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Charity Governance: What's Trust Law Got to Do With It? (symposium)

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CHARITY GOVERNANCE: WHAT'S TRUST LAW GOT TO DO WITH IT?

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INTRODUCTION

The irony of the title of this piece is, of course, that charitable trusts enjoy a longer lineage than the legal form dominant in the United States, the nonprofit corporation. Yet the recognition that charities in this country can take the trust form seems to have either escaped the notice of, or perhaps intimidates, those who study how to improve the governance of nonprofit organizations.[1] We thus find, for example, recommended best practices as to how many directors a nonprofit should have on its board, or the functioning of audit and compensation committees made up of independent directors. Policy makers, too, appear to seek to impose elaborate requirements for the governance of nonprofit corporations, while yielding the field, seemingly without regret, to the possibility of less formalized governance structures, including a single charitable trustee.[2]

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1. While we do not know how many charities today are trusts and how many are corporations, the percentage of trusts is assumed to be small. Section 501(c)(3) makes no distinction between charities based on their organizational form. While the IRS Form 990 does not report organizational form, an informal survey of the IRS Master File database of active Code § 501(c)(3) organizations (other than churches and private foundations) indicates that out of nearly 650,000 total charities, 508,879 are corporations; 12,422 are trusts; and 121,948 are associations. *See* E-mail from Peggy Riley, Statistician, IRS Statistics of Income Division, to Evelyn Brody (Jan. 10, 2005, 15:07 CST) (*on file with author*). Note that churches and small public charities (receipts of normally not more than $5,000) do not have to register with the IRS. I.R.C. § 508(c)(1) (2000).

2. *See, e.g.*, N.Y. ATTORNEY GEN. ELIOT SPITZER, INTERNAL CONTROLS AND FINANCIAL ACCOUNTABILITY FOR NOT-FOR-PROFIT BOARDS (May 2004), *at* www.oag.state.ny.us/charities/internal_controls.pdf. This document begins:

More ironically, at the same time we commonly use the term "trusteeship" to describe what it is that the board of a charity does. Indeed, directors of nonprofit corporations (at least those that are charities) are frequently called "trustees"—either under their state law, their organic documents, or colloquially (including such references by courts, regulators, practitioners, and the press). The common use of the term suggests that we know what we mean by trusteeship. Granted, in the private trust context, the notion of trusteeship has an accepted content, but private trustees merely administer rather than govern. Terminology can affect behavior: For example, Henry Hansmann worries that "if a university trustee asks herself what she is a 'trustee' of, she might naturally conclude that . . . she is a trustee of the endowment fund and that it follows that she has a special responsibility to make certain that the fund is retained intact."[3]

Trust law does appropriately dictate specific aspects of the governance of charities, whether trust or corporate. The definition of charity set forth in the Restatement of the Law of Trusts controls across the board, from inheritance disputes to federal tax law.[4] Investment activity by corporate charities is easily analogized to that of trusts. When it comes to enforcing restrictions on gifts—even those made to corporate charities—regulators and courts commonly apply charitable trust doctrines. These include the authority of the state attorney general to enforce the restriction, and the application of the judicial powers of cy pres and deviation when a modification of the restriction is sought. Indeed, some regulators and courts apply trust doctrine to a corporate charity seeking to change its charitable purpose.[5]

> New York State Attorney General Eliot Spitzer is pleased to offer this booklet to assist current and future boards of directors and officers of New York not-for-profit corporations (and by analogy, trustees of New York charitable trusts and other charitable entities) to understand and carry out their fiduciary responsibilities to the organizations they serve.

Id.

3. Henry Hansmann, *Why Do Universities Have Endowments?*, 19 J. LEGAL STUD. 3, 39 (1990).

4. *See* Treas. Reg. § 1.501(c)(3)–1(d)(2) (2004) ("The term *charitable* is used in section 501(c)(3) in its generally accepted legal sense and is, therefore, not to be construed as limited by the separate enumeration in section 501(c)(3) of other tax-exempt purposes which may fall within the broad outlines of *charity* as developed by judicial decisions.") (emphasis in original); *see, e.g.*, Rev. Rul. 69-545, 1969-2 C.B. 117, 118:

> In the general law of charity, the promotion of health is considered to be a charitable purpose. Restatement (Second), Trusts, sec. 368 and sec. 372; IV Scott on Trusts (3rd ed. 1967), sec. 368 and sec. 372. A nonprofit organization whose purpose and activity are providing hospital care is promoting health and may, therefore, qualify as organized and operated in furtherance of a charitable purpose. If it meets the other requirements of section 501(c)(3) of the Code, it will qualify for exemption from Federal income tax under section 501(a).

5. While both charitable trusts and corporate charities must honor restrictions on gifts, the rules for change of purpose might differ. *See* Am. Law Inst., Principles of the Law of Nonprofit Orgs. ch. 4 (Council Draft No. 1, Oct. 2, 2003) [hereinafter ALI, Nonprofit Law, Council Draft No. 1]. The trust form offers a default requirement to apply to a court for deviation or cy pres in order to modify a re-

In spite of the almost unreflecting invocation of trust law concepts, however, recent and ongoing legal reform projects have not focused on those governance structures and procedures that should apply to trustees of charitable trusts, or on how trust doctrine should apply to corporate governance.[6] In particular, if the law tightens up the requirements for corporate charity governance without addressing charitable trusts, we will likely find charities adopting (or switching to) the trust form in order to avoid requirements newly imposed on nonprofit corporations.[7]

By continuing to make distinctions based on organizational form rather than structure and operations, moreover, we might be asking the wrong questions. To what extent do trusts and corporations have irreducible legal differences? Instead, does it make better sense to classify charities by a metric other than legal form? Consider—

A. Separate Entity

Under the traditional common law, a trust is not an entity—rather, a trust is viewed as a relationship between the settlor and the trustee to use specific property for a designated purpose. By contrast, the fiduciaries of a corporate charity are separate from the legal personality of the charity. Accordingly, for example, a corporate charity could be liable for a breach

striction, while the corporate form generally offers greater board autonomy to adjust to unanticipated circumstances (with protection for restricted gifts). *See id.* at § 240 (Change in Charitable Purpose); § 245 (Consequences of Change in Charitable Purpose); § 430 (Procedures When Circumstances Require Modification of a Restriction); § 440 (Proceeding to Modify a Restriction (Deviation and Cy Pres). *See generally* Evelyn Brody, The Legal Framework for Restricted Gifts: The Cy Pres Doctrine and Corporate Charities (Apr. 2004) (unpublished manuscript, on file with author). For more discussion of the regimes applying to charities of different legal forms, see Evelyn Brody, *The Limits of Charity Fiduciary Law*, 57 MD. L. REV. 1400 (1998). *See also* Evelyn Brody, *Agents Without Principals: The Economic Convergence of the Nonprofit and For-Profit Organizational Forms*, 40 N.Y.L. SCH. L. REV. 457 (1996); Evelyn Brody, *Institutional Dissonance in the Nonprofit Sector*, 41 VILL. L. REV. 433 (1996); Evelyn Brody, *Charitable Endowments and the Democratization of Dynasty*, 39 ARIZ. L. REV. 873 (1997).

6. See the Uniform Trust Code (2000); a major rewriting of the Uniform Management of Institutional Funds Act (final reading postponed until no earlier than 2005); proposed changes to the Revised Model Nonprofit Corporation Act; and enacted revisions to the California nonprofit corporation statute and proposed revisions in New York and Massachusetts, discussed in Dana Brakman Reiser, *There Ought to Be a Law: The Disclosure Focus of Recent Legislative Proposals for Nonprofit Reform*, 80 CHI.-KENT L. REV. 559 (2005). See also the ongoing Restatement (Third) of Trusts project, which has so far issue final volumes in 1992 and 2003; see extended discussion, below, of Council Draft No. 4 (Nov. 10, 2004). See also proposals for reform in the United Kingdom, discussed in Debra Morris, *New Charity Regulation Proposals for England and Wales: Overdue or Overdone?*, 80 CHI.-KENT L. REV. 779 (2005).

7. *Cf.* LARRY E. RIBSTEIN, WHY CORPORATIONS? 2 (Ill. Pub. Law & Legal Theory Research Paper No. 03-11, Sept. 25, 2003), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=451060 (arguing, in the business-organization context, that "new corporate tax rules, increased federal regulation of corporate governance and the changing nature of U.S. business may give firms new incentives to use the partnership form").

of contract or a tort even if the corporate directors have not breached their fiduciary duties to the charity. To a large degree, as described next, this difference is minimized by the trust settlor—and more recently in such modern statutes as the Uniform Trust Code, which offers statutory protection for trustees against claims by third parties similar to that for corporate directors as well as in modern common law.[8]

B. To Whom the Duty Is Owed

Charitable trustees owe their duty to the "charitable purpose"; corporate directors owe their duty to the corporation. Are these statements different? While some observers seek a legal obligation for charity fiduciaries to further social goals even at the expense of a given charity, it should not make a legal difference whether duties are owed to the charitable purpose or to the charity itself. In either case, the fiduciaries must interpret that purpose in light of settlor or donor instruction, but are otherwise free to exercise their discretion. What the trust approach should not suggest, though, is that general societal interests, or charitable goals extraneous to the charity, override the fiduciaries' good faith interpretation of the charity's mission.[9]

C. Fiduciary Standards

It is a common belief that the fiduciary duties imposed on trustees are "stricter" than those imposed on corporate directors. At the same time, the "rules" of a trust are generally determined by the settlor. For example, in general the settlor of a trust may relax fiduciary standards, and may exculpate the trustee from liability for breach of fiduciary duties. Moreover, a charity settlor appears to have as much freedom to modify fiduciary stan-

8. Commentary in the Restatement (Third) of Trusts states:

> Increasingly, modern common-law and statutory concepts and terminology tacitly recognize the trust as a legal "entity," consisting of the trust estate and the associated fiduciary relation between the trustee and the beneficiaries. This is increasingly and appropriately reflected both in language (referring, for example, to the duties or liability of a trustee to "the trust") and in doctrine, especially in distinguishing between the trustee personally or as an individual and the trustee in a fiduciary or representative capacity.

RESTATEMENT (THIRD) OF TRUSTS § 2 (Definition of Trust) cmt. *a* (*Terminology*) & rptr's notes on § 2 cmt. *i* (2003). *See* UNIF. TRUST CODE § 1010 (Limitation on Personal Liability of Trustee) (2003). As clarified in the Comment, this section "does not excuse any liability the trustee may have for breach of trust." *Id.* § 1010 cmt.

9. Am. Law Inst., Principles of the Law of Nonprofit Orgs. § 310 (Duty of Loyalty), at 25 (Council Draft No. 2, Nov. 18, 2004) [hereinafter ALI, Nonprofit Law, Council Draft No. 2] ("Satisfying the duty of loyalty requires the board member to act in a manner that the board member reasonably believes to be in the best interests of the charitable purposes of the organization."). *See also id.* § 310 cmt. *a* (*To whom are fiduciary duties owed?*), at 25–26.

dards as does the settlor of a private trust. While a corporation exists only as provided for in a statute, many corporate requirements are also only default rules that can be overridden by the corporate charter or bylaws. In practical effect, drafters of trust instruments and corporate organic documents can achieve much the same results. Importantly, both trust and corporate law demands certain minimum fiduciary standards that cannot be waived or exculpated, and these minimum fiduciary standards seem to be the same for both charity trustees and directors.

D. Number of Fiduciaries/Size of Board

A trust, even a charitable trust, may have a single trustee. A trustee (whether the sole trustee or a co-trustee) may be an individual or an entity (e.g., a bank or another charity). A trustee may be any person, including the settlor. The typical nonprofit corporation statute requires that the board of directors consist of at least three persons (all individuals).[10] Some states—notably Delaware (which does not have a separate statute for nonprofit corporations)—permit a single director.[11] A director may be the same person as a major donor, and directors may be related to each other. Perhaps the law might better distinguish charities with a single trustee or director (or very small boards) from charities—trust or corporate—with large, independent boards.

E. Duty to Prevent Breach by Co-Fiduciaries

A trustee has a duty to prevent a breach of duty by a co-trustee. A co-director also usually has standing to bring suit against a breaching co-director. The traditional rule is fairly easy to apply in the context of a private trust, whose trustees must only make prudent investments and appropriate distributions. In the case of a charity—trust or corporate—it is not clear how this duty operates in the context of governance, rather than mere administration. Most worrisome is the prospect of a suit for breach of the duty of care brought by an outvoted fiduciary. The duty to prevent breach might best apply one way with regard to explicit donor directions (and perhaps to investments) in both charitable trusts and nonprofit corporations, and another way to charitable trusts and nonprofit corporations with regard to the governance decisions made in running an operating charity.

10. *See* REVISED MODEL NONPROFIT CORP. ACT § 8.02 (1987) (members of a corporate board must be individuals) [hereinafter RMNCA]; *id.* § 8.03 (requiring a minimum of three directors).

11. DEL. CODE ANN. tit. 8, § 141(b) (Michie Supp. 2004) ("The board of directors of a corporation shall consist of 1 or more members, each of whom shall be a natural person. . . .").

F. Summary

In sum, key issues that initially appear unique to trust law on closer inspection turn out to apply to some or all corporate charities, and corporate doctrine might be more appropriate for charitable trusts having an independent governing board of a certain minimum size. In the end, the distinction between "trust law" and "corporate law" might make less sense than identifying what legal principles of governance should apply to charities with multiple, independent fiduciaries, and what (if any) different legal principles should apply to charities governed by only a single fiduciary, or a small number of fiduciaries (particularly if they are related).

I. CHOICE OF LEGAL FORM FOR CHARITY

American law allows for a variety of forms for engaging in charitable activity. These forms might or might not carry different legal consequences, as described below. Creators of a new charity can generally choose between two basic regimes: the nonprofit corporation and the charitable trust.[12] Preference in this country for the corporate form began with the nineteenth-century uncertainty over the validity of charitable trusts.[13] In practice, it must be admitted, rarely does the organizer of a charity carefully consider the legal differences and make a choice based on the advantages of organizational form.[14] American advisers routinely recommend the nonprofit corporate form, although the trust form might be particularly appropriate for a charity (such as a grantmaking foundation) that manages a fund of money and makes designated distributions. As described below, the technical differences between the trust and corporate form for charity are, in practice, minimized by action by the creators and by the existence of

12. Informal or other unincorporated voluntary associations, which traditionally function under the laws of agency and partnership, could expose the participants to personal liability, but the limited liability company form might become popular.

13. *See generally* MARION R. FREMONT-SMITH, FOUNDATIONS AND GOVERNMENT 37–38 (1965) [hereinafter FREMONT-SMITH, FOUNDATIONS AND GOVERNMENT] (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); MARION R. FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS: FEDERAL AND STATE LAW AND REGULATION (2004) [hereinafter FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS]. *See also* NORMAN I. SILBER, A CORPORATE FORM OF FREEDOM: THE EMERGENCE OF THE MODERN NONPROFIT SECTOR (2001).

14. Institutional forces might be evén more important than history: the professional training of charity advisors (particularly attorneys) leads to conformity of organizational form. Today, filing a certificate of incorporation for a nonprofit corporation is ordinarily just one item on the checklist for setting up a new charity. If, however, the charity is established as part of a will, the estate lawyer might pick the more familiar trust form. Moreover, trustees often incorporate after the initial trustees have moved on.

charity regulations—notably the requirements for federal tax exemption—that apply regardless of organizational form. Fiduciary duties, too, are conforming to the corporate standard—under longstanding practice by drafting, and more recently by law.

A. Differences in Creating and Maintaining Status

The process for constituting a charity varies by form. Traditionally, the trust could 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. If the beneficiaries are indefinite and the trust has a charitable purpose, the charitable purpose may exist in perpetuity. A charitable trust formed by will typically is filed with an equity court (sometimes termed chancery court, probate court, surrogate's court, family court, or widow's and orphan's court). A corporation, by contrast, requires the grant of a legislative charter in order to obtain such characteristics as perpetual life. Under modern nonprofit corporation law, corporate charities typically obtain their certificate of incorporation from the state secretary of state's office.

Once a charity has formed, it might have filing obligations. Testamentary charitable trusts commonly file accounts with the court. A nonprofit corporation, like other corporations, typically files an annual report with the secretary of state that is usually quite perfunctory. In some states, additional registration and filing obligations depend on whether the charity is a trust or a corporation, and the type of charity (e.g., churches or universities might be exempt).[15]

Despite any state-level differences between trusts and corporations, the federal tax regime imposes a uniform set of requirements on all charities regardless of organizational form. After all, while few charities are chartered by Congress, most charities desire tax-favored treatment for themselves and for their contributors. Once a charity obtains recognition of federal income-tax exemption under Internal Revenue Code section 501(c)(3), the charity must make publicly available its exemption application—which includes organizing documents (whether articles of incorpora-

15. Some states require charities to make filings with the attorney general. FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS, *supra* note 13, at 315–17. Sometimes, as in the Model Nonprofit Corporation Act, the attorney general's enhanced supervisory role is limited to corporate charities, such as when they seek to engage in an extraordinary transaction, such as a merger, liquidation, or sale of all of the assets. *See id.* at 318–21. More commonly, those charities that solicit charitable contributions are subject to a separate registration and reporting regime. *See id.* at 370–74. Finally, charities operating in specific industries might be subject to the oversight of such government agencies as the Department of Education or the Commissioner on Insurance. *See id.* at 364–70.

tion, trust instrument, constitution, or other)—as well as its annual tax filings.[16] Nevertheless, governance differences based on organizational form apparently exist: The Internal Revenue Service, despite the absence of specific authority, reportedly conditions recognition of charity exemption on such indicators of good governance as a minimum of three members (or even more) of the governing board,[17] but the Service evidently applies no such minimum to charitable trusts.

B. *Overview of Application of Trust Law to Nonprofit Corporations*

A separate question from the procedures that attend the choice of organizational form is the substantive legal effect of this choice. As described in the drafts of the American Law Institute's project on Principles of the Law of Nonprofit Organizations, legal form does not automatically lead to divergent legal results. Indeed, the draft Principles specify issue-by-issue where they apply equally to all charities regardless of their organizational form, or, by contrast, where different results obtain for charitable trusts and for nonprofit corporation charities. Among the most important potential differences between charitable trusts and nonprofit charitable corporations are fiduciary standards and consequences for breach; the definition of charity, and the degree of decisional autonomy for the governing board over restricted gifts and charitable purposes; and supervisory regimes. In these three important areas, however, trust and corporate law have been conforming, with the general result that corporate standards of loyalty and care are being applied to fiduciaries, whether trustees or directors; trust doctrine is being applied to changes in restrictions on gifts; and regulators have the same enforcement powers regardless of organizational form.[18]

The Restatement (Third) of Trusts, which is being drafted and issued as portions are completed, does not contain a comprehensive statement addressing the application of trust law to corporate charities.[19] The Re-

16. I.R.C. § 6104(d) (2000).

17. The Service also reportedly looks for a certain percentage of independent directors to balance the directors who are financially interested or related. *See, e.g.*, IRS Exemption Denial Letter 20044033E (Apr. 5, 2004), available in LEXIS, Fedtax Library, TNT File as 2004 TNT 201-47 (Oct. 18, 2004) ("Since all three members of your original board were related and receiving compensation, we asked you to expand your board of directors by three to four non-related members of the community."). *See also* Treas. Reg. § 1.170A-9(e)(3)(v) (2004) (For nonprivate foundation status under the "10-percent facts and circumstances test," the IRS will take into account the "fact that an organization has a governing body which represents the broad interests of the public.").

18. *See* ALI, Nonprofit Law, Council Draft No. 1, *supra* note 5, § 200 (Choice of Form) gen. cmts., at 14–16.

19. Final volumes of the Restatement (Third) of Trusts have been published in 1992 (covering prudent investing) and in 2003 (in two volumes covering, among other topics, the nature and types of

statement (Second) of Trusts declared generally that "[o]rdinarily the principles and rules applicable to charitable trusts are applicable to charitable corporations."[20] The Second Restatement's comment also observed:

> On the other hand, some of the rules applicable to charitable trusts are not applicable to charitable corporations. Thus, if property is bequeathed to a charitable corporation, the income to be used for one of its charitable purposes, it is not subject to a statutory rule requiring accountings in a probate court which is applicable to charitable trusts. So also, where a liability is incurred to a third person in the carrying out of the charitable purpose, the remedy of the third person, if charities are not immune from liability, is different in the case of a charitable corporation from what it is in the case of a charitable trust; in the case of a charitable corporation an action can be maintained against the corporation, whereas in the case of a charitable trust the property can be reached, if at all, only through an action against the trustees. See §§ 402, 403. So also, the founder of a charitable corporation may have a visitorial power which is not applicable to charitable trusts.[21]

As to governance, the most basic formal distinction is that in the traditional charitable trust, no separation exists between oversight and management. Trustees owe fiduciary duties to the beneficiaries, whereas corporate directors owe their duties to the corporation; however, in the case of a charitable trust, which generally cannot have ascertainable beneficiaries who can enforce their rights, the duty is instead said to run to the charitable purpose.[22] In addition, because formally the trust is not an entity separate from the trustee, a suit by a third party would be brought against the trustee. When the charitable trustee governs an ongoing charitable program rather than just administers a fund for limited purposes, fiduciary liability is of particular concern. An entity approach to the charitable trust permits a separation of the obligations of the charity to third parties from the obligations of the fiduciaries to the charity.[23] Ensuring that liability falls on the

trusts, the definition of charity (§ 28), and the doctrines of cy pres (§ 67) and equitable deviation (§ 66)). Discussion of the current draft of additional provisions is set forth below.

20. RESTATEMENT (SECOND) OF TRUSTS, § 348 cmt. *f* (1959).

21. *Id.*

22. In the context of a charitable trust, the draft Restatement (Third) of Trusts declares:

> Although the commentary hereafter often refers only to trust "beneficiaries," the Section and commentary apply to *charitable* as well as private trusts, with the power to avoid transactions or to seek other relief residing in the appropriate attorney general or others having standing to enforce the trust (§ 94).

Restatement (Third) of Trusts, § 78 (Duty of Loyalty) gen. cmt. *a* (*The trustee and the trust relationship*), at 157 (Council Draft No. 4, Nov. 10, 2004) [hereinafter Restatement (Third) of Trusts, Council Draft No. 4] (emphasis in original). *See also* ALI, Nonprofit Law, Council Draft No. 2, *supra* note 9, § 310 (Duty of Loyalty) cmt. *a* (*To whom are fiduciary duties owed?*), at 25 (combining the corporate and trust approaches to require the fiduciary to act in the best interests of the charitable purposes of the organization).

23. Recognizing that some courts have applied trust law to directors of nonprofit corporations, the Revised Model Nonprofit Corporation Act declares that a "director shall not be deemed to be a trustee

trust and not the trustee is accomplished (for a private as well as a charitable trust) by requiring suit to be brought against the trustee in his or her representative capacity; personal liability to a third party results only if the trustee entered into a contract without disclosing that capacity or was personally at fault in committing a tort.[24]

An even more basic question than whether trust law should apply to the governance of charitable trusts (and possibly to corporations) is the appropriateness of the charitable trust form for anything but the most basic grantmaking fund. As described below, many charitable trusts operate with a board of trustees and employ a structure that separates governance from management.[25] Consider the recent court-ordered restructuring of the massive Hawaiian charity, the Kamehameha Schools/Bishop Estate ("KSBE"). The probate court directed the trustees, among other things, to terminate their "lead-trustee" governance system and to institute a CEO-based management system. Notably, the court observed that two of the five trustees favored a CEO-based management system, but the majority trustees violated KSBE's stipulation with the Attorney General and the Special Master to establish this structure.[26] As Professor Edward Halbach commented on the operation of KSBE:

> [B]oards of directors, regents, or trustees of hospitals, universities, libraries, and the like regularly are responsible not only for the management and expenditure of endowment funds but also for the active operation of public or quasi-public institutions. Activities conducted in the traditional form of express charitable and private trusts, however, and to which the trust law is primarily directed, are usually confined (as KSBE trustees' duties are not) to investment and distribution functions. (Might a court's equitable deviation power or *cy pres* wisely be used to split the trust into two trusts, or into a trust and a non-profit corporation?)[27]

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." RMNCA, *supra* note 10, § 8.30(e).

24. *See* UNIF. TRUST CODE § 1010 (Limitation on Personal Liability of Trustee) (2003).

25. *See, e.g.*, Bylaws of the Board of Trustees of the Leland Stanford Junior University (June 14, 2002) (filed with the University's form 990 available at www.guidestar.com).

26. Order Regarding Order to Show Cause Regarding Special Purpose Trustees' Report and Order to Show Cause Regarding New CEO Based Management System, *In re* Estate of Bishop, Equity No. 2048 (Haw. Prob. Ct. May 7, 1999) (under "CEO Management Based System"), *available at* http://starbulletin.com/1999/05/07/news/removal.html.

27. Edward C. Halbach, Jr., *Foreword, Symposium Issue on the Bishop Estate Controversy*, 21 U. HAW. L. REV. i, ii (1999). Professor Halbach is the Reporter of the Restatement (Third) of Trusts.

II. ASCERTAINING AND ENFORCING FIDUCIARY DUTIES

A. *Current Standards of Conduct: Duty of Care and Duty of Loyalty*

1. Distinct Legal Forms vs. Distinct Legal Effect: Overview

Many legal scholars have advocated a single set of fiduciary standards applicable to all charities, regardless of organizational form—although the commentators do not always agree on what that single standard is to be.[28] Initial enforcement proceedings suggested that trust fiduciary standards would apply to corporate charities, but instead the general trend is to apply the (business) corporate standard.[29] As Judge Gesell declared in the influential "Sibley Hospital" case:

> [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.
>
> . . . 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.[30]

28. *See, e.g.*, Kenneth L. Karst, *The Efficiency of the Charitable Dollar: An Unfulfilled State Responsibility*, 73 HARV. L. REV. 433 (1960); FREMONT-SMITH, FOUNDATIONS AND GOVERNMENT, *supra* note 13; Henry B. Hansmann, *Reforming Nonprofit Corporation Law*, 129 U. PA. L. REV. 497 (1981); James J. Fishman, *The Development of Nonprofit Corporation Law and an Agenda for Reform*, 34 EMORY L.J. 617 (1985); FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS, *supra* note 13.

29. *See* ALI, Nonprofit Law, Council Draft No. 2, *supra* note 9, § 315 (Duty of Care) cmt. *b* (*Trust versus corporate standard of care*), at 38–39. See also RESTATEMENT (THIRD) OF PROPERTY (Servitudes) § 6.14 (2000), which combines the corporate and trust terminology in adopting the corporate standard for the fiduciaries of homeowners associations:

> The directors and officers of an association have a duty to act in good faith, to act in compliance with the law and the governing documents, to deal fairly with the association and its members, and to use ordinary care and prudence in performing their functions.

30. Stern v. Lucy Webb Hayes Nat'l Training Sch. for Deaconesses & Missionaries, 381 F. Supp. 1003, 1013 (D.D.C. 1974) (mem.) (citations omitted); *accord* Oberly v. Kirby, 592 A.2d 445, 462 (Del. 1991) (giving legal significance to the charity founder's choice of the corporate, rather than the trust, form); 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).

In the absence of bad faith or self-dealing, courts prefer to defer to the business judgment of charity managers;[31] legislatures relax the investment duties of institutional fund managers and the risk of personal liability for trustees;[32] and the Internal Revenue Service generally applies a presumption of reasonableness to the determination of independent board members of public charities in setting compensation and other benefits.[33] Moreover, the modern trust standard—whether because of settlor direction,[34] legislation,[35] or even court decision[36]—less frequently operates more "strictly" than the corporate standard.

It can be difficult simply to state the trust and corporate fiduciary standards. Besides the difference between the standards in theory and the standards as practiced, a difference in terminology can mask the essential similarities.

It is traditional to speak of the twin fiduciary duties of loyalty and care. The Revised Model Nonprofit Corporation Act combines a director's

31. The business judgment rule enjoys wide judicial acceptance in the nonprofit context. In holding that the business judgment rule can be available to a board that properly constitutes a special litigation committee, the Minnesota supreme court stated:

> Other states have applied the business judgment rule to decisions of nonprofit corporations, explicitly or implicitly. The highest courts of Alabama, Hawaii, and South Dakota have done so, as have intermediate appellate courts of Colorado, New York, Ohio, South Carolina, Tennessee, and Wisconsin. We find no case denying a nonprofit organization the protection of the business judgment rule.

Janssen v. Best & Flanagan, 662 N.W.2d 876, 883 (Minn. 2003) (footnote omitted). *See generally* ALI, Nonprofit Law, Council Draft No. 2, *supra* note 9, § 365 (Business Judgment Rule) & cmts. and rptr's notes, at 152–63.

32. *See* UNIF. MGMT. OF INST. FUNDS ACT (1972 and ongoing reform project); RESTATEMENT (THIRD) OF TRUSTS: PRUDENT INVESTOR RULE (1992).

33. *See* Treas. Reg. § 53.4958-6 (2004) (rebuttable presumption that a transaction is not an excess benefit transaction).

34. Marion Fremont-Smith observes: "Modern trust documents invariably include both relief from the strict duties of care and loyalty as well as provisions for exculpation in the event of their breach. Accordingly it is rare that the strict liability embodied in the law of trusts described herein is enforced by a court." FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS, *supra* note 13, at 188.

35. See, for example, the Reporter's Notes in the draft Restatement (Third) of Trusts:

> The present Comment is like recent uniform acts in abandoning the traditional doctrine that a trustee has an absolute duty not to misdeliver trust income or principal. Uniform Trust Code § 1006 (Reliance on Trust Instrument) states: "A trustee who acts in reasonable reliance of the terms of the trust as expressed in the trust instrument is not liable to a beneficiary for a breach of trust to the extent the breach resulted from the reliance." . . . Cf. Uniform Prudent Investor Act § 1(b), protecting a trustee from a liability to the extent the trustee acts in reasonable reliance on the trust provisions.

Restatement (Third) of Trusts, Council Draft No. 4, *supra* note 22, § 76 (Duty to Administer the Trust in Accordance with Its Terms and Applicable Law) rptr's notes on cmt. *f*, at 135–36.

36. *See* John H. Langbein, *Questioning the Trust Law Duty of Loyalty: Sole Interest or Best Interest?*, 114 YALE L.J. (forthcoming 2005) (manuscript at 144) (on file with Chicago-Kent Law Review) [hereinafter Langbein, *Sole Interest or Best Interest?*] (illustrating judicial refusal to apply the "sole interest rule" duty of loyalty: "The courts looked at the merits of this mode of trust investing [in mortgage participations] and preferred the trust beneficiary's best interest over his or her sole interest.").

fiduciary duties into a single provision called "standards of care."[37] If we can break this provision apart, the corporate duty of loyalty arises from the director's duty to act "in a manner the director reasonably believes to be in the best interests of the corporation," and the duty of care arises from the director's obligation to act "with the care an ordinarily prudent person in a like position would exercise under similar circumstances"; overlaying both duties is the obligation to act "in good faith."[38] A trustee owes the beneficiaries the duty of loyalty[39] and the duty of prudence[40] (and the duty of im-

37. The "general standards for directors," set forth in section 8.30(a) of the Revised Model Nonprofit Corporation Act, contains three component requirements:

> A director shall discharge his or her duties as a director, including his or her duties as a member of a committee:
>
> (1) in good faith;
>
> (2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and
>
> (3) in a manner the director reasonably believes to be in the best interests of the corporation.

RMNCA, *supra* note 10, § 8.30(a). As explained in the Official Comment to section 8.30, the drafters intend this standard of conduct to embrace both the duty of care and the duty of loyalty imposed on a nonprofit director. Specific aspects of the duty of loyalty are then developed in sections 8.31 (Director Conflict of Interest), 8.32 (Loans or Guarantees for Directors and Officers), and 8.33 (Liability for Unlawful Distributions).

Fremont-Smith reports that a 1987 survey revealed only ten states with statutory standards of conduct for their nonprofit directors. By January 1, 2003, however, thirty-seven states had adopted a duty of care provision in their nonprofit corporation acts, and six additional states had adopted a duty of care provision in their business corporation act. Twenty-three of these forty-three states follow the three-part articulation in Revised Model Nonprofit Corporation Act § 8.30(a) (which follows the pre-1998 articulation in the Model Business Corporation Act). FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS, *supra* note 13, at 207.

38. Fremont-Smith examines the influence of the Model Act's three-part conception of the nonprofit director's standard of conduct. Her fifty-one-jurisdiction review (including the District of Columbia) found that the "ordinarily prudent person" component appears in thirty-eight of the forty-three statutes articulating a duty of care; that the good faith component appears in forty of the forty-three statutes; and that the "best interests" component appears in the same or modified form in thirty-nine statutes. FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS, *supra* note 13, at 207–08; *cf.* Hillary A. Sale, *Delaware's Good Faith*, 89 CORNELL L. REV. 456 (2004) (arguing that under modern Delaware jurisprudence, the duty to act in good faith is an independent third duty, which may be violated even if the director discharged the duties of loyalty and care).

39. The draft Restatement (Third) of Trusts' "duty of loyalty" begins:

> (1) Except as otherwise provided in the terms of the trust, a trustee has a duty to administer the trust solely in the interest of the beneficiaries, or solely in furtherance of its charitable purpose.
>
> (2) Except in discrete circumstances (Comment *c*), the trustee is subject to a strict prohibition against engaging in transactions that involve self-dealing or that otherwise involve or create a conflict between the trustee's fiduciary duties and personal interests.

Restatement (Third) of Trusts, Council Draft No. 4, *supra* note 22, § 78 (Duty of Loyalty), at 156. Comment *c* describes such exceptions as transactions authorized by the terms of the trust and trustee's compensation. *Id.* § 78 cmt. *c*, at 167, 170. *See also* UNIF. TRUST CODE § 802 (Duty of Loyalty) (2003).

40. The draft Restatement (Third) of Trusts' "duty of prudence" appears in § 77, and begins:

> (1) The trustee has a duty to administer the trust as a prudent person would, in light of the purposes, terms, and other circumstances of the trust.
>
> (2) The duty of prudence requires the exercise of reasonable care, skill, and caution. . . .

partiality among the beneficiaries).[41] Importantly, the draft Restatement (Third) of Trusts grounds the duty of loyalty in the trustee's "duty to administer the trust solely in the interest of the beneficiaries, or solely in furtherance of its charitable purpose."[42] Is acting in furtherance of charitable purpose different from acting "in the best interests of the corporation"? And is "care" different from "prudence"? Indeed, the Revised Model Nonprofit Corporation Act uses the term "prudence" in articulating the duty of care.[43]

Even if the standards for private trusts and business corporations differ, should conformity be sought for charitable trusts and corporate charities? In particular, governing an operating charity—corporate or trust—requires more than administration, and hence more than the exercise of

Restatement (Third) of Trusts, Council Draft No. 4, *supra* note 22, § 77 (Duty of Prudence), at 137. Note that the draft Third Restatement comments:

> More is required than the exercise of reasonable care alone, for a trustee may be liable for losses that result from failure to use the *skill* of an individual of ordinary intelligence, despite [the] use of all the skill the particular trustee possesses. A person who serves as trustee should be reasonably able to understand the basic duties of prudent trusteeship. The practical need in trust law for some objective standard in these matters means that some persons are not properly capable of serving as trustees.

Id. § 77 (Duty of Prudence) cmt. on subsecs. (1) and (2), at 139–40 (emphasis in original).

41. The draft Restatement (Third) of Trusts comments:

> The core of trust fiduciary law is found in §§ 77 through 79—the fundamental standards of fiduciary conduct in trust administration. These three Sections deal, respectively, with the trustee's duties of *prudence* (so fundamental to the investment function and further developed in §§ 90–92), *loyalty* (often called the "cardinal" principle of fiduciary relationships, but particularly strict in the law of trusts), and *impartiality* (balancing the diverse interests and competing claims—concurrently and over time—of the various beneficiaries or objectives of typical modem trusts).

Id. at 112–13 (Introductory Note to Chapter 15, Specific Duties of Trusteeship) (emphases in original). Note that the Third Restatement covers private and charitable trusts in the same sections, so the provisions might be applied differently depending on the type of trust.

42. *Id.* § 78 (Duty of Loyalty), at 156.

43. The comment to § 77 of the draft Restatement (Third) of Trusts provides:

> The duty to act with caution does not, of course, mean the avoidance of all risk but refers to a degree of caution that is reasonably appropriate or suitable to the particular trust, its purposes and circumstances, the beneficiaries' interests, and the trustee's plan for administering the trust and achieving its objectives.

Id. § 77 (Duty of Prudence) cmt. on subsecs. (1) and (2) *b* (*Elements of prudence: care, skill, and caution*), at 141. Compare this to Official Comment 2 to section 8.30 of the Revised Model Nonprofit Corporation Act, which states:

> This familiar language [of ordinary prudence] allows directors of nonprofit corporations to exercise their judgment with due regard to the nature, operations, finances, and objectives of their organizations. The "ordinarily prudent person" concept is used in various contexts. In the context of nonprofit corporations it applies to directors who balance potential risks and rewards in exercising their duties as directors. It is intended to protect directors who innovate and take informed risks to carry out the corporate goals and objectives. The directors need not be right, but they must act with common sense and informed judgment. The duty of care recognizes that directors are not guarantors of the success of investments, activities, programs or grants. It allows leeway and discretion in exercising judgment.

RMNCA, *supra* note 10, § 8.30 off. cmt. *2* (*Duty of Care*).

prudent stewardship over the investment and distribution of assets. The draft Restatement (Third) of Trusts begins the section on "Powers and Duties of Trustees" with: "In administering a trust, a trustee . . . ."[44] Similarly, the Uniform Trust Code labels the trustee's duty of prudence as the duty of "prudent administration."[45] Governing boards may—and perhaps should be encouraged to—take reasonable and appropriate risks rather than simply endeavor to preserve the value of assets.[46] Indeed, the 1998 revision of the standard of conduct for directors in the Model Business Corporation Act deleted the term "prudent" from the formulation of the duty of care for this very reason.[47] The Revised Model Nonprofit Corporation Act was based on the prior version of the Model Business Corporation Act. One state has incorporated the 1998 business-law formulation of the director's standards of conduct into its nonprofit corporation act.[48]

2. Reducing Fiduciary Liability—Subject to Minimum Standards

Both trust and corporate law are enabling regimes, setting forth default rules in the absence of direction to the contrary in the trust instrument or articles of incorporation and bylaws. Well-drafted documents creating charities typically minimize the fiduciaries' risk of liability for breach. However, considerations of public policy set a lower bound on a charity

44. Restatement (Third) of Trusts, Council Draft No. 4, *supra* note 22, § 70 (Powers and Duties of Trustees), at 7. In addition, the draft Third Restatement comments:

> The most important of the discretionary powers in most trusts are those having to do with various aspects of the investment function, together with, in many trusts, those having to do with discretionary distributions, such as a power to invade principal for an income beneficiary or the power to distribute income to a beneficiary or among a class of beneficiaries.

Id. § 87 (Judicial Control of Discretionary Powers) cmt. *a* (*Scope of Section; cross-references*), at 401.

45. UNIF. TRUST CODE § 804 (Prudent Administration) (2003).

46. *See also* John H. Langbein, *Mandatory Rules in the Law of Trusts*, 98 NW. U. L. REV. 1105, 1115 (2004) [hereinafter Langbein, *Mandatory Rules*] ("Trust law discourages investments that require trustees to engage in active entrepreneurship.").

47. *Compare* MODEL BUS. CORP. ACT § 8.30(a)(2) (General Standards for Directors) (1998), *with* MODEL BUS. CORP. ACT § 8.30(b) (Standards of Conduct for Directors) (2002). As explained in the Official Comment:

> In earlier versions of the Model Act the duty of care element was included in subsection (a), with the text reading: "[a] director shall discharge his duties . . . with the care an ordinarily prudent person in a like position would exercise under similar circumstances." The use of the phrase "ordinarily prudent person" in a basic guideline for director conduct, suggesting caution or circumspection vis-à-vis danger or risk, has long been problematic given the fact that risk-taking decisions are central to the directors' role. When coupled with the exercise of "care," the prior text had a familiar resonance long associated with the field of tort law. See the Official Comment to section 8.31. The further coupling with the phrasal verb "shall discharge" added to the inference that former section 8.30(a)'s standard of conduct involved a negligence standard, with resultant confusion. In order to facilitate its understanding and analysis, independent of the other general standards of conduct for directors, the duty of care element has been set forth as a separate standard of conduct in subsection (b).

MODEL BUS. CORP. ACT § 8.30 (Standards of Conduct for Directors) cmt. (2002).

48. *See* W. VA. CODE ANN. § 31E-8-830 (Standards of conduct for directors) (West 2002).

organizer's power to waive fiduciary liability and to relax duties of loyalty and care.[49] Under either trust doctrine or corporate law, a charity founder cannot entirely waive fiduciary duties or the consequences of breach.[50] As the Massachusetts Supreme Judicial Court declared in 1867: "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."[51]

The default rules under corporate law are more relaxed than under trust law. As to the duty of loyalty, a fiduciary may enter into an "interested transaction" with the corporation if certain procedural conditions are satisfied: A properly approved conflict-of-interest transaction requires the interested fiduciary to disclose the material facts, and abstain from the decision; and disinterested board members to exercise their business judgment, in good faith, and on the reasonable belief that the transaction is not just fair, but also in the best interests of the charity.[52]

49. *See generally* ALI, Nonprofit Law, Council Draft No. 2, *supra* note 9, § 320 (Waivers and Exculpations in the Organic Documents), at 47.

50. The draft Restatement (Third) of Trusts comments: "A trustee's duties, like trustee powers, may be modified by the terms of the trust, but the fiduciary duties of trusteeship are subject to certain minimum standards that are fundamental, and normally essential to the trust relationship. . . ." Restatement (Third) of Trusts, Council Draft No. 4, *supra* note 22, § 87 (Fiduciary Duties and the Exercise of Trustee Powers) cmt. *b* (*All powers are subject to trustee's fiduciary duties*), at 377. Thus, in the settlor's grant to the trustee of discretion, "words such as 'absolute' or 'sole and uncontrolled' or 'unlimited' are not interpreted literally." *Id.* § 87 (Judicial Control of Discretionary Powers) cmt. *d* (*Extended discretion: limitations, interpretation, and effects*), at 408. *See also* RESTATEMENT (THIRD) OF TRUSTS, § 29 cmt. *m*, at 66–67 (2003):

> Thus, a provision that purports to prevent a court from removing a trustee will be disregarded if removal appears appropriate to proper administration of the trust; and an arbitrary restriction on the appointment of trustees or successor trustees may be invalid if not reasonably related to the trust purposes. A provision is also invalid to the extent it purports to relieve the trustee altogether from accountability . . . , or to relieve the trustee from liability even for dishonest or reckless acts. . . .

See generally FREMONT-SMITH, FOUNDATIONS AND GOVERNMENT, *supra* note 13, at 433–34; FREEMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS, *supra* note 13, at 188. Public policy would not allow a trustee to be relieved of responsibility for willful and deliberate breaches, gross negligence, or fraud. *See* Report of [A.B.A.] Committee on Charitable Trusts, *Duties of Charitable Trust Trustees and Charitable Corporation Directors*, 2 REAL PROP. PROB. & TR. J. 545, 555 (1967). As Carl Zollmann 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." CARL ZOLLMANN, AMERICAN LAW OF CHARITABLE TRUSTS 424 (1924) (footnotes omitted).

51. Jackson v. Phillips, 96 Mass. 539, 571 (1867).

52. The law has long recognized that it is inappropriate to ban all interested transactions between fiduciaries and the modern nonprofit organization. Such, however, was the traditional trust approach, under which, essentially, the state prohibited any conduct between a charity and its fiduciaries that is hard for an outsider to monitor and judge for fairness. 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 of January 1, 2003, forty-eight states have adopted conflict-of-interest provisions for nonprofit corporate directors (thirty-six in nonprofit corporation statutes, and

Moreover, Professor John Langbein argues that the trust law duty of loyalty should be moved closer to the corporate articulation. He finds that imposing a duty to administer the trust "solely in the interests of the beneficiaries" deprives the trust of transactions that might best serve the trust in situations where the trustee also benefits.[53] Professor Langbein's "reform urged here is to allow a conflicted trustee to defend on the ground that the particular transaction was prudently undertaken in the best interest of the beneficiaries."[54] He observes that his approach would apply only to poorly drafted instruments, given the settlor's power to authorize such transactions; moreover, a trustee can already apply for advance judicial approval of a conflicted transaction (in which case the court will apply the best-interests test).[55]

As to the duty of care, nonprofit directors who are informed, exercise independent judgment, and act in good faith are protected from personal liability under a court-created standard of review called the "business judgment rule." As a result, a director can be found liable for breaching the duty of care only by committing gross negligence (basically, acting recklessly or not in good faith). At the same time, many state nonprofit corporation statutes permit the articles of incorporation to contain a personal monetary "liability shield" for directors who, in good faith, breach the duty of care (but not the duty of loyalty).[56]

another twelve available by reference to business corporation statutes). FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS, *supra* note 13, at 218. Under a variety of processes in these statutes for validating self-dealing transactions with a corporate charity, "the transaction is not voidable by the corporation. In addition, eighteen states and the [Revised Model Nonprofit Corporation Act] provide that upon validation the director may not be held liable to the corporation for damages resulting from the conflict of interest transaction." *Id.* at 219 (footnote omitted). In general, such a transaction will be reviewed for substantive fairness only in the absence of a process requiring decision making by disinterested fiduciaries. Even so, under the federal tax laws, all private foundations are still subject to the strict prohibition on self-dealing, with an exception only for reasonable compensation. *See generally* ALI, Nonprofit Law, Council Draft No. 2, *supra* note 9, § 330 (Interested Transactions and Compensation) & cmts. and rptr's notes, at 68–91.

53. *See* Langbein, *Sole Interest or Best Interest?*, *supra* note 36 (manuscript at 104).

54. *Id.* (manuscript at 161).

55. *Id.* (manuscript at 105).

56. *See generally* ALI, Nonprofit Law, Council Draft No. 2, *supra* note 9, § 370 (Limitations on Monetary Liability for Breach) & cmts. and rptr's notes, at 164–80. *See also* RMNCA, *supra* note 10, Alternative § 2.02(b)(5) (Optional Article Provision); *id.*, § 8.30(d) (General Standards for Directors). Alternative section 2.02(b)(5) permits the articles of incorporation to include:

> (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;

Some default rules in recent trust-law reforms have moved away from absolute liability. Regardless of legislated relief, the settlor of a charitable trust typically includes provisions in the instrument that relieve the trustee(s) of legal duties to the maximum extent permitted; this generally results in a lenient standard like that imposed on corporate directors.[57]

As to the duty of loyalty, a trust settlor may want to relax the traditional proscriptions on dealings between the trustee and the trust, so that transactions make take place if fair to the trust and in its best interests (the corporate standard). However, as articulated in section 105(b)(3) of the

> (iii) for any transaction from which a director derived an improper personal economic benefit . . . .

Id. Alternative § 2.02(b)(5). Correspondingly, alternative section 8.30(d) adds a second sentence to the standard section 8.30(d) (discussed under § 330 (Standards of Conduct for Governing Board and Its Members: Duty of Loyalty and Duty of Care)). Alternative section 8.30(d) thus reads:

> (d) A director is not liable to the corporation, any member, or any 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. Alternative § 8.30(d). Twenty-one states have made available to their nonprofit corporations the option to adopt a liability shield (three in their business corporation statutes, which cover nonprofit corporations). *See* FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS, *supra* note 13, app., tbl. 3 (Fiduciary Duties Under State Laws), at 514–17.

The Revised Model Nonprofit Corporation Act is based on the 1984 Revised Model Business Corporation Act. On the theory 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 moved to permit business corporations to indemnify directors and—usually only upon shareholder approval—to adopt a shield against monetary damages for directors who act in good faith and not out of self-interest. A monetary shield does not alter the standard of care, but rather limits the corporation to nonmonetary remedies such as injunction or removal of the offending director. Limiting the potential cost for duty-of-care breaches to the compensation received might make courts more inclined to uphold standards of care, and can be reconciled with a restitutionary measure of damages. Nonmonetary remedies, such as removal, remain.

The legal question remains whether shareholders of corporations in those states without enabling statutes might nevertheless adopt such charter amendments. The 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. In any case, the contractarian view of charter liability shields is hard to apply to the "principal-less" model of a memberless nonprofit corporation (unless prospective donors are viewed as basing their decision to contribute on the existence of such an amendment to the articles). Indeed, the absence of shareholders suggests that it should be unnecessary to require nonprofit corporations without members to adopt such a charter amendment. Nevertheless, alternate 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 adopting enabling legislation, and, second, on each charity's articles of incorporation. *Compare* RMNCA, *supra* note 10, § 8.30(d), *with* DEL. CODE ANN. tit. 8., § 102 (Michie 2001).

57. The draft Restatement Third of Trusts contains the following comment, which appears to be focused on a private trust:

> A trustee cannot properly hire his or her own family members . . . in the administration of the trust, except as the family member may be a beneficiary of the trust and the employment is consistent with the trust's purposes and beneficial interests, and also with the trustee's duty of impartiality (§ 79).

Restatement (Third) of Trusts, Council Draft No. 4, *supra* note 22, § 78 (Duty of Loyalty) cmt. *e(1)* (*Undivided loyalty: employing trustee's family members*), at 186–87. It is not clear whether the general policy to defer to the terms of the trust would differ on this issue in the context of a charitable trust.

Uniform Trust Code, the terms of the trust cannot override "the requirement that a trust and its terms be for the benefit of its beneficiaries . . . ."[58] Similarly, the draft Third Restatement comments:

> Even express authorization . . . would not completely dispense with the trustee's underlying fiduciary obligations to act in the interest of the beneficiaries and to exercise prudence in the administering the trust. Accordingly, no matter how broad the provisions of a trust may be in conferring power to engage in self-dealing or other transactions involving a conflict of fiduciary and personal interests, a trustee violates the duty of loyalty to the beneficiaries by acting in bad faith or unfairly.[59]

As to the duty of prudence, the draft Restatement (Third) of Trusts comments: "A primary question is whether and to what extent the settlor's language may authorize the trustee to act beyond the bounds of what would otherwise be a reasonable judgment."[60] The Reporter observes:

> Although the commentary here . . . does not foreclose the possibility of an interpretation that dispenses with the requirement of "reasonableness," it does not follow Trusts Second in its recognition of that result as the ordinary construction of typical language of extended discretion . . . , because that construction neither seems routinely appropriate nor does case authority actually support that generalization. It is difficult to find cases in which the court has upheld an exercise of discretion that, in the circumstances, truly appears to have been *unreasonable*.[61]

Importantly, the Reporter's Notes quote a leading treatise that concluded:

58. *See also* UNIF. TRUST CODE § 105(b)(10) (2003) (providing that the instrument cannot override "the effect of an exculpatory term under Section 1008"). Section 1008 provides, in part:

> (a) A term of a trust relieving a trustee of liability for breach of trust is unenforceable to the extent that it: (1) relieves the trustee of liability for breach of trust committed in bad faith or with reckless indifference to the purposes of the trust or the interests of its beneficiaries. . . .

Id. § 1008. Professor John Langbein cites to Uniform Trust Code § 105(b)(3) in observing: "A default rule is one that the settlor can abridge, but only to the extent that the settlor's term is 'for the benefit of [the] beneficiaries.'" Langbein, *Mandatory Rules*, *supra* note 46, at 1112 (footnote omitted). He concludes: "although the various fiduciary rules are default rules, the settlor may not abrogate them in their entirety, because eliminating all fiduciary duties would make the trust illusory [by effecting an absolute transfer to the trustee]." *Id.* at 1122–23.

59. Restatement (Third) of Trusts, Council Draft No. 4, *supra* note 22, § 78 (Duty of Loyalty) cmt. *c(2)* (*Authorization in terms of trust*), at 167–68.

60. *Id.* § 87 (Judicial Control of Discretionary Powers) cmt. *d* (*Extended discretion: limitations, interpretation, and effects*), at 409. The comment continues:

> Examination of the overall tenor of language granting powers and other terms of trusts may lead to diverse, refined interpretations on a case-by-case basis. For example, a court may conclude that the language of extended discretion and other evidence before it manifests a settlor intention to authorize the particular trustee to act with a lesser degree of *caution* (e.g. to accept a greater degree [of] compensated risk), but not a lesser degree of *care*, than would otherwise be appropriate to the particular trust and its circumstances under the duty of prudence (§ 77).

Id. (emphasis in original).

61. *Id.* at rptr's notes on § 87 cmt. *d*, at 419 (emphasis in original).

> In many cases it would appear that the same result is reached regardless of which standard [i.e., extended or simple discretion] is applied by the court . . . . There is agreement that a trustee must act in good faith and without an improper motive, and that a trustee must not act arbitrarily or capriciously, that is, without any exercise of his judgment. . . .[62]

3. Conclusion as to Organizational Form

The "strict" fiduciary duties for charitable trusts can be modified by the settlors to match those for corporate charities. Importantly, both trust and corporate law impose minimum—i.e., nonwaivable—duties of loyalty and care, exercised in good faith. Nothing unique to either the trust or the corporate form impedes conforming the standards of fiduciary duty for all forms of charity.[63] It is fair to ask, though, whether the minimum fiduciary duties for charities (trust or corporate) should be stricter than those for private trusts and business corporations.

B. *Effect of Structural Protections*

Structural differences between trusts and corporations, or between types of trusts and types of corporations, loom larger than substantive differences in fiduciary duties.

62. *Id.* (quoting GEORGE G. BOGERT & GEORGE T. BOGERT, THE LAW OF TRUSTS AND TRUSTEES § 560 (Supp. 2003)).

63. Subsection (3) of § 77 of the draft Restatement (Third) of Trusts provides: "(3) If the trustee possesses, or procured appointment by purporting to possess, special facilities or greater skill than that of a person of ordinary prudence, the trustee has a duty to use such facilities or skill." *Id.* § 77, at 137. Similarly, the Uniform Prudent Investor Act § 2(f) requires a trustee to use the trustee's own skills and expertise in carrying out the trustee's fiduciary duties. UNIF. PRUDENT INVESTOR ACT § 2(f) (1995). *See also* Unif. Mgmt. of Inst. Funds Act § 3(k) (draft Mar. 2, 2005), *available at* http://www.law.upenn.edu/bll/ulc/umoifa/2005MarDraft.htm. A comment to section 8.30 of the Revised Model Nonprofit Corporation Act describes the existence of a similar rule under the law of nonprofit corporations:

> The concept of "under similar circumstances" relates not only to the circumstances of the corporation but to the special background, qualifications, and management experience of the individual director and the role the director plays in the corporation. In many public benefit corporations an important role of directors is fund-raising. Many directors are elected to the board to raise money or because of financial contributions they have made to the corporation. These individuals may have no particular skill or background that otherwise would be helpful to the corporation. No special skill or expertise should be expected from such directors unless their background or knowledge evidences some special ability. Such individuals upon becoming directors are obligated to act as directors and may not simply act as figureheads ignoring problems. However, their role should be considered in determining whether they have met their obligations under section 8.30.

RMNCA, *supra* note 10, § 8.30 off. cmt. 2 (*Duty of Care*).

1. Governing Board Composition, Size, and Decision Making

For a charitable trust, the settlor determines the number (which may be as low as one), qualification, and other rules regarding selection of trustees.[64] The trustees of a charitable trust may be individuals or institutions. Other differences between the trust and corporate legal regime can be eliminated in the organic documents. For example, as a general rule a corporate director may resign, but, under the common law, a trustee may do so only with court approval (unless the trust instrument provides otherwise).[65]

For a nonprofit corporation, most states—and section 8.03 of the Revised Model Nonprofit Corporation Act—require a minimum of three directors, but some states allow as few as one; no state imposes a maximum number.[66] A charity is free to incorporate in a jurisdiction that permits the desired minimum board size.[67] In contrast to trustees, the directors of the board of a nonprofit corporation must be individuals, not entities.[68] Rea-

64. See, for example, Moody v. Haas, 493 S.W.2d 555 (Tex. Civ. App. 1973), in which the court refused to authorize the expansion of the board of a $120-million family foundation from three to seven:

> If . . . a court could disregard the settlor's plan for administration of a public charity simply because the judge believed that another plan would be better, such rule would substantially discourage the establishment of charitable trusts, or, at least, encourage the settlors to seek other jurisdictions in which to establish them. The adoption of such rule also would upset the stability of many of the charitable foundations that now exist in Texas[, many of which] . . . including the largest ones, have fewer than seven trustees.

Id. at 567. The appeals court seemed particularly disturbed by expert testimony calling for representation on the board that reflect geographic, professional, and minority-group diversity, observing of these to-be-majority trustees: "The selection of the individuals who are to administer the trust may substantially influence not only the manner in which the trust is administered but also the areas of the charitable purpose that will be emphasized." *Id.* at 562, 564.

65. *See, e.g.*, Bylaws of the Board of Trustees of the Leland Stanford Junior University, *supra* note 25, § 1.08 (Resignation) ("Any Trustee may in writing delivered to an officer of the Board resign as Trustee, such resignation to be effective when accepted by the Board at a meeting or at any time by the Chair."). In contrast to § 36 of the Restatement (Third) of Trusts, the Uniform Trust Code permits a trustee to resign, commenting: "This section rejects the common law rule that a trustee may resign only with permission of the court, and goes further than the Restatements, which allow a trustee to resign with the consent of the beneficiaries." UNIF. TRUST CODE § 705 cmt. (2003) (citation omitted).

66. See the American Law Institute's Principles of Corporate Governance:

> small publicly held corporations and large publicly held corporations that are majority-owned by a single person, a family group, or a control group . . . should have at least three directors who are free of significant relationships with the corporation's senior executives. The number three is chosen . . . in the belief that it is the number of directors necessary to attain a critical mass on the board.

AM. LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 3A.01 (Composition of the Board in Publicly Held Corporations) cmt. c (*Rationale*) (1992) [hereinafter ALI PRINCIPLES OF CORPORATE GOVERNANCE].

67. *But see* STAFF OF SENATE COMM. ON FIN., STAFF DISCUSSION DRAFT 13 (2004), *available at* http://www.finance.senate.gov/hearings/testimony/2004test/062204stfdis.pdf [hereinafter SFC STAFF DISCUSSION DRAFT] (requiring as a condition of federal tax exemption a governing board of between three and fifteen members).

68. *Cf.* 15 PA. CONS. STAT. ANN. § 5732 (West 1995) (As for corporate officers, president and secretary must be individuals, but treasurer may be a corporation.).

sonable criteria for board membership may be included in the organic documents.[69] A nonprofit corporation may condition board membership on such ideological characteristics as membership in the organization or adherence to a certain philosophy, and on such performance characteristics as experience in a particular industry, satisfactory performance as a board member, and attendance at a certain number or percentage of meetings.[70]

Despite the variety of skills and perspectives that constitute an effective board, importantly, in the corporate context, the board as a whole, rather than any separate director, has the authority to govern the corporation, and the group takes action by (usually) majority decision of those constituting a quorum.[71] Most of the work of a governing board of any significant size occurs in committees.[72] The committees report back their activities and recommendations to the governing board, and the governing board retains ultimate responsibility for oversight. As described in comments to the Revised Model Nonprofit Corporation Act: "directors may not abdicate their responsibilities and secure exoneration from liability simply by delegating authority to board committees."[73] Expressed another way, the articles or bylaws of a nonprofit corporation cannot specify that some board members have only limited duties (although they may have different tasks). See the following example provided by the official comments to the ALI Principles of Corporate Governance:

> C, who is rich and charming, has been a director of Y Corporation for several years. C's only significant contribution to Y has been a willingness to entertain important customers. C has said: "I do not have the

69. *See* RMNCA, *supra* note 10, § 8.02 off. cmt.

70. *See* ALI PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 66, § 3A.04 (Nominating Committee in Publicly Held Corporations: Composition, Powers, and Functions). The Comment to section 3A.04 reads:

> Policies on board composition might include such elements as the desired mix of senior executives, persons with a significant relationship to the senior executives, and persons without such a relationship. Criteria for board membership might include such elements as occupational background and field of skill. Criteria for continuation on the board might include such elements as age and attendance to board duties.

Id. at cmt. *e* (*Other Functions*). Similarly, the Business Roundtable comments:

> Because the corporation's need for particular backgrounds and experiences may change over time, the board should monitor the mix of skills and experience that directors bring to the board to assess, at each stage in the life of the corporation, whether the board has the necessary tools to perform its oversight function effectively.

THE BUSINESS ROUNDTABLE, PRINCIPLES OF CORPORATE GOVERNANCE 11 (May 2002).

71. *See generally* Stephen M. Bainbridge, *Why a Board? Group Decisionmaking in Corporate Governance?*, 55 VAND. L. REV. 1 (2002) (derived from STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS 191–240 (chapter 5) (2002)).

72. *See generally* ALI, Nonprofit Law, Council Draft No. 2, *supra* note 9, § 325 (Board Responsibility and Delegation), at 53–67; *id.* § 3A.5 (Committees of the Board), at 251–62.

73. RMNCA, *supra* note 10, § 8.25 off. cmt. (quoting MODEL BUS. CORP. ACT § 8.25 Official Comment).

> capacity to oversee Y's business," and has made no attempt to oversee it. Y Corporation has gone into bankruptcy because of mismanagement. C, as a result of the failure to oversee the conduct of Y's business, has committed a breach of the duty of care. The fact that C may not have the capacity of an "ordinarily prudent person" is no defense. C will be held to an objective standard.[74]

As in the case of a corporate board, a trust settlor might appoint multiple trustees to best serve the purposes of the trust: "Cotrustees are often appointed to gain advantage of differing skills, perhaps a financial institution for its permanence and professional skills, and a family member to maintain a personal connection with the beneficiaries."[75] Trust law has long recognized the desirability of permitting charitable trustees to act by majority decision even when the default rule required co-trustees of a private trust to act unanimously.[76] Section 39 of the Restatement (Third) of Trusts now provides, as to both charitable and private trusts:

> Unless otherwise provided by the terms of the trust, if there are two trustees their powers may be exercised only by concurrence of both of them, absent an emergency or a proper delegation; but if there are three or more trustees their powers may be exercised by a majority.[77]

The recently promulgated Uniform Trust Code cautions, however:

> Cotrusteeship should not be called for without careful reflection. Division of responsibility among cotrustees is often confused, the accountability of any individual trustee is uncertain, obtaining consent of all trustees can be burdensome, and unless an odd number of trustees is named deadlocks requiring court resolution can occur. Potential problems can be reduced by addressing division of responsibilities in the terms of the trust. . . .[78]

In contrast to the corporate rule that the board acts as a group, the settlor's authority to determine the rules of the trust extends to a power to

74. ALI PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 66, § 4.01 (Duty of Care of Directors and Officers; the Business Judgment Rule) cmt. to § 4.01(a), first paragraph, illus. 6.

75. UNIF. TRUST CODE § 703 cmt. (2003).

76. *See* RESTATEMENT (SECOND) OF TRUSTS § 383 (Several Trustees) (1957) ("If there are several trustees of a charitable trust, the powers conferred upon them can properly be exercised by a majority of the trustees, unless it is otherwise provided by the terms of the trust."). *See generally* FREMONT-SMITH, FOUNDATIONS AND GOVERNMENT, *supra* note 13, 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."). For an articulation of the policy and effect of majority decision making by trustees, see *Madden v. University Club of Evanston*:

> The practicality and fairness of this section is evident: it facilitates trust management because it (1) allows cotrustees to act without unanimous agreement and (2) frees dissenting minority trustees from liability which may result from the acts of the majority. The dissenter is not, however, empowered to bring an action involving the trust property contrary to the wishes of the majority.

422 N.E.2d 1172, 1174 (Ill. App. Ct. 1981).

77. RESTATEMENT (THIRD) OF TRUSTS § 39 (Exercise of Powers by Multiple Trustees) (2003).

78. UNIF. TRUST CODE § 703 cmt. (2003).

allocate different responsibilities to different trustees, and a trustee is not liable for the performance of responsibilities assigned to another. The general rule is set forth in subsection (1) of § 81 of the draft Third Restatement: "If a trust has more than one trustee, except as otherwise provided by the terms of the trust, each trustee has a duty and the right to participate in the administration of the trust."[79] A comment in the draft Third Restatement explains:

> The duties of multiple trustees, as discussed in this Section, may be reduced, modified, or specially allocated by the terms of the trust.
>
> Thus, trust provisions may allocate roles and responsibilities among the trustees, or relieve one or more of the trustees of duties to participate in particular aspects of the trust's administration.... The settlor's limiting of a trustee's functions or allocation of functions among the trustees usually, either explicitly or as a matter of interpretation, has the effect of relieving the trustee(s) to whom a function is not allocated of any affirmative duty to remain informed or to participate in deliberations about matters within that function.[80]

In the absence of such an allocation in the trust instrument, "each co-trustee has a duty, and also the right, of active, prudent participation in the performance of all aspects of the trust's administration."[81] The draft Third Restatement adds:

> The trustee's duty to participate in administering the trust does not require an equal level of effort or activity by each co-trustee, as recognized in the variability of their "reasonable" compensation (§ 38, Comment *i*). Accordingly, the duty of participation by each of the co-trustees does not prevent them from deciding (short of constituting delegation) to allow one or more of the co-trustees to carry more of the burden in regard to various matters, for example, by initiating, analyzing, reporting, and making recommendations for reasonably informed action by all of the trustees. It does, however, prevent the trustees from "dividing" the trusteeship or its functions in a manner that is not authorized by the terms of the trust.[82]

79. Restatement (Third) of Trusts, Council Draft No. 4, *supra* note 22, § 81(1) (Duty With Respect to Co-Trustees), at 287. *Compare* UNIF. TRUST CODE § 703 (2003).

80. Restatement (Third) of Trusts, Council Draft No. 4, *supra* note 22, § 81 (Duty With Respect to Co-Trustees) gen. cmt. *b* (*Effect of the terms of the trust*), at 289–90. The comment continues: "Even in matters for which a trustee is relieved of responsibility, however, if the trustee knows that a co-trustee is committing or attempting to commit a breach of trust, the trustee has a duty to take reasonable steps to prevent the fiduciary misconduct." *Id.* at 290. The comment adds: "Furthermore, absent clear provision in the trust to the contrary, even in the absence of any duty to intervene or grounds for suspicion, a trustee is entitled to request and receive reasonable information regarding an aspect of trust administration in which the trustee is not required to participate." *Id.* See discussion of enforcement, below.

81. *Id.* § 81 (Duty With Respect to Co-Trustees) cmt. on subsec. (1) *c* (*Active personal participation: general rule*), at 291.

82. *Id.* at 292. In previously analyzing on the Bishop Estate controversy (see above), the Reporter for the Restatement (Third) of Trusts had commented:

Alternatively, the draft Restatement (Third) of Trusts explains: "[i]n appropriate situations, a panel of co-trustees . . . may, in administering the trust, function in the manner of corporate boards of directors."[83] Many of the problems identified in the Uniform Trust Code's cautionary comment would be obviated by adopting a governing-board view of co-trustees. In the absence of settler direction, however, operational issues would remain; for example, could the board act by majority of the quorum, rather than by absolute majority?[84]

Contrariwise, it is possible for the founder of a corporate charity to include a requirement in the articles of incorporation requiring the assent of the founder or another to certain corporate decisions. Section 8.01(c) of the Revised Model Nonprofit Corporation Act provides:

> (c) The articles may authorize a person or persons to exercise some or all of the powers which would otherwise be exercised by a board. To the extent so authorized any such person or persons shall have the duties

> Hiring and relying upon employees and other agents, whom trustees can readily direct, supervise and terminate, however, is far different from what might be loosely called "delegation" among co-trustees. The latter invites inevitable risks of improperly "dividing up" the trusteeship and its responsibilities. It would also give rise to the practical difficulties and realities of instructing and monitoring peers in the co-trusteeship—not to mention the inability to fire them—with the attendant risks (to put it gently) of a "reciprocal-leniency" mentality. . . .

Halbach, *supra* note 27, at vii. *See also id.* at vii n.18 (citing RESTATEMENT (THIRD) OF TRUSTS: THE PRUDENT INVESTOR RULE §§ 227(c)(2) & 227 cmt. *h* (1992)).

The draft Third Restatement also observes that this duty to participate "does not prevent delegation on a prudent basis between or among [co-trustees] with respect to essentially ministerial matters, such as the custody of trust property and the implementation of decisions that have been made by proper vote of the co-trustees." Restatement (Third) of Trusts, Council Draft No. 4, *supra* note 22, § 81 (Duty with Respect to Co-Trustees) cmt. on subsec. (1) *c(1)* (*Delegation to other co-trustee(s)*), at 293. Separately, this comment recognizes delegation by a trustee in anticipation of unavailability for illness or absence, and where "it would be unreasonable to expect the co-trustee personally to perform the function(s) in question" or as "may be expressly or impliedly authorized . . . by the terms of the trust." *Id.* at 293–95.

83. Restatement (Third) of Trusts, Council Draft No. 4, *supra* note 22, § 81 (Duty With Respect to Co-Trustees) cmt. on subsec. (1) *c(2)* (*Special situations*), at 295. The draft Restatement comment continues:

> Of relevance for purpose of this possibility are not only (though critical) the number of trustees but also their circumstances (skills and experience, compensation, other commitments, etc.) and the nature and scale of the trust's asset holdings, investment programs, and other activities. Also, compare § 80 (delegation to agents) that trustees sometimes will need to and may rely on suitable officers and staff; and compare more generally, on charities established in trust form, ALI Principles of the Law of Nonprofit Organizations (Council Draft No. 1, 2003) § 200 (on choice and consequences of organizational form) and ch. 3 (on "governance") . . . .

Id. at 295–96.

84. *See, e.g.*, Donaldson v. Borough of Madison, 213 A.2d 33, 41 (N.J. Super., Ch. Div., 1965) ("While the number of trustees who may constitute a quorum is in the first instance a matter within the discretion of the trustees, the number may not be less than a majority of all of the trustees in office and, whatever the number required for a quorum may be, action may not be taken without the concurrence of a majority of all of the trustees in office.").

> and responsibilities of the directors, and the directors shall be relieved to that extent from such duties and responsibilities.[85]

A common problem for charities with large boards—such as are found in higher education and in arts and cultural institutions—is identifying who sits on the "real board." The draft Principles of the Law of Nonprofit Organizations discusses the desirability of a model, for both trust and corporate charities, that empowers less than the full board to act as the governing body—at least to the extent of clarifying a strong role for the executive committee. The draft further asks whether courts should afford greater deference to executive committees of nonprofit organizations than to those of business corporations (and, in states where the Revised Model Nonprofit Corporation Act has not been adopted, whether legislatures should allow charter overrides permitting a structure like that available to trust settlors to limit the responsibility of nonexecutive committee members).[86]

As a separate matter, for charitable trusts, the traditional approach had been to prohibit delegation of action,[87] but recent reform projects support—if not require—the use of prudent delegation.[88] Corporations cannot act

85. RMNCA, *supra* note 10, § 8.01(c).

86. ALI, Nonprofit Law, Council Draft No. 2, *supra* note 9, § 325 (Board Responsibility and Delegation) cmts. on subsec. (a) *1* (*Role of the governing board*), at 55.

87. The Reporter's Notes on § 80 (Duty With Respect to Delegation) of Council Draft No. 4 of the Restatement (Third) of Trusts begin:

> The contents of this Section differ significantly from the rules stated in Restatement Second, Trusts § 171.... The earlier Trusts Restatements have allowed delegation only for ministerial acts, or other acts to the extent the trustee has no reasonable alternative ...; and they had specifically forbidden delegation of the "power to select investments"....
>
> The position of the American Law Institute was fundamentally changed in 1992 in Restatement Third, Trusts (Prudent Investor Rule)....

Restatement (Third) of Trusts, Council Draft No. 4, *supra* note 22, § 80 (Duty With Respect to Delegation) rptr's notes, at 280.

88. *See* UNIF. TRUST CODE § 807 (2003). For charitable trusts, the draft § 80 of the Restatement (Third) of Trusts provides:

> (1) A trustee has a duty to perform the responsibilities of the trusteeship personally, except as a prudent person of comparable skill might delegate those responsibilities to others.
>
> (2) In deciding whether, to whom, and in what manner to delegate fiduciary authority in the administration of a trust, and thereafter in supervising or monitoring agents, the trustee has a duty to exercise fiduciary discretion and to act as a prudent person of comparable skill would act in similar circumstances.

Restatement (Third) of Trusts, Council Draft No. 4, *supra* note 22, § 80 (Duty With Respect to Delegation), at 263. A comment provides: "Decisions of trustees concerning delegation are matters of fiduciary judgment and discretion. Therefore, these decisions are not to be controlled by a court except to prevent abuse of that discretionary authority. On control of discretionary powers generally, see § 87." *Id.* § 80 (Duty With Respect to Delegation) cmt. on subsec. (1) *d* (*General fiduciary duty and discretion*), at 268. Certain responsibilities are evidently too core to delegate:

> With professional advice as needed, the trustee personally must at least define the trust's investment objectives. In addition, the trustee must personally either formulate or approve the trust's investment strategies and programs. Admittedly, even these limited generalizations are necessarily and desirably couched in terms that are less than self-defining.

Id. at cmt. on subsec. (1) *f(1)* (*Powers with respect to the investment function*), at 273–74.

without a certain amount of delegation, although the board may not abdicate its responsibilities.[89] In the case of either a trust or a corporation, the law requires the fiduciary to monitor compliance with delegated tasks.[90] Articulating nonprofit board duties, the Missouri Attorney General recently wrote:

> [P]roper control and oversight is not a function of Board members individually and informally. Instead, it is a function of the Board as whole and is evidenced by the formal actions it takes: first, in establishing the policies and procedures that will govern the Foundation's ordinary activities; and, second, in the formal review and approval of the actions of management in carrying out the Board's vision. When this approach is followed, it not only ensures that proper control and oversight are in fact

89. Under corporate law, the board may determine the degree of delegation. The Official Comment to the 2002 amendments to the standard of care set forth in the Model Business Corporation Act explains:

> [B]y employing the concept of delegation, section 8.30(c) does not limit the ability of directors to establish baseline principles as to management responsibilities. Specifically, section 8.01(b) provides that "all corporate powers shall be exercised by or under the authority of" the board, and a basic board function involves the allocation of management responsibilities and the related assignment (or delegation) of corporate powers.

MODEL BUS. CORP. ACT § 8.30 (Standards of Conduct for Directors) off. cmt. (2002). However, courts typically draw the line at the abdication of responsibilities (including monitoring), as well as the delegation of core activities. In the Sibley Hospital case, Judge Gesell declared:

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

Stern v. Lucy Webb Hayes Nat'l Training Sch. for Deaconesses & Missionaries, 381 F. Supp. 1003, 1014 (D.D.C. 1974) (mem.) (citations omitted). *See also, e.g.*, Boston Athletic Ass'n v. Int'l Marathons, Inc., 467 N.E.2d 58, 65 (Mass. 1984) (ruling that "[a]n officer of a nonprofit corporation cannot have apparent authority to encumber the principal function of the corporation and to divert the substantial earning capacity of the corporation to private benefit").

For a charity trustee that is itself a corporation, the draft Restatement (Third) explains:

> Although a corporate trustee has the same responsibilities as an individual trustee with respect to performing or delegating administrative functions of a trust, a corporation acts—and thus may administer trusts without "delegation"—through its directors, officers, and appropriate employees. This does not preclude prudent delegation to others, as agents . . ."

Restatement (Third) of Trusts, Council Draft No. 4, *supra* note 22, § 80 (Duty With Respect to Delegation) cmt. on subsec. (1) *d (General fiduciary duty and discretion)*, at 268.

90. *See* Restatement (Third) of Trusts, Council Draft No. 4, *supra* note 22, at cmt. *(d)(2) (Prudence in delegation)*, at 269 ("The trustee then has a further duty to act with prudence in supervising or monitoring the agent's performance and compliance with the terms of the delegation."); UNIF. TRUST CODE § 807 (2003); UNIF. PRUDENT INVESTOR ACT § 2(d) (1995); Unif. Mgmt. Inst. Funds Act § 5 (draft Mar. 2, 2005). A fiduciary may reasonably rely on others for information obtained through a proper delegation of responsibilities. For example, subsections (b) and (c) of section 8.30 of the Revised Model Nonprofit Corporation Act generally permit a director to rely on others in gathering information. RMNCA, *supra* note 10, § 8.30.

practiced by the Board, it also provides a ready record demonstrating where, when and how the Board fulfilled this essential duty.[91]

In sum, regardless of the organizational form chosen, a charity founder can achieve as small or as large a governance structure as desired. Modern trust law can easily accommodate a charitable trust having a corporate board/management structure. At the same time, a one-member board of a corporate charity runs many of the oversight risks of a single-trusteed charity, particularly when the fiduciary performs all the management functions himself or herself.[92] As discussed next, recommended "best practices"—and some aspects of corporate law for certain (generally large) corporations—require that those who provide governance not be the same persons as those who provide management.

2. "Independent" Fiduciaries

The duty of loyalty is often expressed by the principle that good governance generally requires fiduciaries who lack incentives or relationships that would compromise their ability to make objective decisions based on the best interests of the charity, rather than on the personal interests of the fiduciaries. This principle actually comprises two distinct concepts: independence and (usually financial) disinterest. Like all principles, however, neither of these components can realistically be absolute.

a. *Independence vs. Accountability*

First, independence itself has two components.[93] The first—what might be called external independence—is neither required nor desirable, and indeed might constitute lack of accountability to key constituents.[94]

91. Missouri Attorney General's Office, Attorney General Jay Nixon, *Attorney General's Review and Recommendations Regarding the Ewing Marion Kauffman Foundation*, pt. 6 (Mar. 2004), *at* http://www.ago.state.mo.us/newsreleases/2004/kauffmanreport030404.htm.

92. While the organizer could set up the charity as a membership corporation with himself or herself as the sole member, the board of directors cannot be easily neutered. *See* Carolyn C. Clark & Glenn M. Troost, *Forming a Foundation: Trust vs. Corporation*, 3 PROB. & PROP. 32 (May/June 1989); Dana Brakman Reiser, *Decision-Makers Without Duties: Defining the Duties of Parent Corporations Acting as Sole Corporate Members in Nonprofit Health Care Systems*, 53 RUTGERS L. REV. 979 (2001).

93. *Compare* ALI PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 66, § 1.34 cmt. *b*, at 36 (cautioning that "[i]t has long been common to emphasize a distinction between 'inside' and 'outside' directors, without clarifying the precise meaning of those terms").

94. *See generally* Evelyn Brody, *Accountability and Public Trust*, in THE STATE OF NONPROFIT AMERICA 471 (Lester M. Salamon ed., 2002). *See also* ABA Coordinating Comm. on Nonprofit Governance, Guide to Current and Emerging Standards of Nonprofit Corporate Governance: Governing and Best Practices in the Wake of Sarbanes-Oxley (draft Mar. 2005), observing:

> Certain aspects of the independent director principle may not make organizational sense for some kinds of nonprofit organizations. . . . For instance, should a private foundation that receives all of its money from the largesse of a single family be required to have a majority of persons on the foundation board who are not part of such family? . . . . Should a start-up arts

Notably, the founders set forth organizational and operational terms in the organic documents. The donor may properly impose restrictions on the charity's discretion to use gifts, and major donors often are named as trustees or elected to the board of directors. If provided for, members of the organization may exercise influence through their election of the governing board, and through their participation in decisions to take certain extraordinary transactions. Despite these legitimate constraints, though, the fiduciaries must be free to exercise their judgment in the best interests of the organization.[95] As difficult as managing these conflicts are, though, they do not vary by the legal form of the charity. By contrast, the *size* of the board of directors or the number of trustees (as described above) and the composition of the board may determine the degree to which the organization is more responsive to one or another of its constituencies.

b. *Separation of Oversight and Management*

The second—what might be called internal independence—looks for a separation between oversight and management.[96] The ALI's draft Princi-

> or community organization, founded and funded by a group of close friends or neighbors, immediately expand its board to admit persons who are strangers to them and their organization's goals? In such cases, the best interests of the organization and its fundamental mission may lie in <u>not</u> having a majority of "independent" directors.

Id. at 38–39 (emphasis in original).

95. The ABA draft advises:

> For most nonprofit organizations, however, having a majority of independent directors is not only a good idea, but a reality. . . . Even nonprofit organizations that determine that having a majority of independent directors is not appropriate for them should look at the underlying premises of the independent-directors principle and determine whether their organizations meet the spirit of such principle. That is, do board members look with objectivity at the information provided by management, ask good questions at board meetings, and take independent responsibility for the corporation's overall success or failure?

ABA COORDINATING COMM. ON NONPROFIT GOVERNANCE, *supra* note 95, at 39–40.

96. The ABA draft explains why applying the principle of board independence might not be easy for a nonprofit organization:

> 1. ***Deference to Management***. . . . Given the different compositions and expectations of nonprofit boards, the standards by which nonprofit corporations determine whether directors are able to exercise an independent mindset may differ from those used by public companies. First of all, most nonprofit directors are unpaid, and may not feel they have sufficient time to review detailed corporate information to the degree expected of public-company directors who receive substantial compensation for their board commitment. . . .
>
> Another nonprofit-specific independence issue arises from the fact that some nonprofit directors are also substantial contributors and/or fundraisers. That status may give them a proprietary-type interest in the corporation, and lead to close scrutiny of management performance. Alternatively, it may lead them to view their board role as primarily a source of financial support rather than an independent overseer.
>
> 2. ***Board Culture Issues***. . . . There may be a fundamental sense of trust, and a culture of consensus, among board members and management, that seems satisfying and productive for the organization. Thus, some nonprofits may feel that applying public-company-type standards regarding the role and responsibilities of independent directors could result in a loss, rather than enhancement, of board effectiveness.

Id. at 37–38.

ples of the Law of Nonprofit Organizations suggest: "overriding interests of public policy . . . generally require the governing board to: . . . adopt and execute processes conducive to the exercise of independent, informed oversight by a group of individuals separate from management. . . ."[97]

c. *Financial and Other Conflicts*

Finally, we come to the possibility that the fiduciaries themselves face conflicts of interest. These may be financial or nonfinancial, although the law is fairly undeveloped regarding nonfinancial conflicts of interest, such as when a board member suffers a conflict of attention or loyalty that prevents him or her from acting in the best interests of the organization. Commonly, the focus is on whether the decision maker is compensated for or otherwise obtains a direct financial benefit because of his or her position with the organization. Note that in many charities, in addition to volunteer directors, the officers themselves are uncompensated (whether or not the organization also engages professional staff).

As in the case of independence generally, discussed above, conflicts of interest cannot always (and often should not) be eliminated. Instead, as recommended in the draft Principles of the Law of Nonprofit Organizations, the board should "adopt and execute processes to minimize the adverse consequences to the charity from conflicts of interest that might exist between fiduciaries and the charity."[98] When structural independence is not completely achievable—or even desirable—the benefits to the organization of independent decision making can be obtained through such mechanisms as appointing standing or ad hoc committees with independent members, and holding meetings of the governing board without the participation of the interested members. (Under federal tax rules, too, the appropriate decision makers might be less than the full board.[99]) This is obviously not a

97. ALI, Nonprofit Law, Council Draft No. 2, *supra* note 9, § 3A.1(b) (Autonomy and Public Policy Limitations), at 207.

98. *Id.* Moreover, it is important to identify when one or more fiduciaries is "interested" in governance generally or in a specific transaction or conduct. As to a particular transaction or conduct, the interested fiduciary must make appropriate disclosures and refrain from participating in the board's decision.

99. Internal Revenue Code section 4941 prohibits self-dealing between a private foundation and its fiduciaries, substantial contributors, and other disqualified persons, but provides an exception for reasonable compensation. I.R.C. § 4941(d)(2)(E) (2000). For public charities, Code section 4958 imposes "intermediate sanctions" on self-dealing fiduciaries who engage in "excess benefit transactions" with the charity. I.R.C. § 4958 (2000). The Treasury Department regulations under section 4958 apply a presumption of reasonableness for a potentially excess benefit transaction between the charity and a disqualified person, if the transaction was approved in advance by an independent decision-making body acting in good faith (requiring the interested party to make appropriate disclosure and abstain from the decision making, and the decision maker to document the grounds for deciding that the transaction was fair to the charity).

solution for charities lacking unconflicted board members or trustees. Trust law permits a court to appoint a trustee for a limited purpose, but such a device raises difficulties.[100] (The same would be true when a court appoints a director ad litem.)

This still leaves the question of whether compensated executives should also have seats on the governing board (or on particular committees of the board). A few states require that a majority of directors of a nonprofit corporation be financially disinterested.[101] The ABA's Revised Model Nonprofit Corporation Act offers such a provision as optional section 8.13, commenting:

> 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

100. Professor Halbach suggests clarifying the mechanism of appointing trustees for a limited period of time or special purpose:

> Apart from issues about selection and removal procedures, and general concerns over circumstances that increase risks of trustees abusing their positions, the trust law needs to develop clearer and better rules and alternatives, without necessarily punitive undertones, for the temporary or limited substitution of temporary or special trustees, or trustees *ad litem*. Such substitution for regular trustees should be used judiciously, and often mercifully, when and to the extent this appears conducive to the sound administration or representation of the trust. . . .

Halbach, *supra* note 27, at ix. *See also* Evelyn Brody, *A Taxing Time for the Bishop Estate: What Is the I.R.S. Role in Charity Governance?*, 21 U. HAW. L. REV. 537, 538 n.5 (1999) [hereinafter Brody, *A Taxing Time for Bishop Estate*]:

> Not only was it unprecedented (to my knowledge) for a judge to appoint special-purpose trustees to handle the tax issues while leaving the regular trustees in place, but also one can only speculate about how this arrangement might have played out. What does it mean to have one set of trustees for the "real" issues and another set for the tax issues? Are we to assume not only that the special-purpose trustees kept the regular trustees in the dark about the IRS proceeding, but also that the regular trustees kept the special-purpose trustees in the dark about ongoing KSBE matters? What if these KSBE matters—like investment decisions and compensation issues—could give rise to fresh violations of tax requirements? *See generally* Special Purpose Trustees' Report, Apr. 27, 1999 (describing the Special Purpose Trustees' belief that they lack the authority to meet IRS demands to: (1) remove the incumbent trustees; (2) control or determine the method for selecting new trustees; (3) limit the compensation paid to the trustees in the 1999 fiscal year; and (4) prevent the removal of assets from KSBE and subsidiaries beyond the supervision of the court and the IRS). . . .

101. *See* CAL. CORP. CODE § 5227 (West Supp. 2004) (requiring that charity managers may make up no more than 49% of the board positions). *See also* ME. REV. STAT. ANN. tit. 13-B, § 713-a(2) (West Supp. 2003) ("No more than 49% of the individuals on the board of directors of a public benefit corporation may be financially interested persons."); Donald E. Quigley, *The Rules for Managing Nonprofit Corporations Are Changing Fast: Maine Has New Statutory Requirements for Governance, Management, and Asset Transfers*, ME. BAR J., Summer 2002, at 156. *Cf.* N.H. REV. STAT. ANN. § 292:6-a (Board of Directors of Charitable Nonprofit Corporations) (2004) (requiring charitable corporations to have "at least 5 voting members, who are not of the same immediate family or related by blood or marriage," but prohibiting exemptions for private foundations and churches). Mandating a majority of disinterested directors, though, might simply lead to dummy outside directors. *See* James J. Fishman, *Standards of Conduct for Directors of Nonprofit Corporations*, 7 PACE L. REV. 389, 448 n.252 (1987). *See also* Stephen M. Bainbridge, *A Critique of the NYSE's Director Independence Standards*, 30 SEC. REG. L.J. 370 (2002).

and competent directors who had no financial interest in the corporation.[102]

d. Requirements for Tax Exemption

The Internal Revenue Service, which administers the regime of tax exemption under Internal Revenue Code section 501(c)(3) and other provisions, is in the process of issuing guidance on governance.[103]

3. Conclusion as to Organizational Form

Structure, rather than standards, is often the appropriate focus of concern. While the full ability of co-trustees to act like a corporate board is uncertain in the absence of direction in the trust instrument, and while too large a board raises governance problems of its own, both single-director and single-trusteed charities seem to invite failures of proper independence and protection of the public interest. Recent decisions by the Delaware courts have begun to expand on the requirement that the duty of care be carried out in "good faith."[104] This development is far from satisfactorily developed, however. Better might be to make size and independence matter—perhaps by shifting the burden of proof to the small or nonindependent fiduciaries to demonstrate their exercise of care. We turn next to enforcement issues.

C. Enforcement of Fiduciary Duties

1. By Regulators

Every state attorney general enjoys the role known as "*parens patriae*"—inherited from the English view of the sovereign as father of the country—to oversee the performance of charitable trusts and their fiduciaries.[105] Attorney general oversight extends, generally, to those nonprofit corporations that are charities.[106] Two observers cite to "increasing use of

102. RMNCA, *supra* note 10, § 8.13* (Financially Disinterested Majority—Public Benefit Corporations) (*optional section) cmt.

103. *See also, e.g.*, Michael W. Peregrine & Bernadette M. Broccolo, *"Independence" and the "EO" Governing Board: A General Counsel's Guide*, EXEMPT ORG. L. REV., Sept. 2003, at 379.

104. *See* John L. Reed & Matt Neiderman, *"Good Faith" and the Ability of Directors to Assert § 102(b)(7) of the Delaware General Corporation Law as a Defense to Claims Alleging Abdication, Lack of Oversight, and Similar Breaches of Fiduciary Duty*, 29 DEL. J. CORP. L. 111 (2004).

105. *See generally* FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS, *supra* note 13, at 301, 329–30.

106. *See generally* Evelyn Brody, *Whose Public? Parochialism and Paternalism in State Charity Law Enforcement*, 79 IND. L.J. 937 (2004).

charitable trust laws to effect remedies that are unavailable under nonprofit corporation law" (as well as resistance to applying the business judgment rule in the nonprofit context, and even asserting "waste" of corporate assets).[107] State statutes on charity regulation differ as to the authority specifically granted to the attorney general.[108] Despite any enforcement differences by form at the state level, at the federal level, the Internal Revenue Service administers the same requirements of tax exemption under Code section 501(c)(3) regardless of the exempt charity's organizational form.

2. By Co-Fiduciaries

While few private parties have standing to complain about the performance of charity fiduciaries, universally a co-fiduciary is recognized to have standing. Standing, however, is not the same thing as obligation. Trust doctrine contains a duty to prevent a breach of trust by a co-fiduciary: How does this duty operate in the context of an operating charity?

The provision of the Restatement (Third) of Trusts relating to the standing and enforcement duties of co-trustees is currently being drafted. As to standing, the Second Restatement provides: "A suit for the enforcement of a charitable trust can be maintained by one or more of several trustees against the other trustees."[109] The draft Third Restatement provides: "Each trustee also has a duty to use reasonable care to prevent a co-trustee from committing a breach of trust and, if a breach of trust occurs, to obtain redress."[110]

107. Michael W. Peregrine & James R. Schwartz, *Key Nonprofit Corporate Law Developments in 2001*, 11 BNA'S HEALTH L. REP. 272, 272 (Feb. 14, 2002).

108. *See* FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS, *supra* note 13, at 311–21 ("Statutes Enhancing Attorney General's Enforcement Powers").

109. RESTATEMENT (SECOND) OF TRUSTS § 391 *cmt. b* (1959).

110. Restatement (Third) of Trusts, Council Draft No. 4, *supra* note 22, § 81(2) (Duty With Respect to Co-Trustees), at 287. *See also* RESTATEMENT (SECOND) OF TRUSTS § 224(2) (1959), which provides, in part:

> A trustee is liable to the beneficiary, if he
>
> (a) participates in a breach of trust committed by his co-trustee; or
>
> * * *
>
> (c) approves or acquiesces in or conceals a breach of trust committed by his co-trustee; or
>
> (d) by his failure to exercise reasonable care in the administration of the trust has enabled his co-trustee to commit a breach of trust; or
>
> (e) neglects to take proper steps to compel his co-trustee to redress a breach of trust.

(Presumably in the case of a charitable trust, liability runs to the charity.) The examples that follow relate either to the investment or management of trust assets. The fourth, illustrating clause (d), provides:

Recall, however, from above that the board of trustees of a charitable trust generally acts by majority vote. Can an outvoted trustee assert that the majority trustees breached their duty of care? A comment to the section of the Restatement (Third) of Trusts authorizing the exercise of power by co-trustees provides:

> These statutory provisions and the rule of this Section ordinarily protect a dissenting trustee from liability for an act authorized by the majority, while preserving the co-trustee's duty normally to participate in deliberations and decisionmaking and to act reasonably to prevent a breach of trust.[111]

Instead of merely requiring the trustee to act "reasonably," the Uniform Trust Code adds the word "serious" to the situations requiring trustee action against another: "(g) Each trustee shall exercise reasonable care to: (1) prevent a cotrustee from committing a serious breach of trust; and (2) compel a trustee to redress a serious breach of trust."[112]

The foregoing rules are relatively simple to apply in the context of a private trust or a charitable trust or corporation that simply invests assets and makes distributions as directed by the settlor. However, in the context of governing an operating charity, granting standing to any trustee (or director) of a charity risks raising a circularity problem: To allow suit by an outvoted fiduciary confounds the general principle, described above, that the organization is to be governed by the majority of the board. A duty imposed on one fiduciary to sue another raises the following issues:[113]

> 4. A and B are co-trustees. A improperly permits B to have the sole custody and management of the trust property and makes no inquiry as to his conduct. B is thereby enabled to sell the trust property and embezzle the proceeds. A is liable for breach of trust.

RESTATEMENT (SECOND) OF TRUSTS § 224 illus. to cl. (d) (1959).

111. RESTATEMENT (THIRD) OF TRUSTS § 39 cmt. *a* (2003). The Third Restatement provides the following Illustration 1:

> 1. A trust has five trustees. Three of them join in a conveyance of land belonging to the trust. Absent a contrary provision in the trust, such as one stating that the trustees "shall act by unanimous vote," the conveyance is valid. If the conveyance is a breach of trust, the two trustees who did not join in it will not be liable, unless they failed to act reasonably to prevent the breach of trust, such as by failing to bring suit to prevent or set aside the conveyance. . . .

Id. § 39 cmt. *a*, illus. 1. *See also* FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS, *supra* note 13, at 146–47 ("A trustee who refuses to join with the majority in an action that constitutes a breach of trust is not liable for the consequences of the majority action, but he may have a duty to apply to the court to prevent the action.") (footnote omitted).

112. UNIF. TRUST CODE § 703(g) (2003). The draft Third Restatement instead comments "it might be 'reasonable' for a trustee to decide not to bring suit to redress a breach of trust. . . ." Restatement (Third) of Trusts, Council Draft No. 4, *supra* note 22, § 81 cmt. on subsec. (2) *e* (*Whether trustee liable for breach of trust by co-trustee(s)*), at 297–98.

113. *See* ALI, Nonprofit Law, Council Draft No. 2, *supra* note 9, § 350 (Enforcement of Fiduciary Duties) cmts. on subsec. (b) *2* (*Enforcement by co-trustee or co-director*), at 118–21, & rptr's notes 6–12, at 125–31. *See also Symposium Issue on the Bishop Estate Controversy*, 21 U. HAW. L. REV. (1999). In his Foreword to that issue, Edward Halbach addressed the duty to prevent or remedy breaches of trust by the other co-trustees:

* Assuming that the Uniform Trust Code threshold applies, what is a "serious" breach of fiduciary duty?
* Must an objecting fiduciary sue, or is resigning enough? Permitted? Required?
* Under what circumstances must the fiduciary go to the attorney general and the court?
* When may the fiduciary go to the press?
* What happens if a fiduciary does nothing?

In a suit for breach of fiduciary duty initiated by a co-fiduciary, the standing of the co-fiduciary should be more limited in a duty-of-care charge than in a duty-of-loyalty charge, in order to minimize judicial involvement in matters of business judgment.[114] (Indeed, rare is the breach of duty suit brought by a co-fiduciary that does not allege breach of the duty of loyalty as well as breach of the duty of care.) Perhaps the recent expansion of the fiduciary requirement of good faith, as is beginning to be articulated by the Delaware courts, provides the solution.[115] In particular, in the context of the nonprofit organization with a small, self-perpetuating gov-

> The Bishop Estate controversies aptly illustrate the need to recognize flexibility in the conduct deemed appropriate to discharge this duty, specifically, whether and at what stage remedial action might reasonably involve initiating litigation, alerting the Attorney General (or beneficiaries), or seeking publicity to begin a process that will not prove futile or unduly expensive.

Halbach, *supra* note 27, at x n.27.

Professor Halbach also addressed the issue of attorneys fees for a trustee who brings suit to prevent or remedy a breach of trust by co-trustees: "Because of a dissenting or petitioning trustee's legal duty in such matters, it would seem that the attorney fees are expenses ordinarily payable directly from the trust estate, subject to recovery from a trustee who has acted in bad faith or without reasonable cause." *Id.* at x. *See* Restatement (Third) of Trusts, Council Draft No. 4, *supra* note 22, § 88 (Power to Incur and Pay Expenses) cmt. *d* (*Costs of judicial proceedings*), at 427–31.

114. For a case granting standing by minority directors in a duty of care claim, see, for example, Holt v. Coll. of Osteopathic Physicians & Surgeons, 394 P.2d 932, 936 n.4 (Cal. 1964) ("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.") (citation omitted). *But see id.* 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 mismanagement as opposed to a difference of opinion).

Harry Henn and Jeffrey Boyd 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." Harry 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). 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." *Id.* at 1123 n.159; *accord* RMNCA, *supra* note 10, § 6.30 off. cmt. 2, at 119 (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").

115. *See* Reed & Neiderman, *supra* note 104.

erning board, "good faith" can be the vehicle that both constrains the dominating fiduciaries and obligates the passive fiduciaries to act.[116]

Notably, in an influential case on the duty of a director of a business corporation to take action against fellow board members, the New Jersey Supreme Court declared:

> Directors may not shut their eyes to corporate misconduct and then claim that because they did not see the misconduct, they did not have a duty to look. The sentinel asleep at his post contributes nothing to the enterprise he is charged to protect.[117]

The court continued:

> Upon discovery of an illegal course of action, a director has a duty to object and, if the corporation does not correct the conduct, to resign.
>
> In certain circumstances, the fulfillment of the duty of a director may call for more than mere objection and resignation. Sometimes a director may be required to seek the advice of counsel. . . . Modern corporate practice recognizes that on occasion a director should seek outside advice. A director may require legal advice concerning the propriety of his or her own conduct, the conduct of other officers and directors or the conduct of the corporation. . . . Sometimes the duty of a director may require more than consulting with outside counsel. A director may have a duty to take reasonable means to prevent illegal conduct by co-directors; in an appropriate case, this may include threat of suit.[118]

The court observed that "[u]sually a director can absolve himself from liability by informing the other directors of the impropriety and voting for a proper course of action."[119] However, in this case, the court held that the director had a duty to do more, because the wrongdoing directors—the sons of the defendant—"knew that she, the only other director, was not reviewing their conduct; they spawned their fraud in the backwater of her neglect. Her neglect of duty contributed to the climate of corruption; her failure to act contributed to the continuation of that corruption."[120]

116. *See, e.g.*, Lynch v. Redfield Found., 88 Cal. Rptr. 86 (1970), where the court surcharged squabbling directors for permitting funds to accumulate in a noninterest-bearing account for five years, rather than going to court for instruction. The Attorney General had 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. at 92 (quoting a statement of the Attorney General). The nonobstructionist directors should have gone to court to resolve the deadlock.

117. Francis v. United Jersey Bank, 432 A.2d 814, 822 (N.J. 1981).

118. *Id.* at 823 (citations omitted).

119. *Id.* at 826 (citation omitted).

120. *Id.* at 829. The court continued:

> Analysis of proximate cause is especially difficult in a corporate context where the allegation is that nonfeasance of a director is a proximate cause of damage to a third party. Where a case involves nonfeasance, no one can say "with absolute certainty what would have occurred if

As to trusts, the Restatement (Third) of Trusts comments that a trustee cannot resign out from under a problem without disclosure:

> a trustee may not . . . resign for the purpose of facilitating a breach of trust by the remaining co-trustee(s) or of escaping adverse circumstances without disclosing the breach or circumstances to the beneficiaries, settlor, or court, as the case may be. That all trustee powers are subject to a duty of good-faith exercise, see § 187 . . . .[121]

3. Conclusion as to Organizational Form

While the line might be hard to draw, once again organizational form seems less important than situations involving charities—trust or corporate—with very small boards, or with board members lacking appropriate independence. In such a case, resignation might not be sufficient to discharge an outvoted fiduciary's duties, but rather court relief might be required. In such as case, the court should be liberal in authorizing the charity's advancing the fiduciary's attorneys' fees. If the fiduciary has an interest in continuing to serve, an expanded board would prevent inappropriate domination and failure of governance from recurring. A fiduciary who no longer wishes to take an active role in governance should seek court approval to ensure that the assets of the charity are used properly, even if the remedy involves winding up the charity and transferring its assets to another charity that will carry out the wishes of the founders.

Consider the situation involving the Maddox Foundation, which presents an obvious case for finding a duty to bring suit. The Maddox Foundation was established as a charitable trust in Tennessee and was incorporated, after the 1998 death of its founders, in Mississippi. As reported in the press, the two trustees chose Mississippi in which to incorporate in order for the two to continue as the only directors (Mississippi permitting a nonprofit corporation to have as few as a single director, in contrast to the minimum of three required in Tennessee).[122]

> the defendant had acted otherwise." Nonetheless, where it is reasonable to conclude that the failure to act would produce a particular result and that result has followed, causation may be inferred. We conclude that even if Mrs. Pritchard's mere objection had not stopped the depredations of her sons, her consultation with an attorney and the threat of suit would have deterred them. That conclusion flows as a matter of common sense and logic from the record. Whether in other situations a director has a duty to do more than protest and resign is best left to case-by-case determinations. In this case, we are satisfied that there was a duty to do more than object and resign. Consequently, we find that Mrs. Pritchard's negligence was a proximate cause of the misappropriations.

Id. (citations omitted).

121. RESTATEMENT (THIRD) OF TRUSTS § 36 (Resignation of Trustee) cmt. *a* (*Terms of the trust*) (2003).

122. *See* Jay Hamburg, *$100M Charity Caught in Tug of War*, TENNESSEAN, Oct. 5, 2003, at A1.

A complaint filed jointly by director Tommye Maddox Working and the Tennessee district attorney general asserted that the other director, Robin Costa, had breached her fiduciary duties.[123] The Complaint also described provisions in the articles of incorporation of the Maddox Foundation Corporation that:

> provide Ms. Costa with extraordinary authority, including the ability to act unilaterally without the consent of the other member(s) of the board of directors. Until she is determined to "lack capacity by an appropriate court of the State of Mississippi," Ms. Costa has the power that would regularly be exercisable only by a board of directors.[124]

Further, "'[t]he Board of Directors shall have no authority with respect to Robin G. Costa to deprive her of, limit, or interfere with the exercise of the powers reserved to her by the incorporators.'"[125] Director Working and the district attorney general alleged other acts of "willful, wanton or gross negligence and/or misconduct" by Costa, including using foundation assets to pay for her personal expenses, and sought, among other remedies, Costa's removal "in order to prevent malversation, peculation and waste. . . ."[126]

The plaintiffs won a preliminary injunction assuring that Working can continue serving on the board pending resolution of the case.[127] On October 1, 2004, the defendant, however, asserting lack of jurisdiction by the Tennessee court, moved to dismiss the Tennessee attorney general as a party, and to dismiss Working's claims. The Mississippi attorney general then filed suit in Mississippi court and won a temporary restraining order to enjoin any transfer of assets from Mississippi to Tennessee as may be ordered by a Tennessee court.[128] The Tennessee probate court diffused the border clash, at least temporarily, by granting the plaintiffs an accounting but not the appointment of a receiver and the return of the assets to Tennes-

123. Complaint ¶ 108, State of Tennessee v. Costa (7th Cir. Davidson County (Probate Div.)) (filed Sept. 1, 2004) (No. 04P-1430).

124. *Id.* ¶ 39 (quoting Articles of Incorporation ¶ 8f).

125. *Id.* (quoting Articles of Incorporation ¶ 8g).

126. *Id.* at ¶ 108, 111. Separately, director Costa's use of foundation assets to acquire local sports teams (which she operates) appears to violate federal tax limitations on "excess business holdings" of private foundations. *See* I.R.C. § 4943 (2000).

127. Order on Motion for Temporary Restraining Order, State of Tennessee v. Costa, (7th Cir. Davidson County (Probate Div.)) (Sept. 1, 2004) (No. 04P-1430) (on file with author). The court:

> enjoin[ed] Robin G. Costa, individually and as director of the Maddox Foundation, a Mississippi non-profit corporation from: (a) removing and/or replacing Tommye Maddox Working as a member of the Maddox Foundation Corporation's Board of Directors; and (b) appointing someone other than Ms. Working to replace Ms. Working as a member of the Maddox Foundation Corporation's Board of Directors.

Id.

128. Jay Hamburg, *Mississippi Enters Fight over Charity*, TENNESSEAN, Nov. 22, 2004, at A1.

see.[129] Nevertheless, the Mississippi chancery court confirmed its TRO by converting it to a preliminary injunction.[130]

D. *Reform Proposals*

1. State Level

Congress reacted to recent scandals of corporate governance in the business sector by enacting the Sarbanes-Oxley Act of 2002.[131] Not only does this statute not apply to trusts, but also it applies, in general, only to those corporations that are publicly traded and hence subject to the federal securities laws. Notable provisions require executive certification of financial results, independent audit committees, and whistle-blower protections. Private regulation is also imposing best practices. For example, the NASD and New York Stock Exchange adopted rules for listed companies that include a requirement that a majority of the board be uncompensated (except for directors' fees).[132]

While Sarbanes-Oxley thus does not apply to charities, Drexel University made headlines by voluntarily adopting many of the requirements of Sarbanes-Oxley.[133] Marion Fremont-Smith comments:

> The powers granted to officers and directors under nonprofit corporation enabling statutes are designed to encourage independence. They affirm the ability of directors to delegate their duties, to establish committees, and to rely on their reports. They permit, but do not require, that there be an executive committee. The same is true in regard to audit committees, and, in fact, following passage of the Sarbanes-Oxley Act, many charities voluntarily established them.[134]

129. Rob Johnson, *Judge Wants Impartial Report on Charity*, TENNESSEAN, Nov. 23, 2004, at B1.

130. William C. Bayne, *Court Shields Maddox—Foundation Will Remain "Status Quo" Pending Accounting*, COM. APPEAL (Memphis), Nov. 30, 2004, at DS1. In issuing the injunction, the Mississippi judge declared himself "about as nervous as an alligator in a catfish pond"—a response to the earlier comment by the Tennessee judge that "it appeared that the chancellor down there in Hernando[, Mississippi,] seems a little nervous." *Id.*

131. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745.

132. *See* NASD MANUAL Rule 4350 (c)(1) ("A majority of the board of directors must be comprised of independent directors as defined in Rule 4200. . . ."), *at* http://nasd.complinet.com/nasd/display/display.html?rbid=1189&record_id=1159003671 (last visited Mar. 12, 2005); N.Y. STOCK EXCH., CORPORATE GOVERNANCE LISTING STANDARDS § 303A (Nov. 3, 2004), *at* http://www.nyse.com/pdfs/section303A_final_rules.pdf ("1. Listed companies must have a majority of independent directors.").

133. *See* Memorandum from Tobey Oxholm, General Counsel to Drexel University, to National Association of College and University Attorneys Colleagues (Mar. 10, 2003), *at* http://www.nacua.org/documents/Drexel_Sarbanes-Oxley_Memo.doc. (This memorandum includes links to board documents.)

134. FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS, *supra* note 13, at 431.

The desirability of extending some of the Sarbanes-Oxley reforms to the nonprofit sector is a subject of much debate and could influence the choice of state of incorporation, if not the choice of form (as trust or corporation).[135] In early 2005 the New York attorney general released a set of legislative proposals to amend the Not-for-Profit Corporation Law.[136] One proposal purports to mandate an audit committee for organizations with more than 25 board members, and audit committees would be required for organizations having audited financial statements or more than $2 million of revenue. The proposal, however, permits any not-for-profit corporation to opt out of these requirements by amending its articles of incorporation.[137] On September 30, 2004, the governor of California signed SB 1262, the Charity Integrity Act. Primarily directed to charitable solicitations, SB 1262 also contains some governance provisions. In general, the board or trustee of charities having at least $2 million in annual revenues must: obtain audited financial statements, and make these publicly available; "[i]f it is a corporation, have an audit committee appointed by the board of directors"; and "review and approve the compensation, including benefits, of the president or chief executive officer and the treasurer or chief financial officer to assure that it is just and reasonable."[138] In the private sector, the new standards used by the BBB Wise Giving Alliance to rate charities go much further: They recommend that no more than one person who directly or indirectly receives compensation from the charity should serve as a voting member of the board—and should not serve as chairman or treasurer.[139]

Beyond Sarbanes-Oxley, an area of particular concern is the corporate procedure for approving interested transactions between the nonprofit and the fiduciary. Professor Harvey Goldschmid endorses Professor Deborah DeMott's proposal that an interested transaction must be fair to the corpo-

135. *See, e.g.*, BOARDSOURCE & INDEP. SECTOR, THE SARBANES-OXLEY ACT AND IMPLICATIONS FOR NONPROFIT ORGANIZATIONS (2003), *available at* http://www.independentsector.org/issues/sarbanesoxley.html.

136. The four separate bills are available at http://www.oag.state.ny.us/charities/legislation.html (last visited Apr. 1, 2005).

137. Attorney General's Legislative Program, Program Bill 68-05, § 3, at 4–6, *at* http://www.oag.state.ny.us/charities/char_pdf/ag68-05.pdf (last visited Apr. 1, 2004) (proposing new subsections (f) and (g) to N-PCL § 712 (Executive committee and other committees)).

138. S.B. 1262 § 7, 2003–2004 Sess. (Cal. 2004) (amending section 12586 of the Government Code). *See generally* Brakman Reiser, *There Ought to Be a Law*, *supra* note 6 (discussing California, New York, and Massachusetts proposals).

139. *See* BBB Wise Giving Alliance, *Standards for Charity Accountability*, Standard 4 (Mar. 3, 2003), *available at* www.give.org/standards/; BBB Wise Giving Alliance, *Implementation Guide: BBB Wise Giving Alliance Standards for Charity Accountability*, at 9 (Mar. 3, 2003), *available at* www.give.org/standards/.

ration, and that the court's review be governed under loyalty standards, not the business judgment rule:[140]

> There is considerable strength in Professor DeMott's position. My concerns about deferential judicial review include the following: (i) the tendency of nonprofit directors to defer to each other in an environment "not characterized by skepticism and analytical rigor;" (ii) the absence in the nonprofit sector of "extensive [SEC] disclosure requirements, enforcement machinery and private litigation;" and (iii) the fact that nonprofit institutions generally lack voting rights, appraisal rights, and other protections available in the for-profit sector that would lessen the dangers, at least with respect to certain significant transactions.[141]

Marion Fremont-Smith believes that, of all the suggestions to reform the duty of loyalty, Professor Goldschmid's is "the most balanced and likely to gain acceptance."[142] While the burden of proof shifts to the interested party when an interested transaction has not been approved in accordance with corporate procedures, the draft Principles of the Law of Nonprofit Organizations also recommends an enhanced standard of judicial review for conflict-of-interest transactions that have been approved under such procedures.[143]

140. Professor Goldschmid writes:

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

Harvey J. Goldschmid, *The Fiduciary Duties of Nonprofit Directors and Officers: Paradoxes, Problems, and Proposed Reforms*, 23 J. CORP. L. 631, 648 (1998) (footnotes omitted, including a citation to Deborah A. DeMott, *Self-Dealing Transactions in Nonprofit Corporations*, 59 BROOK. L. REV. 131, 143 (1993)).

141. *Id.* Specifically, Professor Goldschmid recommends:

> two important modifications of duty of loyalty law as it would be applied in a for-profit context. First, when there has been proper disclosure with respect to an interested transaction, or another matter implicating the duty of loyalty, followed by disinterested approval, the highly deferential rationally believes test of the business judgment rule should not be the standard for judicial review. A fairness test, or at a minimum the ALI's intermediate test [in the Principles of Corporate Governance], should provide the applicable standard of review. Similarly, reviewing courts should give enhanced scrutiny to allegations of conflict of interest or dominating influence in the nonprofit context. Business and financial relationships, familial relationships, and "taints" to the process, for example, which might be considered of marginal concern in the for-profit context, should be resolved in favor of review under loyalty standards rather than the business judgment rule when nonprofit institutions are involved.

Id. at 650–51 (footnotes omitted).

142. FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS, *supra* note 13, at 436.

143. *See* ALI, Nonprofit Law, Council Draft No. 2, *supra* note 9, § 375 (Burden of Proof and Standard of Review), at 181.

2. Requirements for Federal Tax Exemption

a. *Substantive Requirements*

Congress might import additional governance rules into the Internal Revenue Code. Senator Chuck Grassley has been using his position as chair of the Senate Finance Committee to open a variety of investigations into the functioning of the federal tax exemption, both the substantive rules and compliance and enforcement.[144] In June 2004, the staff of the Senate Finance Committee issued a discussion draft on the IRS role in charity governance, proposing, among other things: applying private foundation self-dealing rules to public charities; barring (or limiting) compensation paid to trustees of nonoperating foundations; requiring that the chief executive officer (or equivalent officer) of a tax-exempt organization sign a declaration under penalty of perjury that he or she has instituted procedures to ensure that the organization's federal tax filings comply with the Internal Revenue Code; for organizations with more than $250,000 in gross receipts, requiring audited financial statements; and, for charitable organizations with over $250,000 in gross receipts, requiring the Form 990 to include "a detailed description of the organization's annual performance goals and measurements for meeting those goals (to be established by the Board of Directors) for the past year and goals for the coming year."[145]

The Senate Finance Committee staff's discussion draft frequently seems to assume that the organization takes the corporate form. In a section called "Encourage Strong Governance and Best Practices for Exempt Organizations," the discussion draft begins: "A charitable organization shall be managed by its board of directors or trustees (in the case of a charitable trust)."[146] A footnote to this sentence then states merely: "The duties of a

144. *See* U.S. GEN. ACCOUNTING OFFICE, GAO-02-526, REPORT TO THE CHAIRMAN AND RANKING MINORITY MEMBER, COMMITTEE ON FINANCE, U.S. SENATE, TAX-EXEMPT ORGANIZATIONS: IMPROVEMENTS POSSIBLE IN PUBLIC, IRS, AND STATE OVERSIGHT OF CHARITIES (Apr. 2002). *See generally* Norman I. Silber, *Nonprofit Interjurisdictionality*, 80 CHI.-KENT L. REV. 613 (2005).

145. SFC STAFF DISCUSSION DRAFT, *supra* note 67, at 10. See also an analysis of some of these proposals, and of some additional tax proposals, by the STAFF OF THE JOINT COMM. ON TAXATION, JCS-2-05, OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES (Jan. 27, 2005), *available at* http://www.house.gov/jct/s-2-05.pdf.

146. SFC STAFF DISCUSSION DRAFT, *supra* note 67, at 12. See also the proposals that: "all compensation that is subject to special IRS filing requirements must be approved annually and in advance by the Board of Directors (excluding from the approval process those members of the Board who have a conflict with respect to the compensation being considered)," *id.* at 5, and "[e]xempt organizations would be required to report how often the Board of Directors met and how often the Board met, without the CEO (or equivalent) present." *Id.* at 10. *See also* OFFICE OF INSPECTOR GEN. U.S. DEP'T OF HEALTH & HUMAN SERVS. & AM. HEALTH LAWYERS ASS'N, CORPORATE RESPONSIBILITY AND CORPORATE COMPLIANCE: A RESOURCE FOR HEALTH CARE BOARDS OF DIRECTORS (Apr. 2003), *available at* http://oig.hhs.gov/fraud/docs/complianceguidance/040203CorpRespRsceGuide.pdf.

board that are described in this paper would also be the duties of a trustee for a charitable trust."[147] It is not clear, however, whether a charitable trust with only one (or two) trustees could obtain tax exemption, in light of the specific proposal that the:

> Board shall be comprised of no less than three members and no greater than fifteen. No more than one member may be directly or indirectly compensated by the organization. Compensated members may not serve as the board's chair or treasurer. For public charities, at least one board member or one-fifth of the Board must be independent. A higher number of independent board members might be required in limited cases. An independent member would be defined as free of any relationship with the corporation or its management that may impair or appear to impair the director's ability to make independent judgments.[148]

Responses to the Senate Finance Committee staff's 2004 proposals, too, generally focused on the corporate model of charity governance. For example, the executive director of BoardSource, a nonprofit organization devoted to improving charity board operations, occasionally used the term "trustee" but clearly contemplated a corporate structure in making a proposal for detailed disclosure of board procedures.[149]

Finally, the federalism circle is closing: Beginning with Maine in 2002, the states are importing the federal tax prohibitions on excess benefit

147. SFC STAFF DISCUSSION DRAFT, *supra* note 67, at 12 n.15.

148. *Id.* at 13 n.17 (citing BBB Wise Giving Alliance, *supra* note 139, Standard 4 but omitting the sentence "Compensated Board Members shall not serve as the board's chair or treasurer"). *See also* Evangelical Council for Financial Accountability, *Seven Standards of Responsible Stewardship*, Standard 2, *available at* http://www.ecfa.org/ContentEngine.aspx?Page=7Standards (last visited Mar. 12, 2005).

149. The executive director of BoardSource, an organization devoted to improving nonprofit governance, proposed that the IRS supplement the publicly available Form 990 by requiring a governance disclosure form for charity boards. *See* Deborah S. Hechinger, *A Simple Way to Help Nonprofit Boards*, CHRON. PHILANTHROPY, Aug. 5, 2004, at 45. She believes that: "Requiring board members to fill out a disclosure form encourages better behavior without creating unintended consequences that jeopardize board performance or discourage people from serving on nonprofit boards." *Id.* She recommended that such a form ask—appropriate to the size and type of the responding organization—such questions as:

* How many times did the board meet this year?
* How many times did the board meet in executive session?
* Was the chief executive officer present at all executive sessions?
* Does the board have term limits for trustees?
* Does the board have a rotation policy for board officers?
* How long has the current board chair been in that position?
* Does the board have a conflict-of-interest policy?
* Did the board review and approve the organization's budget?
* Does the board have an audit committee?
* Has the board engaged in a process to assess the board's performance in the past three years?
* Did the board conduct a formal evaluation of the CEO's performance this year?

Id.

transactions into nonprofit corporate codes.[150] The effect is to give the state attorney general authority to enforce as fiduciaries prohibitions on cases of insider private inurement or excess benefits that exceed the fair market value of the property or services received by the charity.

b. Enforcement

The Senate Finance Committee staff's 2004 discussion draft includes a proposal that the Internal Revenue Service should have equity powers over exempt organizations.[151] This echoes a proposal from 1969, when the Treasury Department recommended to the Ways and Means Committee that the IRS have the power to obtain equitable sanctions in district court to enforce exempt-organization fiduciary duties.[152] The Treasury Department had introduced this proposal with the following general description:

> United States District Courts would be invested with (1) equity powers (including, but not limited to, power to rescind transactions, surcharge trustees and order accountings) to remedy any detriment to a philanthropic organization resulting from any violation of the substantive rules, and (2) equity powers (including, but not limited to, power to substitute trustees, divest assets, enjoin activities and appoint receivers) to ensure that the organization's assets are preserved for philanthropic purposes and that violations of the substantive rules will not occur in the future.[153]

150. 2001 Me. Laws ch. 550. Maine's lead is being followed in proposed legislation in New York and in Massachusetts. *See generally* Brakman Reiser, *There Ought to Be a Law*, *supra* note 6. Marion Fremont-Smith explains:

> By incorporating the prohibitions against private benefit in section 501(c) of the Internal Revenue Code and the limitations on excess benefit transactions in section 4958, [the Maine provisions] gave the state grounds for enforcing federal standards much as had been the case in connection with the adoption of restrictions on private foundations enacted in 1969. Furthermore, they addressed for the first time in state law the problems then being faced by the IRS in attempting to regulate joint ventures between charitable and for-profit investors. These provisions lay the groundwork for increased cooperation between the [Internal Revenue] Service and state attorneys general, a development much desired by both government entities although much limited in application.

FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS, *supra* note 13, at 231 (footnote omitted). Compare, following the imposition of restrictions on private foundations by the Tax Reform Act of 1969, section 1.50 (Private Foundations) in the Revised Model Nonprofit Corporation Act, the purpose of which "was to provide state attorneys general with sanctions that could be enforced in state courts as a complement to the federal sanction of loss of tax exemption." *Id.* at 167.

151. SFC STAFF DISCUSSION DRAFT, *supra* note 67, at 16–17.

152. *See* Treasury Proposals to Improve Private Philanthropy (Treas. Dept. News Release Jan. 18, 1977), [1977] 9 Stand. Fed. Tax Rep. (CCH) ¶ 6156, at 70,850–57 (Jan. 26, 1977).

153. *Id.* at Technical Explanation, part 1.C.1.b.(2)(a), at 70,855 (Improving the Philanthropic Process, Enforcement Procedures, Alternative Sanctions, Treasury Proposal, Detailed Description, Equity Powers). This proposal specified that the federal courts would defer to any state equitable proceedings:

> In the event that appropriate State authorities institute action against a philanthropic organization or individuals based upon acts which constitute a violation of substantive rules of law applicable to such an organization, the United States District Court before whom the federal civil action is instituted or was pending would be required to defer action on any equitable re-

Congress did not enact these 1977 proposals. However, it should be appreciated that explicit statutory remedies have never been the IRS's only weapon: The agency can use and has used the threat of revocation of exemption to exact specific management changes in the course of negotiating "closing agreements" that ensure future compliance—including reduced compensation, repayment of amounts improperly obtained or expended, and the adoption of a compensation committee structure or other governance changes. In the most recent notorious case where this occurred, the Bishop Estate, the charity was a trust.[154]

The Senate Finance Committee staff's discussion draft also proposes that "[a]ny director/trustee (at the time of bringing the proceeding) may bring a proceeding"—although the proposal does not specify whether the issue must be one relating to tax exemption. In describing demand on the board as a prerequisite to suit and the availability of expenses (including legal fees) for a successful prosecution, the discussion draft cites to existing corporate law.[155]

3. Conclusion as to Organizational Form

Possible state and federal corporate legislation opens the door for opportunistic charity fiduciaries to select a less-regulated regime. If policy makers focus on nonprofit corporation law, charities might prefer to form as trusts. If states vary on their substantive or structural requirements, fo-

> lief for protection of the organization or preservation of its assets for its philanthropic purposes until conclusion of the State court action. At the conclusion of the State court action, the District Court could consider the State action adequate or provide further equitable relief, consistent with the State action, as the case warrants. However, no action by a State court would defer or abate the imposition of the initial Federal excise taxes for the violations.

Id. at part 1.C.1.b.(2)(c), at 70,856.

154. See the Kamehameha Schools/Bishop Estate closing agreement, which the IRS insisted be placed on the Web (go to http://www.ksbe.edu/newsroom/filings/toc.html#closing). This agreement required, in addition to a payment from KSBE to the IRS of $9 million plus interest (for a total of about $14 million), the permanent removal of the incumbent trustees; the reorganization of KSBE around a chief executive officer to carry out the policy decisions of the board of trustees; the adoption of an investment policy and a spending policy focused on education; adoption of a conflicts-of-interest policy and adherence to the probate court's directive for setting trustee compensation; a ban on hiring any governmental employee or official until three years after termination of governmental service; and the Internet posting of the final closing agreement and of KSBE financial statements for the next five years. DEP'T OF THE TREASURY, INTERNAL REVENUE SERV., ESTATE OF BERNICE PAUAHI BISHOP, ALSO KNOWN AS, KAMEHAMEHA SCHOOLS BISHOP ESTATE, CLOSING AGREEMENT ON FINAL DETERMINATION COVERING SPECIFIC MATTERS (Aug. 18, 1999), *available at* http://www.ksbe.edu/newsroom/filings/toc.html#closing. *See generally* Brody, *A Taxing Time for Bishop Estate*, *supra* note 100.

155. SFC STAFF DISCUSSION DRAFT, *supra* note 67, at 17 & n.24 ("See generally Cal. Corp. Code Section 5142 (allowing, inter alia, officers and directors to bring an action against a charitable trust) as well as the Revised Model Nonprofit Corporation Act (1987) Section 6.30 Derivative Suits (allowing directors and members to bring derivative suits).").

rum-shopping will result. Notably, organizers might choose a particular state in which to form based on the ease of formation and ongoing regulation, the absence of a requirement that a majority of directors be financially disinterested, or the availability of the limited liability company form for charity. Already an issue of growing importance is the role of state authorities when the charity incorporates in one state but operates in another state. Typically, the state of operation requires the foreign charity to register if it "does business" or owns assets in the state. The degree of state oversight over the "internal affairs" of foreign charities, however, remains largely untested in the courts.

CONCLUSION

The fiduciary standards for trustees of charitable trusts and for directors of corporate charities are more similar than commonly believed. Of course, as long as differences remain between organizational forms and among states, charity organizers will exploit the ability to choose.

As a separate matter, however, the nonprofit sector has itself been coalescing around good governance practices that go beyond the minimum requirements of law. These "best practices" rely to a large degree on structural protections. The corporate model of governance and accountability looks to a well-informed, independent board, of minimum size, acting in good faith and without impermissible conflicts of interest. Trust instruments may set forth provisions for governing charitable trusts that adopt the corporate board/management structure. In general, to ensure appropriate accountability and good governance, the typical operating charity should take the corporate form, or, if a trust, should have a governing board and executive structure similar to that of a nonprofit corporation.

The time might have come for the law of charity governance to reward these structural protections. A charitable trust with a single trustee or lacking separation of oversight and management should—like the nonprofit corporation without appropriate controls—be subject to closer scrutiny to determine whether the governing board and its members met their fiduciary duty. Moreover, the smaller the number of trustees or corporate board, the greater should be the obligation on a fiduciary to initiate action against another who breaches the duty of loyalty or otherwise acts in bad faith. As described above, for boards of business corporations, recent Delaware jurisprudence holds that bad faith renders unavailable a waiver or exculpation of traditional fiduciary duties. However, the burden generally still falls on the plaintiff to prove causation and damages from a director's bad faith breach. The burden of proof shifts to the defendant only in cases of breach of the duty of loyalty, and only if the interested director has not made appropriate disclosure or obtained approval. Is there a workable way for the law—at least in the case of fiduciaries of charities with small or conflicted boards—to require that, in a bona fide allegation that a fiduciary has breached the duty of care by acting in bad faith, the burden of proof should shift to that fiduciary to show absence of harm to the charity?