rather than purchasing annuities for these heirs, accumulated all of the capital and earnings.[344] Nor were these earnings anything to boast of: They averaged a mere three-percent annual return. The Georgia Attorney General's office investigated whether the trustees breached their duty of care by failing to achieve even a conservative level of return.[345] The bank, in turn, finally petitioned, successfully, for court approval to lift the restrictions in the will that limited investments to "lawful instruments," such as municipal bonds, certificates of deposit, and United States Treasury securities.[346] Those fighting to fund the charity contended, however, that the bank could have sought the same deviation in 1972, when Georgia liberalized the investment powers of executors and trustees.[347] On February 6, 1998, the Georgia Attorney General, who sought damages to the estate of over $4.5 million, settled the dispute for a payment by the bank of $150,000 to the charitable trust, and an agreement that the bank will create an advisory board to help the trust review grant applications.[348]

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343. Monica Langley, *Man's Last Wish to Help Poor Blacks on Hold 50 Years*, WALL ST. J., Sept. 27, 1996, at A1; *NationsBank Announces Commitment to Contribute $500,000 for the Health Needs of Indigent African Americans in Macon, Georgia Area*, PR NEWSWIRE, Oct. 16, 1996, *available in* LEXIS, News Library, Prnews File (describing a court decision on October 3, 1996 to permit the funding of the charitable trust from the Anderson estate); Karen M. Thomas, *Georgia Octogenarians Push Bank to Follow Will: Relative Devoted Funds to Medical Care for Blacks*, DALLAS MORNING NEWS, Jan. 19, 1997, at A1, *available in* 1997 WL 2640228 (explaining the legal barriers preventing the release of $2.4 million from W.T. Anderson's estate to provide medical care for blacks at Macon's only nonprofit hospital).

344. The bank changed hands three times during this period. For a long time, the bank trustee appeared to have a conflicting interest, given that one of the members of the bank board was the brother of a living heir:

> Her brother, Peyton Anderson, who died in 1988, had become a household name in the area through his inheritance of the newspaper and a charitable fund set up in his name. The younger Anderson sold the paper to the Knight-Ridder chain. The women [heirs] found it bittersweet that Peyton would be remembered, while W.T. would not.

Thomas, *supra* note 343.

345. *See* Langley, *supra* note 343.

346. *Id.*

347. The living heirs' legal costs have been funded by the only remaining nonprofit hospital in Macon, and thus the only charity that qualifies as a beneficiary under the terms of the will. *See id.*

348. *See NationsBank, Georgia Reach a Settlement on Publisher's Estate*, WALL ST. J., Feb. 9, 1998, at B5.

2. *Modern Portfolio Theory.*—Over the last few decades, the traditional formulations of the prudent man rule suffered the death of a thousand cuts by advances in investment theory.[349] Again, change began in the charitable sector. University trustees believed that they could spend only income, while appreciation belonged to the endowment, and so they tended to invest in bonds rather than stock.[350] After finding that no court decision on the income-versus-appreciation question involved a charitable endowment fund, a study sponsored by the Ford Foundation in 1969 urged trustees to focus on "total return" rather than on legally defined "income."[351]

Shortly thereafter, in 1972, the National Conference of Commissioners on Uniform State Laws adopted the Uniform Management of Institutional Funds Act (UMIFA), which permits charity fiduciaries to "invest and reinvest an institutional fund in any real or personal property deemed advisable by the governing board, whether or not it produces a current return."[352] About the same time, the United States

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349. *See* LONGSTRETH, *supra* note 342. Even after significant recent reforms in trust investment law, a fiduciary must still exercise prudence in setting investment policy and in choosing and supervising any investment advisors or managers to whom investment decisions are delegated.

350. *Cf.* WILLIAM L. CARY & CRAIG B. BRIGHT, THE LAW AND THE LORE OF ENDOWMENT FUNDS 7 (1969) ("'We may be in a period in which the mores regarding these matters are gradually shifting. Fifty years ago most trustees would have argued that it was immoral to purchase common stocks with endowment funds. At present nearly half of college endowment funds are in common stocks, and a similar shift with respect to [the utilization of] capital gains may be occurring.'" (alteration in original) (quoting Bible Inst. Colportage Ass'n v. St. Joseph's B & T Co., 75 N.E.2d 666 (Ind. Ct. App. 1947))).

351. See *id.* at 6, explaining the goal of the study:

> It should be stressed at the outset that the purpose of this report is not to advocate either the expenditure or the preservation of capital gains. . . . The object of our inquiry is merely to determine whether the directors of an educational institution are circumscribed by the law or are free to adopt the investment policy they regard as soundest for their institution, unhampered by legal impediments, prohibitions or restrictions.

Some commentators fault charities less for their outdated investment practices than for resisting changing their traditional spending policies. *See, e.g.*, J. PETER WILLIAMSON, FUNDS FOR THE FUTURE: COLLEGE ENDOWMENT MANAGEMENT FOR THE 1990'S, at 5-104 (1993) ("While there was some reluctance to modify the traditional, rather conservative investment policies pursued by most endowments, the real resistance was to the idea of changing the traditional spending policies."). Williamson described the subterfuge opportunity: "The institutions that prided themselves on spending only income yield, and invested all of their endowment assets in high-yielding fixed-income securities, gave up all chance of appreciation, even appreciation to cope with inflation, but operated entirely within the limits of traditional spending practices." *Id.* at 5-104 to 5-105.

352. UMIFA § 4(1), 7A U.L.A. 719 (1985). This authority, however, is "subject to any specific limitations set forth in the applicable gift instrument" or in other law. *Id.* § 4, 7A U.L.A. 719. UMIFA's standard of conduct is one of "ordinary business care and prudence under the facts and circumstances prevailing at the time of the action or decision." *Id.* § 6,

Treasury Department issued regulations describing which investments made by a private foundation would jeopardize the foundation's tax-exempt status (and thus attract an excise tax).[353] The regulations adopted a total-return approach, as well as a policy of examining investment decisions in the context of the entire portfolio.[354] This flexible approach found favor in the 1974 federal legislation governing pension trustees.[355] Most recently, several states have adopted legislation similarly liberalizing the investment powers of private trustees.[356]

Meanwhile, in 1990, the American Law Institute adopted and promulgated the first volume of the *Third Restatement of the Law of*

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7A U.L.A. 721. UMIFA has been adopted in 40 states and the District of Columbia. *See* UNIFORM MANAGEMENT OF INST. FUNDS ACT, 7A U.L.A. 316 (Supp. 1997).

353. *See* Treas. Reg. § 53.4944-1 (as amended in 1973).

354. *Id.* The regulations provide:

> In the exercise of the requisite standard of care and prudence the foundation managers may take into account the expected return (including both income and appreciation of capital), the risks of rising and falling price levels, and the need for diversification . . . . The determination whether the investment of a particular amount jeopardizes the carrying out of the exempt purposes of a foundation shall be made on an investment by investment basis, in each case taking into account the foundation's portfolio as a whole. No category of investments shall be treated as a per se violation of section 4944. However, the following are examples of types or methods of investment which will be closely scrutinized to determine whether the foundation managers have met the requisite standard of care and prudence: Trading in securities on margin, trading in commodity futures, . . . the purchase of "puts," "calls," and "straddles," the purchase of warrants, and selling short.

Treas. Reg. § 53.4944-1(a)(2)(i). Compare this flexible formulation to an earlier Treasury Department proposal that would have prohibited private foundations from trading in any "inherently speculative devices such as the purchase of 'puts,' 'calls,' 'straddles,' 'spreads,' 'strips,' 'straps,' and 'special options.' Selling short and trading commodity futures would also be prohibited." HOUSE COMM. ON WAYS AND MEANS & SENATE COMM. ON FINANCE, 91ST CONG., TAX REFORM STUDIES AND PROPOSALS: U.S. TREAS. DEPT. 305 (Comm. Print, Part 3, Feb. 5, 1969).

A foundation manager who knowingly participates in making a jeopardizing investment, without reasonable cause, faces a penalty of 5% of the amount involved, but not more than $5000, and up to another $10,000 if he or she refuses to agree to part or all of the removal from jeopardy. I.R.C. § 4944(a)(2), (b)(2), (d)(2) (West 1997). A similar scheme operates under I.R.C. § 4945 (West 1997), entitled "Taxes on Taxable Expenditures."

355. The Employee Retirement Income Security Act of 1974 (ERISA) (codified as amended in scattered sections of 29 U.S.C.) adopted the corporate standard of care and prudence.

356. *Cf.* UNIF. PRINCIPAL AND INCOME ACT, 7B U.L.A. 1 (Supp. 1997) (listing jurisdictions which have adopted the Act); UNIF. PRUDENT INVESTOR ACT, 7B U.L.A. 18 (Supp. 1997) (commenting that the Act has been substantially adopted in Florida, Illinois, New York, and Virginia). The *Uniform Principal and Income Act* is needed because the *Uniform Management of Institutional Funds Act* does not apply to outside holders of funds, such as banks or trust companies, even if a charitable institution is the sole beneficiary. *See* UMIFA § 1 cmt. 1, 7A U.L.A. 713 (1985).

*Trusts*, which is devoted exclusively to revisions in the prudent man rule.[357] The Reporter, Professor Edward C. Halbach, Jr., explained its genesis in excessively hidebound interpretations, including commentary in earlier Restatements:

> The "black letter" of the potentially and intendedly flexible, traditional rule is not objectionable, nor is it inconsistent with modernization . . . . What has led to widespread criticism in the last quarter of a century, to the enactment and consideration of modernized statutes . . . , and to The American Law Institute's prudent-investor project is the way in which the rule has previously been elaborated in Restatement commentary or other treatises and applied by courts in most of the states.[358]

The *Third Restatement* embodies modern portfolio theory in its amended section 227: The general standard of prudent investment "requires the exercise of reasonable care, skill, and caution, and is to be applied to investments not in isolation but in the context of the trust portfolio and as a part of an overall investment strategy, which should incorporate risk and return objectives reasonably suitable to the trust."[359] Ignoring the differences between private trusts and charitable trusts, section 389 states simply: "In making decisions and taking actions with respect to the investment of trust funds, the trustee of a charitable trust is under a duty similar to that of the trustee of a private trust."[360] Of course, all Restatements, however influential, "are not law but depend on the willingness of courts to follow them."[361]

Modern portfolio theory concludes that increased return comes from taking on increased risk, where the "riskless" return is the interest income one can earn on Treasury securities.[362] However, only a certain type of risk is compensated through higher returns—specifi-

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357. *See* RESTATEMENT (THIRD) OF TRUSTS (THE PRUDENT INVESTOR RULE) (1992). According to the Reporter for the *Restatement (Third) of Trusts*, Edward Halbach, future projects will restate other aspects of trust law. *See* Halbach, *supra* note 102, at 1176 (suggesting that future work on the *Restatement (Third) of Trusts* will cover the subjects of modification and termination of trusts, including issues relating to dead hand control and equitable deviation).

358. RESTATEMENT (THIRD) OF TRUSTS (THE PRUDENT INVESTOR RULE) § 227 reporter's notes, general notes at 59. *But see* Gordon, *supra* note 92, at 54-55 (arguing that cases could also be read to be consistent with modern views of prudent investment practices).

359. RESTATEMENT (THIRD) OF TRUSTS (THE PRUDENT INVESTOR RULE) § 227.

360. *Id.* § 389.

361. Halbach, *supra* note 102, at 1184.

362. *See* RESTATEMENT (THIRD) OF TRUSTS (THE PRUDENT INVESTOR RULE) § 227 reporter's general note on cmts. e-h, at 78 ("[T]he only allowable means of increasing or decreasing the market portfolio's return is by increasing or decreasing risk.").

cally, the risk that the market will go up or down (systemic or systematic risk).[363] The risk from holding any particular publicly traded stock enjoys little compensation, because all but its market risk can be diversified away.[364] In an artificial but fundamental model, the only way to increase return is to shift assets from Treasury bills to stock; additional risk can be taken on by borrowing and buying more stock.[365] (Borrowing—indeed, the notion of increasing risk—has traditionally been verboten to trustees; the *Third Restatement* reverses this rule.[366]) The way to reduce risk is to shift from stock to Treasuries, or to lend against stock. A fiduciary's most important investment decision is selecting a level of risk and the appropriate asset allocation: "[E]ndowment trustees should be spending the majority of their time on investment objectives and asset allocation because tactical considerations, such as security selection, are of minor importance."[367]

Indeed, one key feature of modern portfolio theory is the "efficient market hypothesis," implying that in major central markets in-

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363. *See id.*

364. *See id.* at 77.

365. As Edward Halbach cautions, no one can hold all of "the market" because there are many different markets for financial instruments. Telephone Interview with Edward Halbach, *supra* note 86. Only short-term Treasuries are risk-free because of the risk of inflation. *Id.* Borrowing provides not rewarded market risk, but rather leverage. *Id.*

366. RESTATEMENT (THIRD) OF TRUSTS (THE PRUDENT INVESTOR RULE) § 191, at 154; *see also id.* § 227 cmt. h, at 29 ("Borrowing may play an inverse role to that of lending and is permissible for trustees, provided the tactic is employed selectively and cautiously."). See generally Langbein & Posner, *supra* note 339, at 33, explaining:

> In most cases where borrowing has been at issue, the trustee was using trust funds to carry on a business. But the trustee who levers a market fund, like a trustee who buys levered common stock, remains a passive investor . . . . Obviously, leverage increases the risk of the trust assets . . . . But the proper question is whether the risk is excessive, not whether it is achieved by leverage. It is more prudent to give the trust assets a beta of 1.5 by levering a market portfolio than by limiting the portfolio to common stocks having an average beta of 1.5, thereby sacrificing diversification.

Congress subjects most "debt-financed income" of pension funds, charities, and other exempt organizations to the tax on unrelated business income (UBI). (This treatment appears to be motivated by Congress's fear that exempt organizations can otherwise grow too large. *See generally* Brody, *Of Sovereignty and Subsidy*, *supra* note 29.) A special rule applies to securities lending. See I.R.C. § 514(c)(8) (West 1997) and the Treasury Regulations thereunder. In addition, universities and pension funds may generally leverage real property investments without generating UBI. See I.R.C. § 514(c)(9) and the regulations thereunder.

367. WILLIAM T. SPITZ, SELECTING AND EVALUATING AN INVESTMENT MANAGER 3 (1992). Spitz also advises: "Because the return on an endowment is determined primarily by asset mix and investment philosophy decisions, trustees should not delegate these decisions to investment managers." *Id.*

creased effort does not increase the odds of "beating the market."[368] As a result, increasingly throughout the 1980s "individual and institutional investors threw in the stock-picking towel and opted for indexing—that is, simply buying and holding one or more of the broad market indexes such as the Standard & Poor's 500-Stock Index."[369] Surprisingly, however, only about 10 percent of the shares constituting the S&P 500 are held in index funds, and the typical endowment allocates only 1.2 percent of assets to index funds.[370] Yale University recently found itself the subject of a Harvard Business School case study for shifting the half of its portfolio invested in index funds into active management. Asserted its chief investment officer: "We started out owning the market, but over time we convinced ourselves that we have the ability to find people who can beat the market."[371] One might expect that under such a "conservative" paradigm as a trust, the modern prudent investor rule would forbid active investing strategies. Professor Halbach tries to explain why the *Third Restatement* does not require passive investing:

> Assessments also tend to discourage incurring heavy investigative and transaction costs . . . in pursuit of strategies designed to beat the market through "timing" or "stock picking" in major central markets. On the other hand, these assessments have not prevented all intelligent and careful investors from including active management strategies in the investment programs for which they are responsible. Like-

368. *See, e.g.*, BURTON G. MALKIEL, A RANDOM WALK DOWN WALL STREET 194 (rev. ed. 1996) ("Even a dart-throwing chimpanzee can select a portfolio that performs as well as one carefully selected by the experts."). For example, in 1995, the Standard & Poor's 500-Stock Index (S&P 500) produced a 37.53% return (including reinvested dividends), beating over 85% of domestic stock mutual funds. Robert McGough, *It's Strange! It's Pricey! It's a Winner!*, WALL ST. J., Jan. 5, 1996, at R4, *available in* 1996 WL-WSJ 3085768. Of course, the S&P 500 does not reflect the entire investment market: "Investors in S&P 500 index funds are, whether they know it or not, making an implicit bet that the largest companies in the nation will be the top performers." *Id.* Rather than selecting the 500 largest U.S. companies, however, a committee at Standard & Poors seeks to ensure that each industry is represented proportionate to its presence among all publicly traded stocks. *Id.* Commentators generally view active investment strategies as appropriate for less efficient markets, such as real estate and foreign stock exchanges. *See, e.g.*, Halbach, *supra* note 102, at 1163 (stating that specialized advice or delegation is necessary when investing in foreign markets or in venture capital and real estate).

369. MALKIEL, *supra* note 368, at 194.

370. *See* SPITZ, *supra* note 367, at 3.

371. Marlene Givant Star, *Yale Endowment Leaves Tradition Behind*, PENSIONS & INVESTMENTS, Apr. 15, 1996, at 3, 41 (internal quotation marks omitted); *accord* Carolyn L. Duronio, *Fiduciary Concerns Under the Prudent Investor Standard*, TR. & EST., Dec. 1996, at 33, 33 (discussing a Harvard Business School case study that analyzed Yale's strategy of investing approximately 50% of its portfolio in "'alternative investments'").

> wise, these assessments would not justify a legal rule that would bar fiduciaries from including active management strategies in investing funds for which they are responsible.[372]

*3. Investing Versus Charitable Program.*—Charities sometimes face program conflicts when managing their endowments. The *Third Restatement* would permit a charity to take "social considerations" into account only "to the extent the charitable purposes would justify an expenditure of trust funds for the social issue or cause in question or to the extent the investment decision can be justified on grounds of advancing, financially or operationally, a charitable activity conducted by the trust."[373] "Program-related investments" are made to advance a charitable purpose rather than to earn a financial return.[374] At the other extreme, reasons of conscience might induce a charity to divest or shun holdings in corporations whose activities clash with the charitable purpose. In the 1980s, institutions divested stock in companies doing business in South Africa.[375] Recently, institutions have been

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372. Halbach, *supra* note 102, at 1162 (footnote omitted); *accord* RESTATEMENT (THIRD) OF TRUSTS (THE PRUDENT INVESTOR RULE) § 227 reporter's general note on cmts. e-h, at 79 (1992) ("The greater the trustee's departure from one of the valid passive strategies, the greater is likely to be the burden of justification and also of continuous monitoring."). Yale's active strategy relies, in large part, on its investment in illiquid markets. Its chief investment officer, David Swensen, commented: "'More than half the portfolio is in asset classes where you couldn't or wouldn't want to buy the market," and "You can be paid for accepting illiquidity. The markets overvalue liquidity to a degree that's hard to understand.'" Star, *supra* note 371, at 41.

373. RESTATEMENT (THIRD) OF TRUSTS (THE PRUDENT INVESTOR RULE) § 227 cmt. c.

374. The private foundation rules under the Internal Revenue Code prohibit excess business holdings. *See infra* note 390. The definition of "business holdings" carves out an exception for "functionally related business[es]"—those businesses or activities that relate (aside from the organization's need for money) to the exempt purpose of the organization. Treas. Reg. § 53.4943-10(b) (as amended in 1984). For example, the regulations describe "investments in small businesses in central cities or in corporations to assist in neighborhood renovation." *Id.* Similarly, jeopardizing investments do not include "program-related investments"—where the primary purpose of the investment is to accomplish an exempt purpose rather than to produce income or property appreciation. I.R.C. § 4944(c) (West 1997). *See generally* David S. Chernoff, *Some Practical Observations About Making, Documenting and Closing Program Related Investments*, PHILANTHROPY MONTHLY, Mar. 1996, at 23 (advising foundations about making program-related investments).

375. *See, e.g.*, Op. Haw. Att'y Gen., No. 85-26, 1985 Haw. AG LEXIS 4, at *23 (Nov. 25, 1985) ("Primary consideration must be given to safety of the trust corpus and production of an adequate return on investment. . . . However, if the [University of Hawaii] Board [of Regents] reasonably concludes that two investment alternatives are economically equivalent, the Board may choose between them on social grounds."). *See generally* RESTATEMENT (THIRD) OF TRUSTS (THE PRUDENT INVESTOR RULE) § 227 reporter's note c (discussing social investing cases and commentaries regarding the duty of loyalty); Daniel Fischel & John H. Langbein, *ERISA's Fundamental Contradiction: The Exclusive Benefit Rule*,

choosing to invest in mutual funds that exclude stocks of tobacco companies.[376] One wonders how far charities will take this "tainted money" concern—recall Shaw's Salvation Army Major Barbara and her repugnance at accepting a donation proffered by a wealthy distiller and arms merchant.[377]

4. *Donor Direction Versus Diversification.*—As described in Part I, a donor can restrict or enlarge the trustee's investment powers. A liberal grant would relieve trustees from being confined to conservative investments.[378] A restrictive grant would obligate trustees to make specified investments, such as limiting investments to government bonds or stock in the family business. For example, the trust indenture of the Duke Endowment, established in perpetuity in 1932 by James B. Duke, prohibited the trustees from both disposing of any of the contributed shares in Duke Power Company, and from investing

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55 U. CHI. L. REV. 1105, 1143-49 (1988) (discussing social investing and the controversy that it has created over the past decade); *see also* Basich v. Board of Pensions, 540 N.W.2d 82, 87 (Minn. Ct. App. 1995) (holding that the courts could not constitutionally interfere with the church's and pension board's policy, based on social and doctrinal grounds, to divest stock in companies doing business in South Africa).

Compare the debate over the Department of Labor's rules for "economically targeted investments" by pension funds. *See* Department of Labor Interpretive Bull. 94-1, 29 C.F.R. 2509.94-1 (1997) (permitting such investments as long as they do not "subordinat[e] the interests of participants and beneficiaries in their retirement income to unrelated objectives"). House Bill 1594, which passed the House on September 12, 1995, but died with the 104th Congress, would have nullified this Interpretive Bulletin: "It is the sense of the Congress that it is inappropriate for the Department of Labor . . . to take any action to promote or otherwise encourage economically targeted investments [ETIs]." *See generally* Alvin D. Lurie, *ETIs: A Scheme for the Rescue of City and Country with Pension Funds*, 5 CORNELL J.L. & PUB. POL'Y 315 (1996) (discussing the debate between the House of Representatives and the Department of Labor over ETIs); Edward A. Zelinsky, *ETI, Phone the Department of Labor: Economically Targeted Investments, IB 94-1 and the Reincarnation of Industrial Policy*, 16 BERKELEY J. EMP. & LAB. L. 333 (1995) (criticizing the Department of Labor's position on ETIs).

376. *See* Glenn Collins, *S.E.C. Allows Priests' Bid for Vote on Nabisco Spinoff*, N.Y. TIMES, Jan. 3, 1996, at D3, *available in* LEXIS, News Library, Nyt File.

377. See GEORGE BERNARD SHAW, MAJOR BARBARA 25-26 (Dan. H. Lawrence ed., Penguin Books 1957) (1907) (preface), declaring:

> [The Salvation Army] would take money from the devil himself and be only too glad to get it out of his hands and into God's. . . .
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> . . . [The Army] must take the money because it cannot exist without money, and there is no other money to be had. Practically all the spare money in the country consists of a mass of rent, interest, and profit, every penny of which is bound up with crime, drink, prostitution, disease, and all the evil fruits of poverty, as inextricably as with enterprise, wealth, commercial probity, and national prosperity. The notion that you can earmark certain coins as tainted is an unpractical individualist superstition.

378. A 1963 study in New York found that because of settlor waivers, only 9% of trust assets (20% of the trusts) were subject to the statutory "legal list" investments. *See* Gordon, *supra* note 92, at 76 n.99.

any income "in any property of any kind except in securities of said Duke Power Company, or of a subsidiary thereof, or in bonds validly issued by the United States of America, or by a State thereof, or by a district, county, town or city."[379]

During the 1960s, congressman Wright Patman held numerous hearings investigating how tax-exempt foundations could be used to further private interests.[380] He called for, among other things, suspending the creation of new foundations, limiting the life of foundations to twenty-five years, imposing a twenty percent tax on foundation income, and requiring that all contributions and capital gains be spent currently.[381] The Patman Report also proposed that a foundation should not be permitted to invest more than three percent of its assets in the stock of any one corporation.[382] The Treasury Department responded with a report in 1965.[383] Far milder than the Patman proposals, but radical nonetheless, the Treasury Report recommended such major legislative changes as prohibiting business dealings between donors and foundations, limiting foundation ownership of voting control of businesses, restricting the deductibility of donor-controlled gifts, and regulating the number of years that donors and their families could serve on governing boards.[384] Several of Treasury's proposals found their way into the Tax Reform Act of 1969.[385]

379. Indenture of James B. Duke Establishing the Duke Endowment, art. 3, Dec. 11, 1924, *in* LEGAL INSTRUMENTS OF FOUNDATIONS 91, 94 (F. Emerson Andrews ed., 1958). Similarly, the Kellogg Trust declared: "The trustees are authorized to hold and retain all shares of stock of said Kellogg Company at any time constituting a part of the trust estate, it being the intention that said shares of stock at all times shall constitute a proper investment by the trustees." W.K. Kellogg Foundation: Provisions of Trust Agreement, art. 4.05, *in* LEGAL INSTRUMENTS OF FOUNDATIONS, *supra*, at 112.

380. *See* HALL, *supra* note 39, at 70-71.

381. *Id.* at 71.

382. *See* Ronald E. Gother, *Analysis and Criticism of the Treasury Proposal to Limit Stock Ownership by Private Foundations*, 13 UCLA L. REV. 1017, 1019 & n.9 (1966) (citing CHAIRMAN'S REPORT TO THE HOUSE SELECT COMMITTEE ON SMALL BUSINESS, 88TH CONG., 2D SESS., TAX-EXEMPT FOUNDATIONS AND CHARITABLE TRUSTS: THEIR IMPACT ON OUR ECONOMY, THIRD INSTALLMENT 133 (Comm. Print 1964)). In 1950, the House would have adopted a 50% limit on the percentage of stock a foundation could own along with the family controlling the foundation, but the plan was rejected by the Senate. *See id.* at 1018. In 1995, the Reece Report suggested a 5% or 10% limit. *See id.* at 1018-19.

383. TREASURY DEPARTMENT REPORT ON PRIVATE FOUNDATIONS, PRINTED FOR USE OF THE HOUSE COMM. ON WAYS & MEANS, 89TH CONG., 1ST SESS. (Comm. Print, Feb. 2, 1965).

384. *Id.* at 36-37, 41-45, 56-57.

385. *See, e.g.*, Tax Reform Act of 1969, Pub. L. No. 91-172, § 101, 83 Stat. 487, 507-11 (1969) (codified as amended at I.R.C. § 4943 (West 1997)) (imposing taxes on foundations' "excess business holdings"); *id.* § 201, 83 Stat. at 556-58 (codified as amended in I.R.C. § 170) (disallowing deduction for certain foundation contributions).

These limitations apply only to private foundations, and not to universities, hospitals, or other "public" charities.[386]

As just illustrated, under prior law, a donor could, and often would, endow the foundation with voting stock in his closely held corporation.[387] This preserved control in the hands of the founder (and the trusted foundation managers).[388] Nor would the controlled foundation make untoward demands for dividends from the corporation.[389] The 1969 Act requires private foundations to divest control stock, thereby permitting them, generally, to own no more than twenty percent of an unrelated business (reduced by the percentage owned by "disqualified persons").[390] However, this rule ignores any ownership interest not exceeding two percent of a company.[391] Thus, if the company is big enough, a foundation can be invested 100 percent in it without violating section 4943 of the Internal Revenue Code.[392] Separately, though, Code section 4944 imposes tax on in-

386. *Id.* § 101, 83 Stat. at 492, 496-98 (codified as amended at I.R.C. § 509). The Tax Reform Act of 1969 also contained restrictions on political activities by private foundations and public charities. *See id.* § 201, 83 Stat. at 561-62 (codified in amendments to I.R.C. §§ 2055, 2106, 2522).

387. *See supra* notes 380-386 and accompanying text. As of the end of 1968, stock in which the donor and his family owned at least 20% "accounted for 44 percent of all contributions to foundations and 70 percent of the contributions to foundations with over $100 million in assets." FOUNDATIONS, PRIVATE GIVING, AND PUBLIC POLICY: REPORT AND RECOMMENDATIONS OF THE COMMISSION ON FOUNDATIONS AND PRIVATE PHILANTHROPY 72 (1970). In some cases, foundations were endowed with, and remained invested in, "specific assets in the form of land, buildings, or mineral rights." WALDEMAR A. NIELSEN, THE BIG FOUNDATIONS 279 (1972).

388. For example, as of 1968, $482 million of the Duke Endowment's $629 million in assets remained in Duke Power Company stock, representing a 55% interest. NIELSEN, *supra* note 387, at 184. Duke Power was also heavily represented on the foundation's board. *Id.* In 1963, the North Carolina Supreme Court denied the trustee's petition to revise the investment provisions of the trust indenture in order to permit diversification into other equities and not just government bonds. *See* Cocke v. Duke Univ., 131 S.E.2d 909, 922 (N.C. 1963). Because of the Tax Reform Act of 1969, however, the court permitted the endowment both to divest itself of excess business holdings and to reinvest in other stocks in order to meet the minimum payout obligation. *See* Davison v. Duke Univ., 194 S.E.2d 761, 777 (N.C. 1973).

389. *See* Thomas Parrish, *The Foundation: "A Special American Institution," in* THE FUTURE OF FOUNDATIONS 7, 28 (Fritz F. Heimann ed. 1973) (quoting Robert Bremner's observation that, before the 1969 Act, "'the foundation was irresistible'").

390. *See* I.R.C. § 4943 (taxes on excess business holdings). Specifically, a foundation can own up to 20% of the voting shares of any one business, reduced by shares held by disqualified persons; if a third party has effective control of the business, the foundation and disqualified persons may together own up to 35%. *See* I.R.C. § 4943(c)(2)(A), (B).

391. *See* I.R.C. § 4943(c)(2)(C).

392. For example, in 1971 over 40% of the Rockefeller Foundation was invested in three Rockefeller oil companies, but held only 1.5% of their stock. *See* NIELSEN, *supra* note 387, at 72.

vestments that jeopardize charitable purposes,[393] which in theory should include an undiversified portfolio.[394] Nevertheless, the Treasury regulations disregard investments gratuitously transferred to the private foundations, and so private foundations holding large concentrations of donor-contributed stock do not violate the jeopardy investment regime.[395]

Moreover, the private foundation excise taxes apply neither to public charities—such as universities—nor to organizations funded like foundations but whose income is dedicated to specified public charities.[396] The seven Wallace foundations (described at the begin-

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393. *See* I.R.C. § 4944. Boris Bittker complained that Congress never explained, either in 1950 or 1969, why it saddled only private foundations, and not publicly supported charities, with this restriction:

> Perhaps it was thought that organizations with widespread public support must function in a glass bowl that will discourage speculative investments, and that the trustees of educational, religious, and medical institutions are so dedicated to their exempt functions that they will avoid excessive risks in the investment of their resources.

Boris I. Bittker, *Should Foundations Be Third Class Charities?*, *in* THE FUTURE OF FOUNDATIONS, *supra* note 389, at 132, 154. Bittker observed that the contrary proposition is equally likely to be true:

> [T]he day-to-day demands of a college, hospital, or church may tug so insistently at the heartstrings of its trustees as to cause them to throw prudence to the winds in a desperate effort to maximize the return on the organization's resources, whereas the trustees of grant-making foundations, having no obligation to meet a weekly payroll, will be inclined to avoid undue risks.

*Id.* at 155.

394. *See* Treas. Reg. § 53.4944-1(a)(2)(i) (as amended in 1973) (indicating that the prudent trustee standard includes the need to diversify); *cf.* Gen. Couns. Mem. 39,537 (July 18, 1986), *concurring in* Tech. Adv. Mem. 86-31-004 (Apr. 14, 1986) (concluding that a highly leveraged investment of 75% of a foundation's assets in a single company of which foundation managers are employees, although less than 2% of the stock, violates section 4944).

395. See the first sentence of Treas. Reg. § 53.4944-1(a)(2)(ii)(*a*) (as amended in 1973).

396. The complex rules governing supporting organizations under Code section 509(a)(3) are beyond the scope of this Article. *See generally* Treas. Reg. § 1.509(a)-4 (as amended in 1981). *See also* Ron Shoemaker & Bill Brockner, *Public Charity Status on the Razor's Edge: IRC 509(a)(3) and the Complexities of the Operated in Connection with Integral Part Test, and Miscellaneous IRC 509(a)(3) Issues*, *in* 1996 (FOR FY 1997) IRS EXEMPT ORGANIZATIONS CPE TECHNICAL INSTRUCTION PROGRAM TEXTBOOK, pt. I, ch. I, at 105-30; Rochelle Korman & William F. Gaske, *Supporting Organizations to Community Foundations: A Little-Used Alternative to Private Foundations*, 10 EXEMPT ORG. TAX REV. 1327 (1994); John F. Reilly & David W. Jones, *Basic Determination Rules for Publicly Supported Organizations and Supporting Organizations*, *in* 1992 (FOR FY 1993) IRS EXEMPT ORGANIZATIONS CPE TECHNICAL INSTRUCTION PROGRAM TEXTBOOK, pt. I, ch. J, at 216-47.

These rules contain a prohibition on direct or indirect control by "disqualified persons," including substantial contributors to the organization. I.R.C. § 509(a)(3)(C); Treas. Reg. § 1.509(a)-4(j). Finding indirect control, the IRS denied supporting- organization status to an entity having a four-member board of directors, one of whom was a substantial contributor and two of whom were employees of a business corporation of which more ning of this Article)[397]—initially funded with Reader's Digest Association nonvoting stock and established to support seven charities including the Metropolitan Museum of Art and Lincoln Center—enjoy classification as such "supporting organizations."[398] By contrast, the two main Wallace foundations (which are private foundations) are required by law to divest themselves of their control of Reader's Digest Association voting stock by the year 2000.[399]

5. *Conclusion.*—In most states, prudence generally requires diversification,[400] but the donor's instructions trump[401] (except for a private foundation's excess business holdings). As the Wallace foundation's woes illustrate, however, donor direction to concentrate in-

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than 35% of the voting power was owned by that substantial contributor. Rev. Rul. 80-207, 1980-2 C.B. 193.

397. *See supra* notes 18-22 and accompanying text.

398. *See I.R.S. Publication 78 (Cumulative List of Organizations Exempt Under Section 501(c)(3))*, <http://www.irs.ustreas.gov/prod/bus_info/eo/eosearch.html//>.

399. *See supra* note 22 and accompanying text. Under a grandfather rule in Internal Revenue Code section 4943, the DeWitt Wallace-Reader's Digest Fund and the Lila Wallace-Reader's Digest Fund may continue to hold no more than 50%. *See* I.R.C. § 4943(c)(4)(A)(i) (West 1997). The funds reduced their holdings to over 70% in 1992, and announced plans to reach the 50% target by increasing the percentage owned by the Reader's Digest Employee Stock Ownership Plan to 20%. *See Offering of Reader's Digest Voting Stock Priced at $48.00 Per Share*, PR NEWSWIRE, Mar. 5, 1992, *available in* LEXIS, News Library, Prnews File. In February 1998, several of the supporting organizations were authorized to sell additional stock in the form of a hybrid security, for only 75% of the market value but carrying a three-year entitlement to any declared dividends and a portion of appreciation during that period. *See Reader's Digest Completes Successful Secondary Hybrid Equity Offering Involving Six Charitable Organizations*, BUS. WIRE, Feb. 13, 1998, *available in* LEXIS, News Library, Curnws File. Until this offering, about 51% of the assets of the selling supporting organizations comprised Reader's Digest nonvoting stock. *See* Stehle, *supra* note 22, at 21. Two of the supporting organizations declined to participate. *See* Geraldine Fabrikant, *Faith Ebbs on Reader's Digest Stock*, N.Y. TIMES, Jan. 16, 1998, at D1, *available in* LEXIS, News Library, Nyt File ("Saying no to the deal are two wealthy institutions with hefty endowments: the Metropolitan Museum of Art and Colonial Williamsburg. . . . 'We think the potential value of the stock is higher,' said William Leurs, president of the Metropolitan Museum. 'And we don't need the cash that much right now.'").

400. See, for example, Duronio, *supra* note 371, at 34:

> The diversification requirement [in the *Uniform Prudent Investor Act*] likely will make life somewhat more difficult for fiduciaries of charitable entities holding large amounts of a donor's family business. In some states, such as Pennsylvania, diversification is not required, with the result that the fiduciaries could usually justify holding the family business interests (subject to the private foundation rules on excess business holdings), but retention will be much more difficult in the future under the prudent investor standard.

401. *See* Sara Stadler, *An Investment Model for the Future*, CONN. L. TRIB., Mar. 10, 1997, at 20 ("Unless the underlying document authorizes or directs the fiduciary to maintain certain assets or, because of special circumstances, the purposes of the trust are better served without their diversification, the [*Uniform Prudent Investor Act*] imposes a duty to diversify investments."); *see also supra* note 356 (describing the Act).

vestments in donor-company stock cannot be justified as being solely in the best interests of the charity's beneficiaries.[402] It is time for the law to declare affirmatively that diversification is a necessary component of the charity fiduciary's duty of care.[403] Imposing an obligation to diversify—at both the state and federal levels, for both private foundations and publicly supported charities—would be a welcome signal to the philanthropic world that the beneficiaries' interests take precedence over the donor's desire to place her family business in friendly hands.[404]

### D. *Foundation for New Era Philanthropy: Fundraising Desperation*

From a legal scholar's perspective, the unhappy saga of the Foundation for New Era Philanthropy presents that rare case: a likely extraordinary breach of the duty of care—multiplied by the dozens—untainted by any hint of a breach of loyalty or complex business judgment. Will state regulators have the stomach to find charity trustees liable for the consequences of their gross negligence or nonfeasance?

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402. According to a former chief investment officer of the Ford Foundation: "'The first rule of investing is to diversify, the second rule of investing is to diversify, and the third rule of investing is to diversify . . . . Nobody in their right mind . . . would have all their assets in a single stock.'" Marina Dundjerski & Holly Hall, *Lilly Now No. 1 Among Foundations*, CHRON. PHILANTHROPY, Jan. 29, 1998, at 1, 11 (quoting John English). *See also id.* (noting that while the Lilly Endowment's nearly exclusive investment in Eli Lilly and Company stock now makes it the country's wealthiest foundation, "[i]n 1992, the Lilly company's stock did poorly, causing the endowment's value to tumble from $3.9 billion to $2.9 billion").

403. Similarly, federal law permits an Employee Stock Ownership Plan to invest disproportionately in employer stock. *See* I.R.C. § 4975(e)(7) (West 1997). The law generally requires the plan to permit employees to diversify at least 25% of their accounts when they reach age 55 (and 50% for their last election). *See* I.R.C. § 401(a)(28)(b). These rules should be revisited for the same reason: to ensure that trustees act out of undivided loyalty for the beneficiaries.

404. Again, this is one area where attorney-general jawboning might exert force even in the absence of a specific statute. For example, lack of diversification was one of the objections raised by the California Attorney General to the proposed (and now-abandoned) conversion of Sharp Memorial Hospital in San Diego:

> Were one to assume this to be a real joint venture proposal, it would, in our view, raise serious issues of imprudent investment. We doubt that it is ever prudent for a non-profit public benefit *corporation to invest virtually all of its assets* in a single investment, let alone [a for-profit limited liability company] in which it is not the managing partner, which has virtually no capital appreciation potential, which is virtually unmarketable after three years, and which yields a return which the charity itself projects at well below the expected rate of return for a properly-managed portfolio.

Letter from James R. Schwartz, California Deputy Attorney General, to John F. Walker, Jr. 5 (Nov. 8, 1996) (on file with author).

*The Wall Street Journal* broke the story, with a May 15, 1995 cover story subtitled "Some Say Matching Grants by New Era Foundation Resemble Ponzi Scheme."[405] Created by John Bennett in 1989, the Foundation for New Era Philanthropy had been inviting selected charities to contribute funds—but only for a short period.[406] At the end of six months, New Era would return the "contributed" amount, plus a matching amount of money from anonymous donors.[407] The six-month deposit, New Era said, would generate income to defray operating expenses. The article disclosed storm clouds, however. Prudential Securities Inc. had just sued New Era for failing to repay a loan secured by the charities' "contributions,"[408] and the *Journal* also reported that "suspicion is growing that the anonymous group of philanthropists who supposedly provide the matching funds doesn't really exist."[409] Claimed Andrew Cunningham, New Era's outside auditor: "'There is so much widespread cynicism in the world that people cannot accept that there's a wealthy philanthropist who has a net worth in the hundreds of millions who is willing to give away substantial amounts and get no credit for it.'"[410]

Quite to the contrary. Hundreds of millions of dollars poured in from about 180 charities—as well as from about 150 individual donors, including such wealthy businessmen as John C. Whitehead (former co-chairman of Goldman Sachs), Laurance Rockefeller (brother of David), and John M. Templeton, Jr. (son of the mutual-funds manager), whose contributions to other charities were also to be doubled. Participating charities praised the program, and passed the word, because New Era had always come through as promised. New Era's 1989 contributions of $306,000 exploded to about $100 million in 1994. (The *Journal* compared that figure to the Rockefeller Foundation's 1994 grants of $95 million.)[411]

According to this first story, many of the participating charities claimed to have first conducted "'due diligence' checks on New Era through references and financial records, including federal tax re-

405. Steve Stecklow, *A Big Charity Faces Tough New Questions About Its Financing*, WALL ST. J., May 15, 1996, at A1, *available in* 1995 WL-WSJ 8711270 [hereinafter Stecklow, *Big Charity*].

406. *Id.*

407. The article opened with a story about the University of Pennsylvania. After a trustee endorsed the program and the University learned that two Philadelphia museums received double their money, the University deposited $600,000 and, as promised, received back $1.2 million six months later. *Id.*

408. *Id.*

409. *Id.*

410. *Id.*

411. *Id.*

turns."[412] The *Journal*, however, wondered why New Era's 1993 tax return declared income of only $33,788 on $41.3 million in contributions, which were supposed to be invested in Treasury bills and certificates of deposit. Furthermore, New Era showed only $31,821 in liabilities, describing funds received from other charities for doubling as contributions to itself.[413] Evidently, "[s]ome nonprofit groups seem concerned that if they raise too many questions about New Era they might lose the opportunity to participate."[414] Albert Meyer, an accounting professor at Spring Arbor College, fought against his school's participating in this "Ponzi scheme," and wrote to the Internal Revenue Service, the Securities and Exchange Commission, and the Pennsylvania Attorney General.[415] His unappreciative president stated, "I have indicated to [New Era's] Mr. Bennett that Albert's actions should in no way be interpreted as coming from Spring Arbor College."[416] However, it was Meyer's tip that cut the scheme short; the SEC's prompt investigation triggered Prudential Securities to inquire where New Era's funds had gone.[417]

The next day, the *Journal*'s front-page cascading headlines told it all: "Crumbling Pyramid: Owing $500 Million, New Era Charity Seeks Refuge from Creditors: Mystery Donors Don't Exist, Founder Tells His Staff; Colleges Face Big Losses—A Hard Blow to Good Works."[418] Details emerged: The Coalition of Christian Colleges and Universities hoped to double $350,000; the Academy of Natural Sciences, in Phila-

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412. *Id.*

413. *Id.* Indeed, New Era's 1993 tax return was its first tax filing. *See* Steve Stecklow, *False Profit: How New Era's Boss Led Rich and Gullible into a Web of Deceit*, WALL ST. J., May 19, 1995, at A1 [hereinafter Stecklow, *False Profit*]. Nor did New Era register with the Pennsylvania charities bureau until 1993. *See id.*

414. Stecklow, *Big Charity*, *supra* note 405.

415. *See also* Barbara Carton, *Unlikely Hero: A Persistent Accountant Brought New Era's Problems to Light*, WALL ST. J., May 19, 1995, at B1, *available in* 1995 WL-WSJ 8712690 ("Mr. Meyer told his wife he was going to 'test the limits of tenure.'").

416. Stecklow, *Big Charity*, *supra* note 405.

417. The SEC subsequently accused Bennett of selling unregistered securities, as well as diverting over $4 million from New Era to private companies he controlled. *See* SEC v. Bennett, 889 F. Supp. 804, 806 (E.D. Pa. 1995) (mem.); SEC v. Bennett, 904 F. Supp. 435, 436 (E.D. Pa. 1995) (mem.); *see also* L. Stuart Ditzen & Daniel Rubin, *SEC: Bennett Diverted $4.2 Million*, PHILA. INQUIRER, May 19, 1995, at A1 (chronicling the numerous organizations from which Bennett diverted the funds). Later figures show a diversion of at least $6.6 million. *See* Steve Stecklow, *Trustee's Filing Identifies 46 Creditors That Made Money Before New Era's Fall*, WALL ST. J., June 19, 1995, at A2, *available in* 1995 WL-WSJ 8730231 [hereinafter Stecklow, *Trustee's Filing*] (quoting George L. Miller, an accountant working with New Era's bankruptcy trustee, as stating that $6.6 million in New Era's funds had been transferred to an entity controlled by Bennett).

418. Steve Stecklow, *Crumbling Pyramid: Owing $500 Million, New Era Charity Seeks Refuge from Creditors*, WALL ST. J., May 16, 1995, at A1, *available in* 1995 WL-WSJ 8711671.

delphia, had deposited \$2.7 million—over one-tenth of its endowment.[419] New Era's attorney asked the bankruptcy court to keep the list of creditors under seal, but the court later declined to spare participants this publicity.[420]

The New Era matching-donation program began in the trusting world of churches and evangelical organizations, where founder John Bennett was prominent.[421] John Templeton, a devout Christian, was so favorably impressed with Bennett that he invited him to serve as a director or trustee of twenty-four of the Templeton Funds, but the billionaire mutual-fund manager was falsely listed on tax filings as a New Era board member and was not, as rumored, the mystery donor.[422] As one seminary president described Bennett, "He comes across as a person of sterling character and for the kingdom of God."[423] The seminary encouraged other schools to apply. Its pastor observed: "It will be worst for organizations that hired personnel on the basis of the [anticipated] matches, or those that have done any rebuilding based on what they expect to receive."[424] Near the end, New Era asked for some charities' entire endowments to hold for doubling.[425]

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419. *Id.*

420. *See In re* Foundation for New Era Philanthropy, No. 95-13729F, 1995 WL 478841, at *1, 7 (Bankr. E.D. Pa. May 18, 1995) (mem.); *see also* Julie Stoiber & Daniel Rubin, *Bankruptcy Court Teeming with Lawyers*, PHILA. INQUIRER, May 19, 1995, at A23 ("'We don't want to embarrass all the executive directors who p—ed their charities' money away'" (quoting a lawyer at the proceeding who paraphrased New Era's motion)). Net amounts lost were much smaller. *See supra* note 15.

421. "'It's amazing,'" commented a Big Six accountant with participating clients, "'Anybody who's significant in the evangelical community has been involved in this thing.'" Stecklow, *Big Charity, supra* note 405. Spring Arbor College had recently added \$1 million, one-sixth of its total endowment, to the several hundred thousand dollars already held by New Era. *Id.*

422. *See* Peter Dobrin et al., *New Era Played on Dire Need for Cash, and Nonprofits Swallowed Their Doubts*, PHILA. INQUIRER, May 21, 1995, at A1 (quoting one participant as stating, "I think the reason we and other organizations got sucked into this was that we all really believed this organization was set up by Sir John Templeton to give away \$1 billion . . . . We couldn't figure out where else the money was coming from."); Stecklow, *False Profit, supra* note 413 (describing the relationship between Bennett and Templeton); *cf.* REVISED MODEL NONPROFIT CORP. ACT § 2.02(c) & cmt. 3(b) (1987) ("In nonprofit corporations incorporators sometimes name respected or famous individuals as directors in the hope that they will serve as directors.").

423. Stecklow, *Trustee's Filing, supra* note 417.

424. *Id.*

425. *Id.*

The Pennsylvania Attorney General quickly charged New Era with violating various state nonprofit and charitable solicitation laws.[426] However, as early as July 1993, the Attorney General had received a suggestion to investigate New Era's matching program.[427] New Era had not yet registered with the charities bureau.[428] After a meeting with the Chief Deputy Attorney General, John Bennett registered New Era as a charity, but refused to register as a professional fundraiser, claiming he was merely offering "opportunities." He also worried that he might have to disclose the names of his secret donors.[429] According to the *Journal*, the Attorney General's office closed its investigation because it could not find any complaining donors who lost money.[430] However, the Bureau of Charitable Organizations continued to receive questions about the legitimacy of the matching program, and began an inquiry in early May 1995 when New Era failed to file a properly audited financial statement.[431] A Pennsylvania legislative investigation found that both the Attorney General's office and the Department of State "should have been more vigilant" in the way they registered and tracked New Era, concluding that current state law should have been sufficient to forestall the latter part of the fraud.[432]

A class of bilked charities soon filed suit in federal court against Bennett, New Era's accounting firm, and six people listed by Bennett as members of New Era's board.[433] But what about the "winners— those early participants that doubled their money or received matched donors' contributions? New Era's bankruptcy trustee hopes

426. Gary Putka, *Pennsylvania Seeks to Freeze New Era Assets*, WALL ST. J., May 17, 1995, at A3, *available in* 1995 WL-WSJ 8711980 (describing the Attorney General's action to freeze the assets of both New Era and Bennett).

427. Stecklow, *False Profit*, *supra* note 413 (describing a letter, written in July 1993 on behalf of the International Research Institute on Value Changes, urging the Attorney General to examine New Era).

428. *Id.*

429. *Id.*

430. *Id.* The SEC, as well, found its initial investigation hard going because of lack of cooperation from participants. Said one official: "We were trying to help them, and they didn't want any help, because they thought if we kept quiet they'd be able to double their money." Knecht & Taylor, *supra* note 23 (internal quotation marks omitted).

431. L. Stuart Ditzen & Robert Moran, *Judge Freezes Assets of Failed New Era Foundation*, PHILA. INQUIRER, May 18, 1995, at A1.

432. STAFF REP. TO THE GEN. ASSEMBLY OF THE COMMONWEALTH OF PA., JOINT STATE GOV'T COMM'N, THE COLLAPSE OF THE FOUNDATION FOR NEW ERA PHILANTHROPY 50 (1995).

433. *See* Museum of Am. Jewish History v. Bennett, Civ. Action No. 95-3003, 1995 U.S. Dist. LEXIS 7632, at *6 (E.D. Pa. June 2, 1995) (mem.) (permitting withdrawal of the civil suit, filed May 18, 1995, on the condition that the museum file a motion in the bankruptcy court that the bankruptcy trustee elect to assert or abandon the museum's claims within a short enough time period that, in the event of abandonment, the museum can reassert its claims within the statute of limitations).

to avoid prolonged litigation by asking for charities to return funds voluntarily to help make whole those that lost money.[434] To their shame (or perhaps because they've already spent the money), some are fighting; hundreds of others, however, have complied.[435] Adding the $41 million repaid to the $30 million still on hand and an expected $15-18 million settlement from Prudential Securities, bankruptcy officials are now estimating losses at $100 million.[436] In 1997, Bennett pleaded no contest to federal charges of fraud and money laundering, and he was sentenced to twelve years in prison.[437] The SEC settled its lawsuit against Bennett without seeking civil penalties, on the ground that after returning his remaining $1.5 million in assets to the bankruptcy trustee, he could not pay any penalties.[438]

Turning from Bennett, the perpetrator, to the duped charities, what fiduciary obligations did their trustees and directors breach? Presumably none violated the duty of loyalty. Rather, each was hoping that this was the golden goose that would keep the organization going. However, a violation of the separate duty of care occurs if the

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434. The bankruptcy trustee is also suing New Era's law firm for $100,000 for "aiding and abetting" Bennett. *New Era Trustee Files 2 Lawsuits to Seek Funds*, CHRON. PHILANTHROPY, Feb. 6, 1997, at 32.

435. *New Era Lawsuits Aim to Recoup Funds*, CHRON. PHILANTHROPY, Apr. 17, 1997, at 49 (stating that the trustee has begun to bring suit against the more than 100 groups that did not participate in the group settlement, having already filed 15 suits).

436. *See* Robert Franklin, *Bankruptcy Trustee Wants Grants Repaid*, STAR TRIB. (Minneapolis), Jan. 23, 1996, at 1B, *available in* LEXIS, News Library, Strib File (stating that trustee recently demanded $175 million in "'fraudulent grants'" received by nearly 1300 nonprofits and individuals); *New Era Trustee Reaches Refund Agreement with Landis Homes; May Begin Litigation Against Other Non-Profit Institutions*, PR NEWSWIRE, Dec. 14, 1995, *available in* LEXIS, News Library, Prnews File (indicating that Princeton agreed to return $2.1 million and Harvard agreed to return $467,000 in order to avoid being sued by New Era's bankruptcy trustee); *Princeton and Harvard Are to Return Money*, N.Y. TIMES, Apr. 11, 1996, at A19, *available in* LEXIS, News Library, Nyt File (reporting that 23 organizations have agreed to return a total of $8.5 million to creditors); *Pyramid Scheme*, *supra* note 24 (reporting that hundreds of organizations that profited from New Era have agreed to repay $41 million); Stecklow, *Trustee's Filing*, *supra* note 417 (noting that the latest court filing involves preliminary losses of at least $98 million).

437. *See* United States v. Bennett, Crim. Action No. 96-503, 1997 U.S. Dist. LEXIS 3092, at *2 (E.D. Pa. Mar. 18, 1997) (mem.) (listing some of the 82 counts filed against Bennett); *Charity Chief Sentenced for Part in Ponzi Scheme*, N.Y. TIMES, Sept. 23, 1997, at A23, *available in* LEXIS, News Library, Nyt File; *Head of Bankrupt Charity Fund Pleads No Contest in Fraud Case*, N.Y. TIMES, Mar. 27, 1997, at D17, *available in* LEXIS, News Library, Nyt File (reporting that the prosecutor expects Bennett to be sentenced to 10 to 30 years); Steve Stecklow, *New Era's Bennett Gets 12 Years in Prison for Defrauding Charities*, WALL ST. J., Sept. 23, 1997, at B15, *available in* 1997 WL 14167231.

438. *See Feds Settle Lawsuit Over New Era Scam*, CHATTANOOGA FREE PRESS, Feb. 8, 1998, at A1 (reporting that the SEC reserved the right to seek penalties should the agency discover any hidden assets, and also bars Bennett from again violating securities law, on pain of penalties).

fiduciary fails to exercise the care of a reasonable, prudent person under the circumstances, in good faith and with due diligence.[439]

While we cannot pass a law against greed,[440] these fiduciary standards are supposed to protect charities from their directors' willful stupidity. Perhaps "faith" is the bigger concern. *The Wall Street Journal* observed: "New Era's matching program was glorious news to religious nonprofits, which often don't qualify for grants from major secular foundations. . . . [S]ays Robert Andriga, president of the Coalition of Christian Colleges and Universities, 'It's almost a gift from heaven, in a religious sense.'"[441] Or perhaps this amazing story reveals the desperation born of the competition to survive. Mainstream organizations became involved when word of New Era's performance spread in the Philadelphia nonprofit community. "The city's cozy relationships between institutions became a double-edged sword," observed the *Journal*.[442] "Because of lost money and crippled fund-raising efforts, the city is hoping that corporate leaders will pick up the slack from the New Era void. But many of the leaders are the same people who championed Mr. Bennett and now appear—in hindsight—to have used poor judgment."[443] The *Philadelphia Inquirer* wondered:

> [H]ow could these trustees, many of them so cautious, savvy and worldwise, still give the foundation their millions? How could they believe its claims?

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439. Moreover, Pennsylvania law treats even charity directors as trustees. *See* 15 PA. CONS. STAT. ANN. § 5547(a) (West 1995).

440. Commented one rare skeptic, Tony Carnes, vice president of the nonprofit research group International Research Institute on Value Changes: "'They could just taste the money. I've never seen anything like it. . . . The weakness around the mouth, the desire in the eyes. I've always heard the expression, "You can see greed written," but I've seen the reality.'" Stecklow, *False Profit*, *supra* note 413.

441. *Id.* Mr. Andriga later stated that 14 of the 80 Christian Colleges in the coalition had lost about $25 million in the scheme. *See* L. Stuart Ditzen et al., *New Era to Liquidate, Not Regroup, Bennett's Lawyer: Success 'Unlikely'*, PHILA. INQUIRER, May 20, 1995, at A1 ("'Is it scriptural to sue one another?'" (quoting Andriga)); *see also* David O'Reilly, *New Era's Woes Baffle Religious Groups*, PHILA. INQUIRER, May 17, 1995, at A10 ("Some of the biggest names in Christian philanthropy were Bennett's clients or grant recipients, including Billy Graham's Evangelistic Association, Campus Crusade for Christ and World Vision . . . .").

442. Stecklow, *False Profit*, *supra* note 413. Philadelphia's recent explosion in cultural institutions means many operate "on a shoestring" while individual, corporate, and government contributions are shrinking. William Power, *Philanthropy: Philadelphia Wonders How It Got Fooled by New Era—and What Lies Ahead*, WALL ST. J., May 18, 1995, at B1, *available in* 1995 WL-WSJ 8712448.

443. Power, *supra* note 442.

> The full answer is complex, according to the dozens of trustees and New Era recipients interviewed last week. Boiled down, it was this: *They wanted to believe.*[444]

As Professor Harvey Dale points out, the hard part of the fiduciary liability question is the conflation of fundraising and investing.[445] No trustee or director would have seriously entertained a double-your-money offer in the context of an investment return. But, after all, anonymous donors do exist.[446] Does this mean, though, that the charitable solicitation business should be measured by a different standard from the one that applies to portfolio management? To use the old portfolio management standard, if anything was speculation as opposed to investment, this looks like it. Scoffed Robert O. Bothwell, executive director of the National Committee for Responsive Philanthropy: "[W]hat checks and balances do we have to make certain we give due consideration to reject this outlandish idea of matching grants from heaven?"[447]

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444. Dobrin et al., *supra* note 422 (emphasis added). A lone Cassandra, the president of the Philadelphia Museum of Art became almost a social nuisance. As quoted in *The Wall Street Journal*, Robert Montgomery Scott would ask, "'Show me the prospectus . . . . Show me where the money would go. . . . I've been involved in raising money enough that I know there isn't a wide pool of anonymous donors.'" Power, *supra* note 442. After the scheme collapsed, Scott graciously said, "I feel like the person lucky enough to have missed the Titanic." B.J. Phillips, *Sophisticated Rich . . . Rubes*, PHILA. INQUIRER, May 17, 1995, at C1. Ironically, New Era president John Bennett made his initial reputation in the philanthropy world by running a training program for nonprofit managers. *See* Steve Stecklow, *Payback Time: New Era's Bennett Took Others' Millions; Now He's Giving Back*, WALL ST. J., Jan. 24, 1996, at A1, *available in* 1996 WL-WSJ 3088206.

445. *See* Jennifer Moore et al., *A Debacle for Charities' Credibility*, CHRON. PHILANTHROPY, June 1, 1995, at 1, 29 (quoting Professor Dale as observing that the New Era scheme "'mixed up for the charities the question of how to invest their assets with the question of how to get donations'").

446. As Kevin Kearns puts it: "Should the investors in the New Era fund have taken responsibility for ensuring that the anonymous donors did indeed exist . . . ? How could they have received these assurances as long as there is an accepted practice in philanthropic circles of ensuring anonymity for donors who request it?" KEVIN P. KEARNS, MANAGING FOR ACCOUNTABILITY: PRESERVING THE PUBLIC TRUST IN PUBLIC AND NONPROFIT ORGANIZATIONS 8 (1996). Moreover, the materials prepared by New Era and provided to prospective "beneficiary donors" are thorough and professional, making the offer seem almost plausible. *See* Foundation for New Era Philanthropy Manual (March 1994), *in* Stephen K. Urice, *Non-Traditional Funding Sources: Understanding and Managing Risks: The "New Era" of Investments*, ALI-ABA COURSE OF STUDY MATERIALS: LEGAL PROBLEMS OF MUSEUM ADMINISTRATION 19, 31-82 (1996).

447. Moore et al., *supra* note 445, at 29 (internal quotation marks omitted). Compounding the imprudence, some participants "were so tempted by the promises of matching funds that they borrowed the money to give New Era, and have nothing to show for it but their debt." Sharon Walsh, *New Era Foundation: Red Flags, Red Ink, Red Faces*, WASH. POST, May 20, 1995, at A1, *available in* 1995 WL 2094703.

What procedures would defending fiduciaries need to show they followed? The business judgment rule requires information-gathering, studying, and deliberation.[448] In looking at process, the unusual nature of the arrangement should bar a simple defense that "everybody was doing it."[449] Presumably scale is a factor: How important was the amount staked compared with the enterprise's overall budget? Moreover, a director or trustee who failed to exercise judgment, by definition, falls out of the protection of the business judgment rule. However, with no question of divided loyalty, in the case of a corporate charity, the burden would probably fall on the plaintiff to demonstrate that the director's behavior could not rationally have been in the best interests of the charity.

As discussed above, breach does not necessarily translate into liability. The questions then become whether the fiduciary's action caused the loss, and how great that loss was. Assuming these problems of proof are overcome, for what would the breaching fiduciaries be liable, assuming the organization cannot fully recover its loss from the bankruptcy estate of New Era? What happens if some of these charities are so weakened by losses that they themselves must file for bankruptcy? For those charities that are trusts, the *Third Restatement of Trusts* would measure damages based on the "total return experience (positive or negative) for other investments of the trust in question, or possibly that of portfolios of other trusts having comparable objectives and circumstances."[450] Observes Professor Halbach: "In theory, the extension is also appropriate to the traditionally avowed objective of restoring the trust estate and its beneficiaries to the position they would have been in had the trust been properly administered."[451]

Worst of all, if a charity sent funds to New Era more than once, will the transfers be viewed as separate transactions, so that the trustee

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448. *See supra* Part III.A.

449. Compare Gordon, *supra* note 92, at 71, which notes that in *Chase v. Pevear*, 419 N.E.2d 1358, 1369 (Mass. 1981), the court did not surcharge a trustee for Penn Central stock, because the stock was widely held by other financial institutions. In fact, the "court did not consider the proportion of the questioned investments either to the trust as a whole or to the other investments in the portfolio." Gordon, *supra* note 92, at 71.

450. RESTATEMENT (THIRD) OF TRUSTS (THE PRUDENT INVESTOR RULE) § 205 cmt. a (1992).

451. Halbach, *supra* note 102, at 1182 (citations omitted). Professor Halbach adds:

> Restatement Third's total return rule can be implemented by referring to: (a) The performance of all or relevant parts of the proper investments of the trust in question; (b) the performance of all or suitable parts of the portfolios of comparable trusts; or (c) the performance of some suitable securities index or other benchmark portfolio.

*Id.* at 1183.

cannot offset the eventual loss by the gains the charity earlier enjoyed?[452] The commentary to the *Third Restatement* urges reducing the incentive for multiple breaches: "[A] trustee whose breach of trust has resulted in exceptional profits might be tempted later to take excessive risks if the prior success provided a degree of insulation from surcharge."[453]

If the fiduciaries are liable, can their organizations reimburse them? Can the charity's directors' and officers' liability policy cover this? Is it likely that it does? Any charity that had enacted a monetary shield for directors who breach their duty of care could probably not obtain a money recovery unless the act were intentional or in bad faith, but a few statutes also exclude gross negligence.

Finally, a court can abate or eliminate liability. In the case of a trust, the *Third Restatement* suggests the following: "In the absence of a statute it would seem that a court of equity may have power to excuse the trustee in whole or in part from liability where he has acted honestly and reasonably and ought fairly to be excused."[454]

What if the attorneys general supervising the defrauded charities feel sorry for them—and worry about the political fallout—and so decline to bring suit against their fiduciaries? As discussed in Part II.C, above, it is unlikely that the beneficiaries, donors, or alumni (many were schools and colleges) could instead bring a derivative suit. Apparently, if they could they would: A survey conducted by the *Chronicle of Philanthropy* soon after the scandal broke found, among other things, that of wealthy donors across the country, 60.1% "are very willing to take legal action against a charity's senior officers and trustees for mismanagement."[455]

So do we just leave punishment to the marketplace of donations? Commented the president of the Pew Charitable Trusts: "'It's a dark day for Philadelphia' . . . . 'I'm afraid that people won't trust the ability of nonprofits to manage themselves and will be afraid to give

452. The *Third Restatement* provides:

> A trustee who is liable for a loss caused by a breach of trust may not reduce the amount of the liability by deducting the amount of a profit that accrued *through another and distinct breach of trust; but if the breaches of trust are not* separate and distinct, the trustee is accountable only for the net gain or chargeable only with the net loss resulting therefrom.

RESTATEMENT (THIRD) OF TRUSTS (THE PRUDENT INVESTOR RULE) § 213.

453. *Id.* § 213 cmt. f.

454. *Id.* § 205 cmt. g.

455. Moore et al., *supra* note 445, at 24.

money.'"[456] The *Chronicle of Philanthropy* survey found that 76.9% of donors believed "they need to take greater control over how the money they donate is used."[457] In the end, our laws and legal enforcement mechanism can go only so far. James J. Bausch, president of the National Charities Information Bureau, a private watchdog, expressed his views to the *Chronicle*:

> The fact that a regulator doesn't kick up a big question about New Era doesn't excuse the boards of charities that were involved from questioning the investment of millions of dollars with New Era. . . . You can't enact laws and regulations that lead everybody by the hand to do things they ought to be doing when they take the pledge to be a board member.[458]

Moreover, even totally self-sufficient charities need institutional legitimacy. Worse than no legislation might be bad legislation, and the entire sector, as visible and large as it has become, remains politically vulnerable.[459]

## IV. CONCLUSION

On the eve of the four hundredth anniversary of the monumental Statute of Charitable Uses,[460] we seem no closer to devising a reliable legal mechanism for prodding charitable fiduciaries to carry out their duties. Trustees of charitable trusts and directors of nonprofit corporations operate under legal regimes designed for their proprietary cousins. In the absence of private beneficiaries or shareholders to look after their own interests, however, charity fiduciaries frequently escape accountability for their self-dealing and neglect or mismanagement. Few charities have members endowed with voting rights, and state attorneys general have limited resources to devote to monitoring the nonprofit sector. Similarly, at the federal level, the Internal Revenue Service is a tax collector, not a policing agency (although its new

456. Julia M. Klein & Peter Dobrin, *Cultural Leaders Say Collapse Won't Harm Major Programs*, PHILA. INQUIRER, May 21, 1995, at A19 (quoting Rebecca Rimel, president of the Pew Charitable Trusts).

457. Moore et al., *supra* note 445, at 24 (stating that 97.4% of donors "have less respect for the managerial skills of senior non-profit executives").

458. Elizabeth Greene & Grant Williams, *Asleep on the Watch?*, CHRON. PHILANTHROPY, July 27, 1995, at 1, 36 (internal quotation marks omitted).

459. *See* Brody, *Institutional Dissonance*, *supra* note 25, at 503.

460. Statute of Charitable Uses, 1601, 43 Eliz. 1, ch. 4 (Eng.) (providing a mechanism for the enforcement of charitable trusts); *see also* Fishman, *Development of Nonprofit Law*, *supra* note 44, at 621 & n.19 ("The new procedure was little employed after a period of time and, the importance of the law of charitable trusts lies in the preamble of the statute, which contains an enumeration of charitable purposes." (citation omitted)).

powers to tax "excess benefits" will undoubtedly draw it further into charity operations, akin to its long-standing supervisory role over private foundations).

This Article makes modest proposals for legal reform. First, to avoid degrading the standard of care required of nonprofit directors while eliminating the risk that board service could mean impoverishment, it suggests that we impose a (low) maximum monetary sanction on nonprofit directors for breaches of their duty of care. Injunctive remedies, such as removal, would remain, and such a rule would have no effect on breaches of the duty of loyalty. Second, it suggests that the recent wave of nonprofit hospital sales statutes moves the control of these charities too far from the private discretion of hospital directors and invites too much political risk in the determination of how best to use these assets.[461] Third, it suggests that the duty of care includes an affirmative duty to diversify investments, regardless of donor direction to retain stock in the family business. In the end, however, there are limits to the law. As a result, the charitable sector must improve its own efforts to educate and review the behavior of fiduciaries in order to retain the confidence of the donating public and the independence so cherished by all charities.[462]

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461. Public subsidy is a separate question. Elsewhere, I examine the appropriateness of tax exemption for nonprofit hospitals. *See* Evelyn Brody, Charities in Tax Reform: Threats to Subsidies Overt and Covert (manuscript on file with author).

462. *See, e.g.*, Robert Franklin, *State Foundations Propose Self-Regulation*, STAR TRIB. (Minneapolis), Jan. 27, 1996, at 1B, *available in* LEXIS, News Library, Strib File (reporting that the Minnesota Council on Foundations proposed to its membership the "tightest self-regulation of grant makers in the nation."). *See generally* Brody, *Institutional Dissonance*, *supra* note 25 (highlighting the need for nonprofits to monitor their own efficiency in light of the lack of accountability inherent in the nonprofit form).