

**NOTE**

## THE PRINCIPAL PROBLEM: TOWARDS A MORE LIMITED ROLE FOR FIDUCIARY LAW IN THE NONPROFIT SECTOR

*Natalie Brown\**

## INTRODUCTION

CONSIDER three recent scandals involving reputable nonprofit corporations: the Red Cross, the Central Asia Institute, and Yale University.

*The Red Cross*

In the wake of the September 11th terrorist attacks, the public donated approximately \$500 million to the Red Cross to aid victims of the attack.<sup>1</sup> The Red Cross, however, felt that it would be “fiscally irresponsible” to give the whole \$500 million to the families of the immediate victims, and it announced plans to reserve over \$200 million in donations for emerging terrorism attack needs.<sup>2</sup> This announcement sparked a congressional oversight hearing and factored into the decision of the Red Cross’s president to resign.<sup>3</sup> The crux of the debate: Was the Red Cross diverting funds that donors presumably intended for immediate victims for its own institutional needs?<sup>4</sup>

*The Central Asia Institute*

The Central Asia Institute (“CAI”), a nonprofit that promotes literacy and education in central Asia, is famous for being the brainchild of co-

---

\* J.D. 2012, University of Virginia School of Law; M.Phil. 2008, Columbia University; B.A. 2004, University of Chicago. I would like to thank Professor Kevin Kordana for inspiration and guidance in writing this Note. I am also grateful to the members of the Virginia Law Review, especially James Percival, Justin Lollman, and Karl Herrmann, and Michael Shirts for rigorous critiques and comments. All errors are my own.

<sup>1</sup> Corey Kilgannon, Red Cross Offers to Refund Gifts for Sept. 11, N.Y. Times, Nov. 12, 2001, at B10.

<sup>2</sup> Id.

<sup>3</sup> Id.

<sup>4</sup> Id.

founder Greg Mortenson, the author of *Three Cups of Tea*. In 2011, an exposé by Jon Krakauer placed CAI and Mortenson under scrutiny. Amongst Krakauer's allegations is the claim that CAI paid virtually all of Mortenson's expenses for writing and promoting *Three Cups of Tea*, although it received no royalties.<sup>5</sup> In Krakauer's view, Mortenson's use of CAI's assets to write and promote his book was a wrongful taking of nonprofit assets for self-interested gain. But the decision to fund Mortenson was economically sound from the perspective of CAI and its beneficiaries. While the board certainly could have followed a better process in making the decision to fund a pursuit that resulted in personal benefit for Mortenson, the publicity from the book generated over \$20 million in donations to CAI in 2010 alone.<sup>6</sup>

#### *Yale University*

On March 31, 2011, Yale announced its decision to partner with the National University of Singapore ("NUS") to create Yale-NUS College, a four-year undergraduate program in Singapore that will open to students in 2013.<sup>7</sup> Many current beneficiaries of Yale, however, strongly oppose Yale's affiliation with the new program designed to help students abroad. Some believe that locating Yale in an authoritarian state with a record of human rights violations and accepting constraints on academic freedom compromises Yale's mission.<sup>8</sup> Others object that it attaches Yale's name to an experience that is not comparable to that found in New Haven.<sup>9</sup> While the objections vary in content, they are unified in their desire to protect the Yale brand that current beneficiaries value. As one professor put it, current beneficiaries do not want Yale to become "Yale-New Haven."<sup>10</sup>

---

<sup>5</sup> Jon Krakauer, *Three Cups of Deceit* 37 (2011).

<sup>6</sup> *Id.* at 36.

<sup>7</sup> NUS and Yale to Create Singapore's First Liberal Arts College, *YaleNews* (Mar. 31, 2011), <http://opac.yale.edu/news/article.aspx?id=8396>.

<sup>8</sup> Seyla Benhabib, *Why I Oppose Yale in Singapore*, *Yale Daily News* (May 18, 2011), <http://www.yaledailynews.com/news/2011/may/18/benhabib-why-i-oppose-yale-singapore>; Christopher Miller, *Yale's Principles for Sale in Singapore*, *Yale Daily News* (April 3, 2011), <http://www.yaledailynews.com/news/2011/apr/03/yale-principles-sale-singapore>.

<sup>9</sup> Muhammad Cohen, *Yale Alumni Lament Singapore Sting*, *Asia Times Online* (Sept. 9, 2011), [http://www.atimes.com/atimes/Southeast\\_Asia/MI09Ae03.html](http://www.atimes.com/atimes/Southeast_Asia/MI09Ae03.html).

<sup>10</sup> Christopher L. Miller, *Yale in Singapore: Lost in Translation*, *Chron. Rev.*, May 6, 2011, at B2.

Three scandals. Or are they? What unifies these three events is that whether they deserve the name “scandal” depends largely on whose interests we believe nonprofits should protect.

\*\*\*

Fiduciary law developed in the for-profit sector rests on the premise that corporate boards and directors are agents who owe their principals duties to act with care and loyalty. This body of law is the bedrock of state-level efforts to govern nonprofit corporations. Nonprofit law scholars have increasingly recognized, however, that fiduciary law developed to govern for-profit corporations does not readily translate into the nonprofit sector. A substantial body of literature has sought to strengthen nonprofit governance by tailoring for-profit fiduciary law to fit the needs of nonprofit corporations. If we could only monitor and enforce fiduciary duties well, the story goes, then we could assure that nonprofits better fulfill their missions. No one has satisfactorily answered, however, the fundamental question of to whom nonprofit boards and directors owe their fiduciary duties. Without understanding whose interests fiduciary law should protect, attempts to strengthen it are premature.

In for-profit corporations, shareholders with claims to residual profits are the principals. But nonprofit corporations do not have shareholders entitled to profits. They instead have a variety of constituents, including donors, beneficiaries, customers, and the general public, none of whom have primacy under current law. Although the question of to whom nonprofit duties are owed has been raised, most notably by Professor Evelyn Brody, courts and scholars have largely avoided the task of answering it.<sup>11</sup> The result is a vague body of law that gives little guidance to those seeking to comply and allows the state discretionary enforcement power.

Sometimes, the question of to whom duties are primarily owed is irrelevant. Acts of overt theft or extreme negligence by a director or officer are easy cases in which a fiduciary duty would be violated no matter to whom it is owed. But these are also situations in which fiduciary duties are less needed to provide guidance and deter wrongdoing, since

---

<sup>11</sup> Evelyn Brody, *Agents Without Principals: The Economic Convergence of the Nonprofit and For-Profit Organizational Forms*, 40 N.Y.L. Sch. L. Rev. 457, 465 (1996). Brody, for example, surveys potential nonprofit principals but concludes she “cannot . . . answer the normative question: Who are the ‘principals’ to whom society *wants* the charity to answer.” *Id.* at 512 (emphasis in original).

the wrongfulness of the acts is patent and the reputational penalties for malfeasance severe.

Rather, the scandals surveyed here involved directors and officers making decisions that shifted missions or prioritized some constituents over others. Such occurrences are commonplace in the governance of complex organizations, but in these cases resulted in a public contest over the question of whose interests the nonprofit should serve. Such controversial decisions can be seen simultaneously as both discretionary judgment calls and as opportunities for directors to abuse their authority by allocating assets on a self-interested basis. These murky situations are precisely those in which nonprofits could most benefit from a clear principal to guide and enforce in whose interests decisions should be made, both to promote good governance and to define where nonprofits can act without fear of legal repercussions. But the law has not clarified to whom nonprofit boards and directors owe their duties. These scandals illustrate how boards are in practice left to define to whom they believe they owe their duties through their decisions, and unhappy stakeholders are free to push back publicly.

The important question, then, is whether there is an appropriate principal in nonprofit corporations. Corporate fiduciary law diagnoses governance problems in terms of agency costs and resolves problems by creating enforceable relationships under which agents must act in the interests of their principals. Thus, unless a principal is named, fiduciary duties are often empty because there is no principal by which to guide decisions and measure performance. This Note will consider potential classes of nonprofit principals and demonstrate that each would be an inappropriate principal. Since nonprofits have no suitable principals, fiduciary law is a poor mechanism for nonprofit governance and should be acknowledged as such rather than modified and reformed. Future efforts to shape nonprofit governance should thus recognize a legal toolkit that is more limited than we have hitherto assumed.

Part I will examine the basic legal structure that governs the nonprofit sector, as well as academic attempts to reform existing fiduciary law. It will argue that academic proposals to tweak fiduciary law are premature since they do not address the foundational issue of to whom duties should be owed. Part II will examine the traditional rationales for fiduciary law in order to provide the background necessary for evaluating why a constituency should or should not be owed a fiduciary duty. Part III will consider to whom, if anyone, nonprofit corporations should owe du-

ties, and it concludes that no candidates are appropriate principals. Having examined the problems with fiduciary law, Part IV will discuss why the role of law in nonprofit governance, if any, must consequently be limited to prescribing targeted rules that do not require courts to infer a principal and promoting private market mechanisms for nonprofit governance. This argument will show that the legal tools available for nonprofit reform are more limited than we have assumed, and will call for refocusing academic debate on viable legal mechanisms for promoting good nonprofit governance.

#### I. THE LEGAL STRUCTURE OF THE NONPROFIT SECTOR

The defining feature of nonprofit corporations is that they must adhere to the “nondistribution constraint.”<sup>12</sup> This constraint mandates that a nonprofit may not distribute any profit it earns to those who control the firm.<sup>13</sup> A nonprofit thus has no residual claimants. This constraint limits how a nonprofit can raise capital because it generally cannot issue shares entitled to profits. It also limits how a nonprofit can dispose of its assets at dissolution. As a general rule, a dissolving nonprofit must transfer unrestricted assets to another nonprofit with an exempt charitable purpose, and in some states to a nonprofit with a substantially similar charitable purpose.<sup>14</sup> Assets held in trust or otherwise restricted require the nonprofit to petition the court under the doctrines of *cy pres* or deviation to

---

<sup>12</sup> Henry B. Hansmann, Reforming Nonprofit Corporation Law, 129 U. Pa. L. Rev. 497, 501 (1981).

<sup>13</sup> See Model Nonprofit Corp. Act § 6.40(a) (2008). A problem when writing about issues of state law is how best to aggregate the law of various states. Nonprofit corporations generally incorporate in the state in which their activities are pursued, and there is no equivalent of Delaware in the nonprofit sector. Garry W. Jenkins, Incorporation Choice, Uniformity, and the Reform of Nonprofit State Law, 41 Ga. L. Rev. 1113, 1116 (2007). The Model Nonprofit Corporation Act (“Model Act”), however, is a good representative of state law because either the Model Act or the Revised Model Nonprofit Corporation Act has been adopted in some form by more than half the states. Marion R. Fremont-Smith, Governing Nonprofit Organizations: Federal and State Law and Regulation 514–17 tbl.3 (2004). The most important exceptions are California, Delaware, and New York. This Note indicates important instances when the law of these states differs from that of the Model Act. Another compilation of nonprofit law is the American Law Institute’s Principles of Nonprofit Organization. Still in draft form, this restatement embodies current and emerging consensus on nonprofit law and is cited where it adds additional clarity. Principles of the Law of Nonprofit Orgs. (Tentative Draft No. 1, 2007).

<sup>14</sup> See, e.g., *In re Multiple Sclerosis Serv. Org. of N.Y.*, 496 N.E.2d 861, 866–67 (N.Y. 1986).

substitute another charitable object that approaches the donor's designated purpose as closely as possible.<sup>15</sup>

An important exception to the rules governing distribution of assets involves "mutual benefit" nonprofits. In some jurisdictions, nonprofits are subdivided into public benefits and mutual benefits.<sup>16</sup> Public benefit nonprofits typically serve a public or charitable purpose.<sup>17</sup> Mutual benefits, by contrast, do not serve public charitable purposes and members can claim the nonprofit's assets at dissolution.<sup>18</sup> They might include organizations such as a social clubs, trade organizations, or homeowners associations. This Note focuses only on public benefit nonprofits, because they differ from mutual benefits in their governance and tax concerns.

A nonprofit's articles of incorporation outline its purpose and operational framework. A key choice is whether the nonprofit will have a membership with voting power. The term "member" has a narrow legal meaning. It refers to "[a] person who has the right, in accordance with the articles of incorporation or bylaws . . . to select or vote for the election of directors or delegates or to vote on any type of fundamental transaction."<sup>19</sup> Most public benefit nonprofits have no members and are instead run entirely by a "self-perpetuating board of directors."<sup>20</sup> In those that do have members, the members and directors are often the same people.<sup>21</sup> The directors of public benefit nonprofits are thus typically insulated from member oversight and control.

---

<sup>15</sup> See Model Nonprofit Corp. Act § 14.05(c) (2008). Note, however, that in eleven states, including California and New York, the *cy pres* doctrine is applied to the nonprofit's general assets as well. Fremont-Smith, *supra* note 13, at 184.

<sup>16</sup> See, e.g., Cal. Corp. Code §§ 5059–5060 (Deering 2009).

<sup>17</sup> See, e.g., id. § 5111 ("[A] corporation may be formed under this part for any public or charitable purposes.").

<sup>18</sup> See, e.g., id. § 7111 ("Subject to any other provision of law of this state applying to the particular class of corporation or line of activity, a corporation may be formed under this part [governing mutual benefit corporations] for any lawful purpose; provided that a corporation all of the assets of which are irrevocably dedicated to charitable, religious, or public purposes and which as a matter of law or according to its articles or bylaws must, upon dissolution, distribute its assets to a person or persons carrying on a charitable, religious, or public purpose or purposes may not be formed under this part."); id. § 8717(b) (making the default rule for mutual benefits distribution of assets to the membership at dissolution); see also *In re L.A. Cnty. Pioneer Soc'y*, 257 P.2d 1, 7 (Cal. 1953) (explaining that mutual benefit charities, but not public benefit charities, may transfer assets to members upon dissolution).

<sup>19</sup> See Model Nonprofit Corp. Act § 1.40(37)(i).

<sup>20</sup> Fremont-Smith, *supra* note 13, at 159.

<sup>21</sup> *Id.*

A nonprofit incorporated under state law can separately qualify for federal tax exemptions and deductions. There are many kinds of tax-exempt nonprofits, but the most applicable category for this Note are 501(c)(3) public charities. These charities must be organized for one of the public purposes specified in Section 501(c)(3) of the Internal Revenue Code, their assets cannot inure to the benefit of private shareholders or individuals, and they are restricted in their abilities to lobby and campaign.<sup>22</sup> They commonly include organizations that focus on education, health, arts, and other services. The primary benefit of 501(c)(3) status is that it qualifies the nonprofit to receive tax-deductible donations.<sup>23</sup> Many 501(c)(3)s, however, receive the bulk of their income from commercial sources. In 2008, 501(c)(3)s reported \$1.4 trillion in revenue, with the largest shares going to hospitals and higher education.<sup>24</sup> Commercial fees accounted for 69.8% of all revenue for public charities.<sup>25</sup>

Corporate fiduciary law is the backbone of state regulation of nonprofit corporations, and states have largely imported for-profit fiduciary law without much modification to govern nonprofit corporations.<sup>26</sup> The basic framework of for-profit fiduciary law provides that directors and officers owe fiduciary duties to the corporation and its shareholders, requiring them to act with care and loyalty to protect their principals' interests. These duties provide both guidance to directors to channel their decision making and civil penalties for noncompliance. The application of law conceived in the for-profit context to nonprofit corporations is at times, however, uneasy.

In both the for-profit and nonprofit context, directors' and officers' substantive decisions are typically shielded from judicial review by the business judgment rule, a rebuttable presumption that "in making a business decision, the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in

---

<sup>22</sup> I.R.C. § 501(c)(3) (Supp. V 2011).

<sup>23</sup> I.R.C. § 170(a)(1), (c).

<sup>24</sup> Kennard T. Wing et al., *Urban Inst., The Nonprofit Sector in Brief: Public Charities, Giving, and Volunteering*, 2010, at 2 (2010), available at <http://www.urban.org/publications/412209.html>.

<sup>25</sup> *Id.* at 3.

<sup>26</sup> See Harvey J. Goldschmid, *The Fiduciary Duties of Nonprofit Directors and Officers: Paradoxes, Problems, and Proposed Reforms*, 23 *J. Corp. L.* 631, 638 (1998) (stating that nonprofit law uses "for-profit 'hand-me-downs'").

the best interests of the company.”<sup>27</sup> In the for-profit context, courts justify deference to the board’s decisions on grounds that they should respect the shareholders’ selection of management and that after-the-fact litigation is an inappropriate mechanism for evaluating business decisions.<sup>28</sup> The business judgment rule is applied to nonprofits as well, although some question whether deference is justified in the nonprofit sector where directors are often self-perpetuating and unchecked by shareholder choice or oversight.<sup>29</sup> A plaintiff, however, can rebut the presumption by showing the director’s action breached one of the two core duties fiduciary law imposes on directors: the duty of care and the duty of loyalty.<sup>30</sup>

In general terms, the duty of care requires that directors take reasonable care managing a corporation.<sup>31</sup> It governs the process and formalities by which directors reach decisions: They must be reasonably informed and pay reasonable attention to their responsibilities. But in practice the duty of care carries little weight. In the for-profit context, a corporate director or officer does not breach the duty of care absent “gross negligence.”<sup>32</sup> Delaware has further weakened the duty of care by enacting a statute that allows corporations to adopt amendments shielding directors who breach the duty from personal liability.<sup>33</sup>

Courts give more attention to the duty of loyalty, which broadly requires a director to act in the best interests of the corporation rather than in his own self-interest. According to the American Law Institute, the duty requires:

---

<sup>27</sup> *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985) (internal quotation marks omitted).

<sup>28</sup> *Joy v. North*, 692 F.2d 880, 885–86 (2d Cir. 1982).

<sup>29</sup> See *Janssen v. Best & Flanagan*, 662 N.W.2d 876, 883 (Minn. 2003) (“We find no case denying a nonprofit organization the protection of the business judgment rule.”). For an argument against the application of the business judgment rule in the nonprofit sector, see Denise Ping Lee, Note, *The Business Judgment Rule: Should It Protect Nonprofit Directors?*, 103 Colum. L. Rev. 925, 967 (2003).

<sup>30</sup> *In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27, 52 (Del. 2006).

<sup>31</sup> See *Principles of the Law of Nonprofit Orgs.* § 315 (Tentative Draft No. 1, 2007) (“The duty of care requires each governing-board member—(a) to become appropriately informed about issues requiring consideration, and to devote appropriate attention to oversight; and (b) to act with the care that an ordinarily prudent person would reasonably exercise in a like position and under similar circumstances.”).

<sup>32</sup> *Smith*, 488 A.2d at 873.

<sup>33</sup> Del. Code. Ann. tit. 8, § 102(b)(7) (2011).



each governing-board member—(a) to act in a manner that he or she reasonably believes to be in the best interests of the charity, in light of its stated purposes; and (b) to handle appropriately . . . situations in which the interests of the charity do or might conflict with the interests of fiduciaries and related persons.<sup>34</sup>

Examples of actions that could violate the duty of loyalty include using the nonprofit's assets for personal gain through direct theft or contracting with the nonprofit on favorable terms<sup>35</sup> or usurping a corporate opportunity.<sup>36</sup> Trust law flatly prohibits transactions between the trust and a trustee or an entity in which the trustee is interested.<sup>37</sup> But nonprofit corporate law standards permit conflict of interest transactions if the facts are revealed to and voted on by disinterested directors or members or if the transactions are fair to the corporation.<sup>38</sup>

The conventional explanation for giving more scrutiny to the duty of loyalty is that decisions involving a conflict of interest are less entitled to judicial deference given the taint of self-interest.<sup>39</sup> Judge Frank Easterbrook and Professor Daniel Fischel argue that the dichotomous treatment of the duties of care and loyalty are better explained through “the differential payoffs from breach and policing.”<sup>40</sup> Violations of the duty of loyalty are typically easier for courts to detect than negligence, making them easier to enforce.<sup>41</sup> Judge Easterbrook and Professor Fischel also argue that market penalties are less able to deter violations of the duty of loyalty than the duty of care.<sup>42</sup> Acts of chronic negligence or underperformance can be retrospectively punished by investors and the labor market more easily than “take the money and run” incidents of one-time malfeasance that can characterize duty of loyalty violations.<sup>43</sup> Ac-

---

<sup>34</sup> Principles of the Law of Nonprofit Orgs. § 310.

<sup>35</sup> See, e.g., *Nixon v. Lichtenstein*, 959 S.W.2d 854, 857–58 (Mo. Ct. App. 1997) (finding a violation where directors paid themselves excessive compensation and used the nonprofit's funds for a variety of personal expenses).

<sup>36</sup> See, e.g., *Ne. Harbor Golf Club v. Harris*, 661 A.2d 1146, 1151 (Me. 1995) (discussing whether an officer's purchase of property abutting the nonprofit usurped a corporate opportunity).

<sup>37</sup> See Restatement (Third) of Trusts § 78(2) (2007).

<sup>38</sup> See Model Nonprofit Corp. Act § 8.60.

<sup>39</sup> Frank H. Easterbrook & Daniel R. Fischel, *The Economic Structure of Corporate Law* 103 (1991).

<sup>40</sup> *Id.*

<sup>41</sup> *Id.*

<sup>42</sup> *Id.*

<sup>43</sup> *Id.*

cordingly, a strong duty of loyalty is needed to supplement the market penalties. For these reasons, courts have imposed a strong duty of loyalty to supplement the market penalties.<sup>44</sup>

The contours and rationales behind the fiduciary duties developed in the for-profit context fit uneasily, however, in the nonprofit context.<sup>45</sup> Nonprofits differ in key ways from for-profits in their organization and in the regulations and markets to which they are subject. A difference of particular importance is the structure of a nonprofit's board of directors. Most public benefit nonprofits are governed by self-perpetuating boards of directors<sup>46</sup> composed of the founders or their appointees, and many are composed of volunteers.<sup>47</sup> As a consequence, nonprofit directors are insulated from many mechanisms that promote accountability in the for-profit sector, including shareholders and the labor and takeover markets.<sup>48</sup>

Nonprofits' limited choice of capital structure also reduces the ability of capital markets to discipline their behavior. They often lack powerful institutional investors and are not typically subject to securities regulations, exchange requirements, or pressures caused by share price and analyst reports.<sup>49</sup> Nonprofits are subject to disclosure requirements, but those requirements have limited utility. Those claiming federal tax exemption must typically file annual disclosures on Form 990 specifying details including their income, disbursements, achievements, governance

---

<sup>44</sup> *Id.*

<sup>45</sup> See, e.g., Evelyn Brody, *The Limits of Charity Fiduciary Law*, 57 *Md. L. Rev.* 1400, 1500 (1998) (“[D]irectors of nonprofit corporations operate under legal regimes designed for their proprietary cousins.”); Geoffrey A. Manne, *Agency Costs and the Oversight of Charitable Organizations*, 1999 *Wis. L. Rev.* 227, 235 (“[T]he analytical power of the theory of the firm does not readily transfer to the realm of nonprofits.”).

<sup>46</sup> Fremont-Smith, *supra* note 13, at 159.

<sup>47</sup> See, e.g., Carter G. Bishop, *The Deontological Significance of Nonprofit Corporate Governance Standards: A Fiduciary Duty of Care Without a Remedy*, 57 *Cath. U. L. Rev.* 701, 702 (2008) (noting “the diverse charitable missions of nonprofit organizations and the high rate of unpaid donor and volunteer service among charitable nonprofit boards of directors”).

<sup>48</sup> See, e.g., Deborah A. DeMott, *Self-Dealing Transactions in Nonprofit Corporations*, 59 *Brook. L. Rev.* 131, 142–43 (1993) (discussing nonprofit directors' arguments that they are not required to consider third-party takeover offers).

<sup>49</sup> For examples of other scholars who have commented on factors that limit for-profit corporations but that do not apply to nonprofits, see, for example, Goldschmid, *supra* note 26, at 636, and Manne, *supra* note 45, at 228.

structure, and policies.<sup>50</sup> Form 990 is also regularly required by state regulators.<sup>51</sup> Churches, however, are exempt from federal disclosure requirements,<sup>52</sup> and federal and state regulators rarely have resources to review their filings.<sup>53</sup>

Nonprofit fiduciary duties are also more difficult to enforce than for-profit duties because most interested parties lack standing to sue.<sup>54</sup> Generally only the state attorney general and sometimes directors and members have standing to sue a nonprofit.<sup>55</sup> Case law on nonprofit corporations and charitable trusts, to which courts sometimes draw analogies,<sup>56</sup> shows that beneficiaries have usually been granted standing only where they can establish a “special interest” in funds administered by the organization.<sup>57</sup> Attorneys general, however, have few resources to devote

<sup>50</sup> Internal Revenue Serv., Form 990, Return of Organization Exempt from Income Tax 1–2 (2012), available at <http://www.irs.gov/pub/irs-pdf/f990.pdf>.

<sup>51</sup> See Peter Swords, *The Form 990 as an Accountability Tool for 501(c)(3) Nonprofits*, 51 *Tax Law.* 571, 577 (1998).

<sup>52</sup> I.R.C. § 6033(a)(3)(A).

<sup>53</sup> See Swords, *supra* note 51, at 578.

<sup>54</sup> See Manne, *supra* note 45, at 238 (“[S]tanding rules have essentially undermined the effectiveness of default fiduciary rules as they apply to the nonprofit sector.”).

<sup>55</sup> For a chart detailing parties with standing to bring direct and derivative actions under current state and model statutes, see *Principles of the Law of Nonprofit Organizations* 46–47 (Tentative Draft No. 3, 2011). In addition to suits by the attorney general, twenty states currently permit derivative actions by board members and twenty-five by members. *Id.*

<sup>56</sup> Courts often reason analogously between nonprofit, corporate, and charitable trust law. For example, in *Holt v. College of Osteopathic Physicians and Surgeons*, 394 P.2d 932, 936–37 (Cal. 1964), the court applied charitable trust law to trustees of a nonprofit corporation, stating:

It is true that trustees of a charitable corporation do not have all the attributes of a trustee of a charitable trust. They do not hold legal title to corporate property . . . and they are not individually liable for corporate liabilities . . . . The individual trustees in either case, however, are the ones solely responsible for administering the trust assets . . . and in both cases they are fiduciaries in performing their trust duties . . . . Rules governing charitable trusts ordinarily apply to charitable corporations.

Similarly, in *Alco Gravure v. Knapp Foundation*, 479 N.E.2d 752, 755 (N.Y. 1985), the court reasoned analogously from trust law to address whether plaintiffs had standing to sue a corporation: “As to the individual plaintiffs, no case squarely in point has been found but on analogy to trust law they should be accorded standing.” The court later continued the analogy: “Normally, standing to challenge actions by the trustees of a charitable trust or corporation is limited to the Attorney-General . . . .” *Id.*

<sup>57</sup> See, e.g., *Alco Gravure*, 479 N.E.2d at 755 (“The general rule is that one who is merely a possible beneficiary of a charitable trust, or a member of a class of possible beneficiaries, is not entitled to sue for enforcement of the trust. . . . There is an exception to the general rule, however, when a particular group of people has a special interest in funds held for a charitable purpose, as when they are entitled to a preference in the distribution of such funds

to enforcement: New York and California have only eighteen and ten attorneys devoted to this enforcement, respectively, yet are amongst the best-staffed state offices for charitable enforcement.<sup>58</sup>

Scholars have noted with dissatisfaction the ill fit between for-profit corporate law and nonprofit corporations. Widespread public perception that the nonprofit sector is plagued by waste and lack of accountability has made tailoring corporate law to the nonprofit sector an important goal.<sup>59</sup> There are a host of proposals to reform nonprofit law. A significant number of these proposals focus on retaining but modifying fiduciary law to improve nonprofit governance.

Debate has focused in and out of the courtroom on how robust fiduciary duties should be in the nonprofit sector. In *George Pepperdine Foundation v. Pepperdine*, the court held a nonprofit director to a lower standard than a for-profit director.<sup>60</sup> Although the holding was subsequently overruled, Professors James Fishman and Stephen Schwarz explain that it “reflects a widespread attitude that nonprofit directors are essentially volunteers, and aggressive attempts to enforce their responsibilities are inappropriate and will discourage individuals from board service.”<sup>61</sup> Professor Brody, for example, has argued that lower standards benefit nonprofits by allowing them to attract directors who might not otherwise serve.<sup>62</sup> Other courts have held that nonprofit and for-profit standards should be the same, because directors perform the same func-

---

and the class of potential beneficiaries is sharply limited in number.” (citations omitted)); see also Fremont-Smith, *supra* note 13, at 328.

<sup>58</sup> Fremont-Smith, *supra* note 13, at 445.

<sup>59</sup> See, e.g., Terri Lynn Helge, Policing the Good Guys: Regulation of the Charitable Sector Through a Federal Charity Oversight Board, 19 Cornell J.L. & Pub. Pol’y 1, 8 (2009) (“To restore public confidence in the charitable sector, there must be responsible oversight of the sector . . .” (citing Susan N. Gary, Regulating the Management of Charities: Trust Law, Corporate Law, and Tax Law, 21 U. Haw. L. Rev. 593, 595 (1999))). A 2008 Brookings report found that 34% of Americans had “not too much” or no confidence in charities. Paul C. Light, Brookings, How Americans View Charities: A Report on Charitable Confidence, 2008, at 1 (2008). Approximately 70% thought that charities waste “a great deal” or a “fair amount” of money. *Id.* at 2. A 2007 Ethics Resource Center survey found that 55% of nonprofit employees had witnessed misconduct in their organizations. Ethics Resource Center, National Nonprofit Ethics Survey 2 (2007).

<sup>60</sup> See 271 P.2d 600, 604 (Cal. Dist. Ct. App. 1954), overruled by *Holt*, 394 P.2d at 937.

<sup>61</sup> James J. Fishman & Stephen Schwarz, *Nonprofit Organizations: Cases and Materials* 142 (4th ed. 2010).

<sup>62</sup> Brody, *supra* note 45, at 1413 (arguing that “more exacting standards” for the duty of care can “do more harm than good” by discouraging directors from serving).

tions in both.<sup>63</sup> Academics have extended this discussion to whether a duty of loyalty that flatly prohibits conflict of interest transactions should be adopted given that nonprofit directors often make decisions without meaningful supervision.<sup>64</sup>

Debate has also traditionally centered on how to assure duties are enforced given the limited resources of attorneys general.<sup>65</sup> Some scholars have proposed extending standing to nonprofits' patrons<sup>66</sup> and founders;<sup>67</sup> creating for-profit monitoring companies with the contractual right to sue;<sup>68</sup> and allowing relators authorized by the attorney general to sue at their own expense.<sup>69</sup> Others have criticized proposals as likely to drain nonprofits' resources through defense of frivolous suits<sup>70</sup> and as leaving open practical questions such as for how long a donor should have the right to sue.<sup>71</sup>

More recently, attention has centered on whether to recognize a third fiduciary duty for nonprofit boards—the duty of obedience. Although not yet widely adopted, this duty would require directors to refrain from

---

<sup>63</sup> See *Stern v. Lucy Webb Hayes Nat'l Training Sch. for Deaconesses & Missionaries*, 381 F. Supp. 1003, 1013 (D.D.C. 1974).

<sup>64</sup> Compare Hansmann, *supra* note 12, at 569–73 (arguing that conflict of interest transactions undermine the assurances provided by the nondistribution constraint), and Thomas H. Boyd, Note, *A Call to Reform the Duties of Directors Under State Not-For-Profit Corporation Statutes*, 72 *Iowa L. Rev.* 725, 727 (1987) (arguing that public benefits should be held to a trustee standard because they lack membership control), with Fishman & Schwarz, *supra* note 61, at 197 (“Self-dealing transactions can be efficient for the organization. The transaction costs are low. Interested directors may be able to lend money or provide services or do business with a nonprofit at a lower rate, because they know the organization best.”), and Goldschmid, *supra* note 26, at 647 (referring to Hansmann’s proposal as “too inflexible”).

<sup>65</sup> See, e.g., Manne, *supra* note 45, at 238 (“[F]iduciary rules lose their deterrent effect if no one can enforce them.”); Dana Brakman Reiser, *Enron.org: Why Sarbanes-Oxley Will Not Ensure Comprehensive Nonprofit Accountability*, 38 *U.C. Davis L. Rev.* 205, 206 (2004) (“Traditionally, commentators on nonprofit law have lamented the unsatisfying level of its enforcement.” (citations omitted)).

<sup>66</sup> See Hansmann, *supra* note 12, at 609.

<sup>67</sup> See Kenneth L. Karst, *The Efficiency of the Charitable Dollar: An Unfulfilled State Responsibility*, 73 *Harv. L. Rev.* 433, 446 (1960) (discussing reforms to both charitable trusts and charitable corporations).

<sup>68</sup> See Manne, *supra* note 45, at 229.

<sup>69</sup> See David Villar Patton, *The Queen, the Attorney General, and the Modern Charitable Fiduciary: A Historical Perspective on Charitable Enforcement Reform*, 11 *U. Fla. J.L. & Pub. Pol’y* 131, 170–71 (2000).

<sup>70</sup> Fremont-Smith, *supra* note 13, at 448–49.

<sup>71</sup> See Rob Atkinson, *Unsettled Standing: Who (Else) Should Enforce the Duties of Charitable Fiduciaries?*, 23 *J. Corp. L.* 655, 668 (1998) (arguing the duration of a donor’s standing to sue, if granted, “should be defined by the duration of the gift”).

deviating from the purposes for which the organization was created.<sup>72</sup> In *Queen of Angels Hospital v. Younger*, for example, the court found that a hospital violated what is now called the duty of obedience when it decided to convert to a series of neighborhood clinics.<sup>73</sup> This controversial duty would arguably protect donor and founder intent but could also promote inefficiency by requiring assets to remain where they are less needed.<sup>74</sup>

In sum, much academic criticism takes as a premise that tailoring the content and enforcement of fiduciary law developed in the for-profit context can satisfactorily reform nonprofit governance law. Debate centers primarily on the pros and cons of proposed tweaks. Yet despite the abundance of proposals, there remains no widely accepted theory of the ends nonprofit fiduciary duties are designed to achieve and whose interests they protect. Absent such a theory, it is premature to ask how the law should be modified. If there are no appropriate principals of nonprofit corporations, as this Note ultimately concludes, and thus there are no fiduciary relationships between nonprofit boards and any of their constituents, then proposals to reform nonprofit law that rest upon fiduciary duties are misguided.

## II. THEORY AND FOUNDATIONS OF CORPORATE FIDUCIARY LAW

A critique of the application of corporate fiduciary law to the nonprofit sector must begin with an inquiry into the purposes fiduciary law serves. Traditionally, fiduciary law attempts to address the problem of agency costs. Absent fiduciary protections, a manager-agent has incentives to divert capital to maximize his own benefit at the expense of the corporation and its shareholders' interests. For example, a manager who does not fully own the firm bears a smaller fraction of the cost of corpo-

---

<sup>72</sup> See, e.g., *Manhattan Eye, Ear & Throat Hosp. v. Spitzer*, 715 N.Y.S.2d 575, 593 (N.Y. Sup. Ct. 1999) (finding the duty of obedience "requires the director of a not-for-profit corporation to 'be faithful to the purposes and goals of the organization,' since '[u]nlike business corporations, whose ultimate objective is to make money, nonprofit corporations are defined by their specific objectives'" (citation omitted)).

<sup>73</sup> 136 Cal. Rptr. 36, 41 (Cal. Ct. App. 1977).

<sup>74</sup> Compare *Fremont-Smith*, supra note 13, at 226 (rejecting the duty of obedience "[t]o the extent . . . [that it] does not carry with it a duty to assure that the trust is meeting contemporaneous needs"), with Linda Sugin, *Resisting the Corporatization of Nonprofit Governance: Transforming Obedience Into Fidelity*, 76 *Fordham L. Rev.* 893, 904–05 (2007) (advocating an obligation of fidelity that requires directors to commit themselves to the organization's mission but allows them flexibility to decide the organization's future course).

rate expenses than a manager who is the sole owner.<sup>75</sup> Such a manager can maximize his own welfare by consuming resources in the form of perks that shareholders would optimally prefer to retain as profits. Fiduciary law attempts to correct this situation by construing directors and officers as agents who have duties to operate in the interests of the corporation and its shareholders. Fiduciary duties both guide decisions by aligning agents' interests with the principals' interests and deter diversions from those interests by imposing ex post penalties for breach of duties.

Contemporary scholars view the firm as a nexus of contracts between suppliers, laborers, investors, and other constituencies,<sup>76</sup> yet in the for-profit context, duties are owed to shareholders rather than to other constituencies. The rationale for this decision is that most other constituents gain adequate protection through contracts that specify their rights and obligations vis-à-vis the firm.<sup>77</sup> Shareholders, however, are not adequately protected through contracts. They bear risk in exchange for a residual claim to the firm's profits. They cannot write detailed contracts specifying how directors and officers should behave in all future circumstances and have poor ability to monitor directors' behavior.<sup>78</sup> Where it is impossible to specify via contract the directors' and officers' actions, fiduciary duties arise to protect the shareholders' interests by making the directors and officers their agents. A strong fiduciary duty regime induces investment by providing shareholders assurance that their assets will be properly deployed.

In theory, one could contract for the protections provided by fiduciary duties, requiring, for example, managers to use their best efforts to increase residual profits.<sup>79</sup> But fiduciary duties provide additional benefits over contract. In particular, they are superior to contract where the corporation is collecting funds from small investors with diversified portfolios who have few incentives to learn how firms are financed, to partici-

---

<sup>75</sup> Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 *J. Fin. Econ.* 305, 312–13 (1976).

<sup>76</sup> See Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 *J.L. & Econ.* 301, 302 (1983); Jensen & Meckling, *supra* note 75, at 310.

<sup>77</sup> Easterbrook & Fischel, *supra* note 39, at 90.

<sup>78</sup> *Id.* at 91–92.

<sup>79</sup> See, e.g., Andrei Shleifer & Robert W. Vishny, *A Survey of Corporate Governance*, 52 *J. Fin.* 737, 741 (1997) (discussing how in principle one could reach a similar result with residual control rights through contract).

pate in governance, or even to exercise their existing control rights.<sup>80</sup> Under the fiduciary duty regime, small investors who do not wish to bear the costs of researching and contracting are theoretically given baseline governance assurances that promote diversified investment.

Scholars have not adequately theorized the purpose of applying fiduciary law to nonprofit corporations. A nonprofit manager has potentially even stronger incentives than a for-profit manager to maximize his welfare at the expense of his principals. Because the manager cannot share in profits, he never bears the wealth effects of his decisions.<sup>81</sup> Far from providing donors or other constituents a signal that their contributions will be used as intended, the nondistribution constraint can perversely encourage managers to act inefficiently. In the nonprofit context, where bad behavior by one nonprofit can jeopardize the trustworthiness of the nonprofit brand for all, uniform enforcement of fiduciary duties could theoretically promote trust across the sector in a way that contract could not.<sup>82</sup>

But although fiduciary duties are vaguely viewed as mechanisms for holding directors and officers accountable, to whom they are accountable in the nonprofit context—in other words, to whom they owe duties—is unclear. Fiduciary duties cannot promote trust and accountability if we do not understand whose interests officers and directors should serve. The following Part explores potential constituents to whom nonprofit directors and officers could be deemed to hold fiduciary duties, and concludes that nonprofits have no appropriate principals.

### III. TO WHOM NONPROFITS OWE FIDUCIARY DUTIES

#### *A. Current Law*

Deciding which nonprofit constituencies are primarily owed duties matters in cases where constituent interests conflict. Conflicts are particularly stark in events such as charitable solicitation, change of purpose, and conversion. A nonprofit that runs a campaign where ninety percent

---

<sup>80</sup> *Id.*

<sup>81</sup> Eugene F. Fama & Michael C. Jensen, *Agency Problems and Residual Claims*, 26 *J.L. & Econ.* 327, 344 (1983) (noting that “nonprofits have agency problems with internal decision agents similar to those faced by residual claimants in other organizations . . . where important decision managers do not bear a major share of the wealth effects of their decisions”).

<sup>82</sup> See DeMott, *supra* note 48, at 134 (“[D]onors and prospective donors, having come to distrust one nonprofit, may distrust comparable organizations as well.”).



of the contributions go to overhead, for example, might displease donors who wish their money to go directly to beneficiaries, but might act in the best interests of its beneficiaries if there is no other way to raise funds.<sup>83</sup> A nonprofit hospital that wishes to begin operating neighborhood clinics rather than a centralized hospital might violate the intentions of original donors but better serve the community.<sup>84</sup>

Some states have enacted legislation to address specific instances where conflicts arise, especially in the contexts of charitable solicitation and dissolution.<sup>85</sup> But outside these cases, nonprofit statutes and restatements are unclear about to whom the fiduciary duty is owed, remaining silent or simply stating that duties are owed to the corporation or its charitable purpose.<sup>86</sup> Although one might conclude from this language that nonprofit directors and officers simply owe their duties to the “corporation,” a corporation is only an abstraction that stands in for a set of relationships between constituents and articulated missions.

A duty to a corporation provides little guidance for directors unless the relationships and missions to be primarily protected are further defined. Interpreted literally, a duty to the corporation could imply that directors and officers have a duty to benefit the corporation as an institutional entity, yet few would endorse a duty that required the protection of bureaucracy at the expense of mission or stakeholders. Indeed, a congressional oversight committee accused the Red Cross of protecting its institutional needs at the expense of giving money to September 11th

---

<sup>83</sup> See *United Cancer Council, Inc. v. Comm’r of Internal Revenue*, 165 F.3d 1173, 1175 (7th Cir. 1999) (detailing how the United Cancer Council, a charity on the brink of bankruptcy, hired an outsider fundraiser who solicited \$28.8 million in donations at a cost of \$26.5 million, leaving only \$2.3 million of the donations to serve the charitable purpose).

<sup>84</sup> See *Queen of Angels Hosp. v. Younger*, 136 Cal. Rptr. 36, 41 (Ct. App. 1977) (holding that a nonprofit whose organizational documents committed it to running a hospital and that solicited donations for the hospital could not abandon the hospital to run clinics even if the clinics were a desirable use).

<sup>85</sup> For example, twenty-two states have enacted statutes requiring registration and reporting by charities involved in public solicitation. *Fremont-Smith*, supra note 13, at 445. Sixteen state statutes require that a nonprofit give notice to the attorney general of intent to dissolve or sell assets, and three require court approval of dissolution. *Id.* at 431–32.

<sup>86</sup> See, e.g., Cal. Corp. Code § 5231(a) (Deering 2009) (duties owed to the “best interests of the corporation”); N.Y. Not-for-Profit Corp. Law § 717 (Consol. 2002) (silent on the question of to whom directors owe duties); Model Nonprofit Corp. Act § 8.30(a)(2) (2008) (duties owed to the “best interests of the nonprofit corporation”); Principles of the Law of Nonprofit Orgs. § 310(a) (Tentative Draft No. 1, 2007) (duties owed to “the best interests of the charity, in light of its stated purposes”).

victims.<sup>87</sup> A vague duty to a corporation thus allows directors and officers in practice to define for themselves to whom they owe duties through their decisions or to balance constituent interests at will. Such a duty is difficult to monitor and enforce. Because there is no clear principal, directors can rationalize decisions by pointing to the competing interests of other classes, potentially engaging in dubious decision making under the color of balance.<sup>88</sup> Stakeholders are discouraged from suing, assuming they have standing, since they have little chance of defeating the directors' decisions. These problems in turn reduce the value of a fiduciary duty. Broad duties to the corporation are duties to everyone and thus to no one. Statutes and commentary that rely on the concept of a duty to the corporation thus simply avoid, intentionally or not, the question of to whom duties should be owed.

In the for-profit context, courts generally hold that duties owed to the corporation are owed to its shareholders.<sup>89</sup> But in nonprofit law, scholars and courts have rarely pressed the concept of a duty to a "corporation." There is little consensus about which, if any, individuals or missions are in fact owed duties. As Professor Brody puts it, "Most state nonprofit laws, perhaps without intending to, create agents without principals."<sup>90</sup>

Case law has done little to clarify to whom duties are owed. Professors Fishman and Schwarz explain, "There are very few reported judicial decisions involving breaches of fiduciary duty by nonprofit directors. When such abuses are uncovered . . . the matter usually is settled quickly. The impact of such notoriety can be devastating to an organization, cutting off donor support even after the problems are rectified."<sup>91</sup>

---

<sup>87</sup> Kilgannon, *supra* note 1, at B10.

<sup>88</sup> Similarly, in the context of stakeholder statutes that allow directors to consider the interests of nonshareholder constituencies, Professor Jonathan R. Macey explains that "the primary beneficiaries of [such] statutes are incumbent managers, who can justify virtually any decision they make on the grounds that it benefits *some* constituency of the firm." Jonathan R. Macey, *An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties*, 21 *Stetson L. Rev.* 23, 32 (1991). For further discussion of the concerns that emerge absent the shareholder primacy norm, see Kathleen Hale, Note, *Corporate Law and Stakeholders: Moving Beyond Stakeholder Statutes*, 45 *Ariz. L. Rev.* 823, 838–39 (2003).

<sup>89</sup> See *Equity-Linked Investors, L.P. v. Adams*, 705 A.2d 1040, 1042 (Del. Ch. 1997) ("[G]enerally it will be the duty of the board, where discretionary judgment is to be exercised, to prefer the interests of common stock . . ."); see also Shleifer & Vishny, *supra* note 79, at 751–52 (describing the justifications for shareholder primacy).

<sup>90</sup> Brody, *supra* note 11, at 465.

<sup>91</sup> Fishman & Schwarz, *supra* note 61, at 136.

The cases that are litigated generally do not explicitly address to whom duties are owed; the few that do reach conflicting results. In *Brzica v. Trustees of Dartmouth College*, the court held that the college did not owe alumni donors solicited in a capital campaign a fiduciary duty.<sup>92</sup> By contrast, solicitation statutes have created fiduciary duties to the person being solicited and the intended recipient.<sup>93</sup> Similarly, courts differ as to whether nonprofits owe duties to customers,<sup>94</sup> beneficiaries,<sup>95</sup> or members.<sup>96</sup>

The following Section examines potential classes of principals, arguing that none are appropriate. The inappropriateness of a potential class usually arises from two sets of problems. The first set of problems arises from the foundational question of whether the law can craft a fiduciary duty relationship between nonprofit agents and a principal class that results in a benefit to the principal. The answer is often no, because the members of the class often have diverse interests that are not unified by common, measurable goals like profit maximization in the shareholder context. A fiduciary duty that maximizes the value to some would thus

---

<sup>92</sup> 791 A.2d 990, 994–95 (N.H. 2002).

<sup>93</sup> See, e.g., Cal. Bus. & Prof. Code § 17510.8 (Deering 2007) (“[T]here exists a fiduciary relationship between a charity or any person soliciting on behalf of a charity, and the person from whom a charitable contribution is being solicited.”); *Preate v. Cancer Fund of Am.*, 620 A.2d 647, 653 (Pa. Commw. Ct. 1993) (holding that organizations that engage in charitable solicitation have a statutory duty to potential donors and recipients).

<sup>94</sup> Compare *Crosse v. BCBS, Inc.*, 836 A.2d 492, 495 (Del. 2003) (holding a nonprofit health service corporation does not owe a duty to plan participants), and *Morrell v. Wellstar Health Sys., Inc.*, 633 S.E.2d 68, 74 (Ga. Ct. App. 2006) (holding nonprofit hospitals do not owe patients a fiduciary duty with respect to the price of medical care), and *Herman v. Capital Blue Cross*, 11 A.3d 23, 28–29 (Pa. Commw. Ct. 2010) (holding that nonprofits do not owe subscribers and policyholders fiduciary duties), with *O’Byrne v. Santa Monica-UCLA Med. Ctr.*, 114 Cal. Rptr. 2d 575, 885 (Ct. App. 2001) (interpreting prior case law to stand for the proposition that a hospital’s board has a duty to “shareholders and/or the public”), and *Health Maint. Network of S. Cal. v. Blue Cross of S. Cal.*, 245 Cal. Rptr. 757, 766 (Ct. App. 1988) (“Corporate ‘members,’ as well as board directors, must owe their loyalty not to any ‘parent’ corporation, but to their own organization, its charitable purposes, and its subscribers.”), vacated, 249 Cal. Rptr. 220 (Ct. App. 1988).

<sup>95</sup> The cases dealing with beneficiaries have focused primarily on standing rather than to whom the duty is owed. See *supra* note 57 and accompanying text.

<sup>96</sup> Compare *Cohen v. Kite Hill Cmty. Ass’n*, 209 Cal. Rptr. 209, 217 (Ct. App. 1983) (holding a homeowner’s association owed duties to its members), and *Baring v. Condrell*, No. 516-N, 2004 Del. Ch. LEXIS 148, at \*21 (Oct. 18, 2004) (noting that directors of a nonprofit membership corporation have a duty to act in the members’ best interests), with *1400 Willow Council of Co-Owners, Inc. v. Ballard*, No. 2008-CA-001155-MR, 2010 Ky. App. LEXIS 94, at \*24 (Ct. App. May 21, 2010) (holding directors owe their duties to the corporation as a whole rather than individual members).

inversely diminish its value to others. The second set of problems addresses the normative question of whether the law should assign a fiduciary duty to a certain principal class assuming that the duty could benefit them. Here again the answer is often no, because duties to act in the best interests of the principals would lead to results at odds with important social priorities.

### *B. Potential Principal Classes*

The following Subsections look at basic potential classes of principals: donors, beneficiaries, customers, the general public as represented by the state, and the charitable purpose. This Note does not consider as potential principals members or voting-only shareholders, the functional equivalent of members. Most public benefit nonprofits do not have members.<sup>97</sup> More fundamentally, a fiduciary duty owed to members or shareholders is in tension with the idea that charitable nonprofits should be run for a public rather than private purpose. It is also seemingly at odds with Treasury regulations that do not allow 501(c)(3)s to be organized or operated to benefit private interests, including shareholder interests.<sup>98</sup>

In practice, individuals often belong to multiple categories of potential principals. A member of a church, for example, can be simultaneously a donor and beneficiary; a student at a university can be both a beneficiary and a customer. The following discussion ignores this complexity and uses simplified types in order to illustrate basic conceptual problems. Likewise, nonprofits might have all or only some of these kinds of constituents. The added complexity of sophisticated nonprofits would further magnify these problems.

#### *1. Donors*

Analogies to shareholders make donors compelling principal candidates: Both make an investment in the corporation that might not be adequately protected by contract, especially in the case of small donors who might not incur the expense of contracting and who will find contracts too expensive to enforce. The corporation, similarly, could benefit

---

<sup>97</sup> Fremont-Smith, *supra* note 13, at 159.

<sup>98</sup> Treasury regulations require a 501(c)(3) to prove that “it is not organized or operated for the benefit of private interests such as . . . shareholders of the organization.” 26 C.F.R. § 1.501(c)(3)-1(d)(1)(ii) (2012).

from the duty because its assurances could induce more donations. Professor Ira Mark Ellman, for example, notes that nonprofits might find it beneficial to subject themselves voluntarily to strict fiduciary duties as a means to attract gifts.<sup>99</sup> Professor Henry Hansmann, alternatively, has argued for duties to “patrons,” a category that includes donors and customers, on the grounds that they cannot monitor the quality and performance of the service or good they fund.<sup>100</sup> A fiduciary duty, like the nondistribution constraint, could theoretically provide quality assurance.

Assuming a duty to donors is appropriate, the practical question is whether it is possible to craft an enforceable duty to donors that would provide benefits to the wide range of donors that might seek to enforce it. Professor Geoffrey Manne notes that donors act for a variety of purposes including desire for a tax deduction, to signal to the community, or to satisfy altruistic desires to give that are fulfilled regardless of how money is used.<sup>101</sup> This Subsection examines three simplified types of donors: sole donors, donors with specific intentions, and donors with deferential intentions. It shows that courts cannot shape a fiduciary duty that is both predictable and adds value to all types of donors.

*a. The Sole Donor*

A donor who is both sole donor to and dominant director of the nonprofit should favor a regime without fiduciary duties. The sole-owner of a for-profit corporation is not subject to fiduciary duties in practice. He owes no fiduciary duties to others because there are no other shareholders, and no one has standing to sue him for breach of duties. By contrast, a nonprofit that has only a single donor that controls the firm can still owe fiduciary duties enforceable by the attorney general and other directors. Accordingly, a sole donor who is in effective control of the corporation experiences duties as a source of liability rather than protection.

The canonical case *George Pepperdine Foundation v. Pepperdine* illustrates this concept. In 1931, George Pepperdine began a foundation intended to benefit Pepperdine College (now Pepperdine University) that

---

<sup>99</sup> Ira Mark Ellman, Another Theory of Nonprofit Corporations, 80 Mich. L. Rev. 999, 1018 (1982).

<sup>100</sup> Hansmann, supra note 12, at 504–09.

<sup>101</sup> Manne, supra note 45, at 234 (noting that donors’ disparate motivations reduce their incentives to monitor).

he endowed with his own fortune.<sup>102</sup> From the time of incorporation, he controlled and dominated the board.<sup>103</sup> Although there were other directors and officers, they deferred entirely to him. Over time, the foundation lost its endowment, allegedly due to his negligent decision making.<sup>104</sup> After a new directorate replaced the former one, the new directors brought suit against George Pepperdine and the other former directors for mismanagement of funds. The judge dismissed the complaint and rejected the notion that what we now term the duty of care should apply. In so doing, he reasoned that a donor who is the sole contributor to and builder of a nonprofit should not be liable for mistakes made running it. He asked rhetorically:

Who is 'Foundation' otherwise than the shadow of George Pepperdine, if not his alter ego? If he as an individual could not be sued for negligently investing his own moneys intended for charitable uses, why should his own 'Foundation' under the management of strangers prosecute an action to recover from the original doner [sic] and his friends what, through negligence, they lost for the Foundation?<sup>105</sup>

The decision can be faulted on normative grounds for ignoring the interests of other constituents, like taxpayers, that arise once a fund is transferred to a nonprofit. But normative concerns aside, it is clear that had George Pepperdine the donor and the Foundation "bargained" over the issue of fiduciary duties, George Pepperdine would have felt that the *absence* of duties added value to his investment. Had he realized that he would be liable for mistakes made managing the endowment, he would likely have discounted his contributions accordingly.

*b. The Purpose-Specific Donor*

Donors who wish the nonprofit to carry out a defined, narrow purpose might prefer a fiduciary duty regime that minimizes directors' discretion and instead makes them adhere closely to donor intent. Recall, for example, the view that donors to the Red Cross intended their donations be

---

<sup>102</sup> *George Pepperdine Found. v. Pepperdine*, 271 P.2d 600, 602 (Cal. Ct. App. 1954), overruled by *Holt v. College of Osteopathic Physicians & Surgeons*, 394 P.2d 932, 937 (Cal. 1964).

<sup>103</sup> *Id.*

<sup>104</sup> *Id.* at 603.

<sup>105</sup> *Id.* at 604.

distributed to the immediate victims of the September 11th attacks.<sup>106</sup> Under this view, donors turned to the nonprofit as a means through which to achieve the goal of purchasing and sending aid to a specific set of recipients. They expected the nonprofit to follow that narrow intention. Accordingly, if the nonprofit were to owe a fiduciary duty to donors, these donors would want the duty to provide assurance that the nonprofit would use their money to achieve their narrow purpose. To be sure, such donors might oversupply goods desired by the beneficiaries.<sup>107</sup> But these hypothetical donors, who can receive value from their donation independent of its utility to the recipient, would not wish a regime that allows directors the discretion to use the contributions in ways they deemed more efficient.

*c. The Deferential Donor*

In contrast to donors with clearly defined objectives, other donors anticipate that directors will exercise degrees of discretion over the use of contributions. These donors would consequently desire the duty of loyalty to permit deference to director decisions about the use of funds, disagreeing only about the boundaries in which discretion can be exercised. Sometimes the nature of the good “purchased” by the donor inherently requires director discretion. A donor who makes an unrestricted gift to a museum will anticipate that the gift is used for museum purposes, but within that constraint expects that directors will exercise discretion. Other donors might make unrestricted contributions for reasons unrelated to any desire to achieve a particular objective, such as to promote their social status in the community or to receive a tax deduction.

Absent strong preferences about the use of funds, these donors require no more than a weak fiduciary duty that requires discretion to be exercised reasonably. The practical question is defining which actions are reasonable. A broad duty will do little to guide actions where the nonprofit switches missions or prioritizes some constituents over others. An open-ended duty thus risks being no duty at all, and offers little improvement of the current status quo in nonprofit governance.

---

<sup>106</sup> See supra note 1 and accompanying text.

<sup>107</sup> See Brody, supra note 11, at 512 (arguing that benefactors over- and undersupply some activities).

*d. Conclusions About Donors and Fiduciary Duties*

The above examples illustrate that a duty to donors raises conflicts between donors themselves. One response would be to tailor the fiduciary duty to the type of donor most in need of its protections. Professor Ellman explains, we must ask if fiduciary law “improves the donor’s position over that which could be achieved through contract.”<sup>108</sup> Donors whose intentions are well defined and who have sufficient interest, means, and sophistication to bargain might receive greater assurances and lower costs by substituting a contractual relationship for a fiduciary relationship with a nonprofit. Small donors with little at stake or donors with open-ended preferences might, therefore, be more in need of a duty.<sup>109</sup> But many donors without clear objectives will also have weaker preferences than other donors about how their money is used, and will therefore value a duty less. Furthermore, small donors would presumably vary in their desires to have narrow or more open purposes followed.

States could also allow nonprofits to tailor the fiduciary duty to their services and donors, or courts could vary their interpretations of fiduciary duties across types of nonprofits.<sup>110</sup> But as the relationship becomes similar to a contractual one that nonprofits must include in their organizational documents or that donors must research, the benefits of the fiduciary duty system are lost. Fiduciary duties that are not uniformly defined and enforced cannot provide guidance and assure the trustworthiness of the nonprofit brand.<sup>111</sup> Requiring courts to interpret or tailor duties retrospectively would lead to duties that are unpredictable, and thus hard to monitor, enforce, and comply with.

This Subsection has focused primarily on whether it is practical to craft a duty to donors. But more criticism has been devoted to the nor-

---

<sup>108</sup> Ellman, *supra* note 99, at 1016.

<sup>109</sup> *Id.* (“Of course, not every donor would bother to bargain for such promises, and many will contemplate gifts too small to motivate the recipient to agree to the demands, even if they were made.”).

<sup>110</sup> Nonprofit law currently imposes uniform standards of fiduciary conduct on all nonprofits, regardless of their type or size. Evelyn Brody, *The Board of Nonprofit Organizations: Puzzling Through the Gaps Between Law and Practice*, 76 *Fordham L. Rev.* 521, 527 (2007). James J. Fishman, however, has questioned whether uniform standards make sense and has proposed the equivalent of close corporations for the nonprofit sector. James J. Fishman, *The Development of Nonprofit Corporation Law and an Agenda for Reform*, 34 *Emory L.J.* 617, 666–68 (1985).

<sup>111</sup> See DeMott, *supra* note 48, at 134 (discussing how one nonprofit’s misconduct can broadly undermine trust in the sector).



mative question of whether nonprofits should owe a duty to donors. The normative answer has typically been no. Professor Brody has argued that privileging donors can lead to allocative inefficiency when donors supply a product that beneficiaries do not demand.<sup>112</sup> A broad duty might seem preferable on normative grounds because it would allow the board to use discretion to transfer assets to more useful purposes. It is important to recognize, however, that a duty that permits substantial director discretion will not necessarily result in more efficient allocation of resources. Directors can also use their discretion to allocate resources in ways that serve special interests, removing assets from more socially valued uses.

## 2. *Beneficiaries*

A beneficiary could range from an individual, to a cause, to a community, and could simultaneously be a customer, member, or other type of constituent. This Subsection addresses the potential of individuals to serve as principals in the roles as recipients of gifts. Beneficiaries in their role qua beneficiaries cannot protect themselves from the nonprofit via contract unless they are also donors or customers. But they also do not contribute assets to the nonprofit that require protection. Beneficiaries are thus weak candidates for principals under the for-profit theory that duties should be owed to those who cannot protect their investments by contracts. Under that theory, a duty to them would make sense only if the donors making contributions receive value from the assurance that nonprofits operate in the interests of beneficiaries.<sup>113</sup>

Stories of nonprofits operating without benefit to or even to the detriment of their beneficiaries also prompt calls for beneficiary protection.<sup>114</sup> There is a basic logic in requiring directors and officers to have a duty to act in the interests of the nonprofit's beneficiaries. After all, the nonprofit is presumably there to help them. But a duty to beneficiaries raises irresolvable practical questions: There are different kinds of bene-

---

<sup>112</sup> Brody, *supra* note 11, at 470.

<sup>113</sup> See Atkinson, *supra* note 71, at 673 (“[B]eneficiaries do not have enforceable rights of their own; their rights are derived from those of donors . . . . In accord with the contract failure theory, any standing on the part of donees must be subordinate to the will of donors . . . .”).

<sup>114</sup> See, e.g., Soutik Biswas, *India's Micro-Finance Suicide Epidemic*, BBC News, Dec. 16, 2010, <http://www.bbc.co.uk/news/world-south-asia-11997571> (discussing microcredit loan recipients committing suicide when unable to repay).

ficiaries whose interests might conflict or not accord with the nonprofit's social goals.

A general duty to all beneficiaries is unfeasible in all but the most extreme cases. Professor James Fishman has pointed to the variety of beneficiaries as a feature rather than bug of a duty to beneficiaries. He writes:

The most fundamental duty of a charitable trustee or corporate fiduciary is loyalty to the beneficiary . . . . The fiduciary's concern must be with the interest of the beneficiary whether it is a distinct individual or an inchoate body such as the public. Because of the indefiniteness of the beneficiary class, the loyalty rule is designed to deter the fiduciary from the temptation of engaging in opportunistic behavior.<sup>115</sup>

In the course of normal decision making, however, nonprofits are frequently called upon to favor some beneficiaries over others, and a duty to all beneficiaries would be over-deterrent and provide little guidance in such contexts. This Subsection explores one-time and continuous beneficiaries to illustrate the problems that emerge.

*a. The One-Time Beneficiary*

Beneficiaries who receive one-time aid from a nonprofit and then have no continuing interest in it should prefer fiduciary duties that give nonprofit managers the flexibility to address emerging needs. An example is a tourist who receives food and blankets from a nonprofit after her hotel is destroyed in a tsunami. This tourist does not know *ex ante* that she will receive aid, and her financial interest in the aid and the nonprofit that provides it is only temporary. Professor Kenneth L. Karst explains, presumably with this kind of beneficiary in mind, "[I]n the typical case, no one knows who a beneficiary will be until the charity confers a benefit on him, and after such a benefit is conferred he has no right to expect further benefits, and thus no remaining interest in the charity's funds."<sup>116</sup> This type of beneficiary will thus generally want a nonprofit's resources to be transferred to the beneficiaries that can use them most efficiently.

But although a duty to this kind of beneficiary would be efficient, it raises practical problems: Such a beneficiary will never sue to enforce a

---

<sup>115</sup> James J. Fishman, *Improving Charitable Accountability*, 62 *Md. L. Rev.* 218, 230 (2003) (citations omitted).

<sup>116</sup> See Karst, *supra* note 67, at 436–37.

duty, because the beneficiary will not understand herself as a beneficiary until she receives aid. Such beneficiaries only come into being through the nonprofit's actions. A nonprofit that owes duties to such beneficiaries thus would define its principals through its conduct, substantially limiting the power of duties to govern that conduct. It is possible to imagine a regime in which outside agencies monitor nonprofits to see if they in fact choose to serve the kind of beneficiaries that the outside agency believes they should serve. But allowing outsiders to decide and enforce who the nonprofit should serve would be a gross intrusion in the nonprofit's decision-making autonomy and merely push to another decision maker the question of whose interests the nonprofit should serve.

*b. Beneficiaries Who Receive Continuous Benefits*

Current, ongoing beneficiaries who receive continuous benefits are in a position to monitor a nonprofit and enforce duties but will often act protectively of their resources to avoid sharing assets with new beneficiaries. These beneficiaries could include alumni who receive continuous value from the school that granted their degrees, chronic recipients of social welfare, or victims of a disease who wish research on their particular disease to continue. As Professor Rob Atkinson notes, "[C]urrent beneficiaries are fighting to retain their favored status as recipients of charitable largess."<sup>117</sup> A duty that reflects the interests of such beneficiaries would heavily influence activity permitted when the nonprofit contemplates a change of purpose, conversion, or move to another geographic area, often in ways that would prevent the movement of resources to more efficient uses.

As an illustration, consider the case where a hypothetical law school decides to offer an online degree program in addition to its traditional, campus-based degree program. Further assume that this expansion is done not to increase the school's coffers, but rather with the noble aim of providing cheap legal education to aspiring students. This decision creates a new class of beneficiaries: students in the online program. While they benefit from the decision, the decision could hurt the traditional class of beneficiaries: current students and alumni of the campus program. The traditional beneficiaries could experience a dilution in the value of their degrees and face more competitors from their school in the legal market. In all likelihood, the traditional beneficiaries, who receive

---

<sup>117</sup> Atkinson, *supra* note 71, at 693.

continuing value from their degrees, would prefer to prevent the creation of the online program. A further complication arises if the school begins using the online program to subsidize its traditional offerings—using less valued students to subsidize more valued ones. In sum, there arises a series of conflicts between beneficiaries.

Cases that pit current and new beneficiaries against each other thus provoke the question of to which beneficiary a nonprofit should owe duties. In this example, it is unclear whether the creation of an online program is a good idea, but it is an idea that we likely think nonprofits should be able to explore. Yet the program clearly could harm the current students, and they could protest such a decision in court if owed a duty.

### *c. Conclusions About Duties to Beneficiaries*

Although there is basic practical sense for a nonprofit to aspire to serve its beneficiaries, an enforceable legal duty to beneficiaries is not desirable. The practical reality is that current, continuous beneficiaries are the only ones in a position to be identified as beneficiaries and to monitor and enforce duties. Yet the duty that they would benefit from and thus push for would likely prioritize their interests over ones with potentially more social value. Even a duty limited to the idea that the nonprofit should not harm its beneficiaries is difficult to articulate in all but the most egregious cases. As the law school example shows, beneficiaries are frequently harmed by even simple decisions to change course or to use revenue from one class of beneficiaries to aid another. These are fundamental business decisions that courts are ill-equipped to review.

### *3. Customers*

Commercial nonprofits have customers who purchase their services or goods, such as hospital patients or university students. Customers are often a subset of beneficiaries: They both contribute money to and typically benefit from the nonprofit's mission or from donations to the nonprofit that offset their costs. Professor Hansmann argues that nonprofit customers need fiduciary duties since nonprofits arise to provide complex services whose quality customers are in a poor position to evaluate,

such as nursing home care, education, and hospital care.<sup>118</sup> Other scholars disagree. Professor Ellman argues that customers can inspect the goods they buy and, unlike donors, can see the marginal impact of their dollars.<sup>119</sup> Customers are protected by contracts, tort, and consumer protection law,<sup>120</sup> and they have no interest in the corporation's subsequent decisions so long as they are provided with the goods they purchase.<sup>121</sup> It seems likely that who is right depends on the particular product. Regardless of whether a duty is needed, however, a duty to customers fails on practical and normative grounds.

As in the context of donors and beneficiaries, a substantial practical problem is that nonprofit customers have competing interests. The Supreme Court of Delaware rejected duties to customers on precisely such grounds. Specifically, in *Crosse v. BCBSD, Inc.*, it considered the claim that a nonprofit insurer violated fiduciary duties to the insured by accumulating millions in profits that it did not pass on to customers in the form of rebates.<sup>122</sup> The court held that the insurer's business model often required it to take actions that harmed individual subscribers, and thus a fiduciary duty between insured and insurer was inappropriate.<sup>123</sup> Nonprofit customers also have conflicts that are not as obvious as those in the insurance context: Customers will vary in their preferences for a nonprofit to continue a product, expand a service, increase quality or cost, and so forth. Nonprofits also frequently charge some customers more to subsidize those paying less.<sup>124</sup> A duty to customers can offer little guidance about what products and prices it is in the best interests of customers to offer; the free market can provide much better direction.

Even if the practical questions can be overcome, it is unlikely that customers would be better off with a fiduciary duty owed to them. The problems faced by nonprofit customers are generally the same as those faced by for-profit customers of the same good or service. Recognizing duties to nonprofit customers but not for-profit customers could threaten the existence of commercial nonprofits in some industries that historical-

---

<sup>118</sup> Hansmann, *supra* note 12, at 506–07.

<sup>119</sup> Ellman, *supra* note 99, at 1025.

<sup>120</sup> *Id.*

<sup>121</sup> Atkinson, *supra* note 71, at 670.

<sup>122</sup> 836 A.2d 492, 494 (Del. 2003).

<sup>123</sup> *Id.* at 495, 497.

<sup>124</sup> See Hansmann, *supra* note 12, at 560–62 (discussing how hospitals charge some patients higher fees in order to cover services to indigent patients or unusually expensive treatments).

ly compete with for-profits. Professor Atkinson, for example, has noted that patients of for-profit hospitals have no right to keep the hospital open.<sup>125</sup> Granting nonprofit patients duties under which they could challenge organizational changes would likely discourage the creation of new nonprofit hospitals. Recognizing enforceable duties to nonprofit customers could increase the costs of such products and place nonprofits at a competitive disadvantage with for-profits in sectors where they compete for customers, ultimately hindering their charitable missions. Accordingly, if some customers desire protections beyond those the market offers, a better solution would be for them to negotiate with either a nonprofit or for-profit without raising costs for customers more generally. In situations where neither the market nor negotiations produce the protections consumers desire, industry-specific regulation could be considered to protect customers.

#### *4. Duty to the General Public*

Public benefit nonprofits are traditionally viewed as benefiting the public at large rather than specific beneficiaries. Historically, it has been the role of the state, and particularly of state attorneys general, to represent the public's interest through the monitoring and enforcement of fiduciary duties.<sup>126</sup> It is tempting, then, to ask why a nonprofit's duties should not be owed to the public at large, as represented and embodied by the contours of state boundaries. It would be impractical to define clearly a fiduciary duty owed to the public in general, a mass even more vague and conflicted than the constituents of a corporation. Proposals that rely on state enforcement would instead necessarily rely on the discretionary judgment of state actors, as representatives of the public, to decide when violations of fiduciary duties occur.<sup>127</sup>

---

<sup>125</sup> See Atkinson, *supra* note 71, at 670 ("Patients of a for-profit hospital have no right to force its owners to keep that particular hospital open, or to stay in the hospital business at all.").

<sup>126</sup> Fremont-Smith, *supra* note 13, at 301.

<sup>127</sup> Scholars have proposed additional mechanisms for increased state oversight, including transferring supervisory power from attorneys general to state agencies that would oversee all aspects of charitable regulation, see Karst, *supra* note 67, at 476–83, and state charity commissions with volunteers appointed by the attorney general and governor with the power to investigate complaints from the public, see Fishman, *supra* note 115, at 272–74. Others have proposed federal agencies to curb abuses in the nonprofit sector and to educate the public. See Helge, *supra* note 59, at 8.

Professor Brody argues that in practice state actors sometimes interpret nonprofit duties as requiring actions that are beneficial to their state.<sup>128</sup> As she puts it, “An attorney general, court, or even legislature might become convinced that a charity board acting contrary to the wishes of ‘the community’ is breaching the duty of loyalty to the charity.”<sup>129</sup> For example, mergers between multistate hospitals systems in the 1990s resulted in attorneys general claiming that the proceeds of the sales should remain in their home states under the theory that the proceeds were “community assets.”<sup>130</sup> In another dispute, an attorney general sued to enjoin the Terra Museum of American Art in Chicago from moving its collection to Washington.<sup>131</sup>

These instances of state actors interpreting duties of loyalty to require loyalty to the community in which they are located reveal substantial problems with requiring a duty to the public that is embodied by the contours of government boundaries. Substantial inefficiency is engendered when states prevent the flow of resources to more valued uses outside their boundaries. As a practical matter, state actors and constituents exist simultaneously on local, state, and federal levels. When their interests conflict because each seeks a contested pool of assets, we have no principled way to decide which group is owed primacy.

More fundamentally, state actors threaten the traditional separation of the nonprofit sector and the government when they interpret fiduciary duties in a way that makes the nonprofit primarily a servant of the state. A strong critical tradition sees the nonprofit sector, sometimes alternatively called the “independent sector,” as adding value and innovation precisely because it is free from the restrictions of state control.<sup>132</sup> The interests of nonprofits are often different from those of governments, because the members of the public they serve are not necessarily coterminous with the boundaries of the states in which they operate. Both duties owed to the public and increased state supervision undermine the nonprofit sector’s independence by substituting the judgment of state-

---

<sup>128</sup> Evelyn Brody, *Whose Public? Parochialism and Paternalism in State Charity Law Enforcement*, 79 *Ind. L.J.* 937, 939 (2004).

<sup>129</sup> *Id.* at 940.

<sup>130</sup> Fremont-Smith, *supra* note 13, at 321.

<sup>131</sup> *Id.* at 322.

<sup>132</sup> See, e.g., Karen Donnelly, Comment, *Good Governance: Has the IRS Usurped the Business Judgment of Tax-Exempt Organizations in the Name of Transparency and Accountability?*, 79 *UMKC L. Rev.* 163, 167 (2010) (criticizing the IRS for usurping the business judgment of nonprofits).

appointed officials for the judgment of the individuals operating the nonprofit sector. As Professor Dana Brakman Reiser puts it, “[P]ublic enforcement of mission undermines charities’ autonomy, the characteristic that enables them to be innovators, to take countermajoritarian positions, to serve the underserved.”<sup>133</sup>

Absent defined duties to clarify which acts amount to violations, state actors currently have wide discretion to make enforcement decisions that promote state interests, sometimes at the expense of the nonprofit. For example, Professors Jonathan Klick and Robert Sitkoff examined the case of the Milton Hershey School Trust, in which the Trust planned to diversify its portfolio by selling its controlling stake in the Hershey Company.<sup>134</sup> Although this action would have been beneficial to the Trust, Pennsylvania’s Attorney General, who was running for Governor, opposed the sale on grounds that it would harm the local community.<sup>135</sup> In such cases where the person appointed to supervise and enforce is primarily indebted to the state, the incentives to prioritize the state’s interests over those of the nonprofit are paramount. State actors, like other beneficiaries, can be greedy.

Although nonprofits serve the “public,” the constituents they serve can be simultaneously narrower and broader than the boundaries of a locality, state, or nation. The examples here caution against a stronger duty to the public that is embodied through state enforcement, because such a duty would threaten to make nonprofits a branch of the state. Although states have legitimate interests in protecting their populations from abusive corporate practices and in protecting their tax investments, these interests are or could be protected by legislation targeted at specific practices.

### 5. Duties to the Charitable Purpose

Some academic efforts have posited that directors and officers owe duties to the nonprofit’s charitable purpose or mission rather than to a particular constituency, and they view the purpose of nonprofit law as aiding the nonprofit in enforcing its mission.<sup>136</sup> This increasingly dominant approach is enshrined in the *Principles of the Law of Nonprofit Or-*

---

<sup>133</sup> Dana Brakman Reiser, *Charity Law’s Essentials*, 86 *Notre Dame L. Rev.* 1, 2 (2011).

<sup>134</sup> Jonathan Klick & Robert H. Sitkoff, *Agency Costs, Charitable Trusts, and Corporate Control: Evidence from Hershey’s Kiss-Off*, 108 *Colum. L. Rev.* 749, 749 (2008).

<sup>135</sup> *Id.* at 755–56.

<sup>136</sup> See, e.g., Reiser, *supra* note 133, at 3.



ganizations.<sup>137</sup> It states, “In the case of a charitable trust, which lacks ascertainable beneficiaries who can enforce their rights, the fiduciary duties are instead said to run to the charitable purpose.”<sup>138</sup> But a duty to a charitable purpose is unenforceable under current law that allows for broad purpose clauses and amendment of purpose. By positing that fiduciary duties should not be owed to any particular constituent class, scholars in fact radically reshape the meaning of fiduciary duties. Their proposals push us from the traditional view in which fiduciary duties serve as tools that govern agency relationships to a view in which directors and courts can potentially make broad, unaccountable decisions about the meaning and purposes of the nonprofit sector under the guise of fiduciary law.

The Model Nonprofit Corporation Act states only that “[e]very nonprofit corporation has the purpose of engaging in any lawful activity unless a more limited purpose is [provided].”<sup>139</sup> It thus specifically enables adoption of the broadest possible charitable purpose. Professor Linda Sugin notes that “[i]t has long been standard for the organizational documents of business corporations to mimic the broadest enabling language of the statute, and nonprofit organizations can do the same and dispense with naming any particular charitable purpose.”<sup>140</sup> But a duty to one’s charitable purpose is “meaningless for organizations with broad purpose clauses.”<sup>141</sup> “Any legal purpose” cannot serve as a benchmark to guide and monitor actions. It is also possible, and indeed likely, for an organization to have multiple purposes. A university that also runs a hospital, for example, can have dual purposes of providing education and providing patient care. When purposes conflict, there is no principled means of determining which should take primacy.

A duty to charitable purpose is further undermined by the fact that statutes and courts typically permit nonprofits to formally amend the purposes specified in their organizational documents—an action that is indeed desirable when the former purpose no longer satisfies societal needs. For example, in *Attorney General v. Hahnemann Hospital*, the trustees amended the articles of incorporation to permit the sale of the hospital, and the court found they violated no fiduciary duty through the

---

<sup>137</sup> Principles of the Law of Nonprofit Orgs. § 310 cmt. a (Tentative Draft No. 1 2007).

<sup>138</sup> *Id.*

<sup>139</sup> Model Nonprofit Corp. Act § 3.01(a) (2008).

<sup>140</sup> Sugin, *supra* note 74, at 902–03.

<sup>141</sup> *Id.* at 902.

amendment.<sup>142</sup> Decisions that gradually transform the organization can also lead to mission creep and change the nonprofit's purpose over time. A duty to charitable purpose cannot provide guidance in the critical situations of conversion, mission creep, or change of charitable purpose where conflicts between constituencies loom largest. As Robert Katz puts it, "[T]he board displays accountability by adhering to the charitable objectives it has elected to pursue, not to alter, or both—unless and until it elects to alter them."<sup>143</sup>

Requiring a duty of obedience to a fixed and narrow purpose designated by the original founders, however, provokes concerns about rigidity and inability to adapt to changing contexts. There is no reason a nonprofit's purpose will necessarily serve the public interest.<sup>144</sup> When its purpose is at odds with the public interest because it is outdated, wasteful, or otherwise undesirable, a duty to charitable purpose might not provide sufficient flexibility for the nonprofit to adapt.

#### IV. TOWARDS A MORE LIMITED ROLE FOR FIDUCIARY LAW IN THE NONPROFIT SECTOR

This Note has argued that the fiduciary duty framework is a poor mechanism for guiding and enforcing good governance in the nonprofit sector because there are no suitable principals. This conclusion necessitates that future efforts to improve nonprofit governance recognize a more limited role for fiduciary law than they have in the past. Fiduciary duties can play roles in deterring egregious financial misconduct that is patently wrong and in providing a vocabulary for those who work in the nonprofit sector to frame and guide their relationships with the nonprofit. But legal efforts aimed at monitoring and strengthening enforcement of fiduciary duties or policing mission are misguided since we cannot define the duty we seek to enforce.

This call for a more limited role for fiduciary law in the nonprofit sector is seemingly at odds with a recent trend amongst nonprofit scholars of faulting the law and its enforcers for being overly focused on financial accountability rather than more affirmatively promoting good gov-

---

<sup>142</sup> 494 N.E.2d 1011, 1017–18 (Mass. 1986).

<sup>143</sup> Robert A. Katz, Let Charitable Directors Direct: Why Trust Law Should Not Curb Board Discretion over a Charitable Corporation's Mission and Unrestricted Assets, 80 *Chi.-Kent L. Rev.* 689, 691 (2005).

<sup>144</sup> See Brody, *supra* note 110, at 526 ("[T]he purposes of a given charity do not necessarily (or even usually) coincide with 'the public interest.'").

ernance and protecting missions.<sup>145</sup> This Note does not quibble with the need to promote more comprehensive good governance; its contribution is rather to show that the toolkit available for nonprofit law reform is more limited than we have acknowledged. Given that fiduciary law cannot define the parties or missions whereby to measure performance, legal reform efforts, if any, should be limited to targeted, rule-based laws and to promoting market-based governance mechanisms.

#### *A. Returning to Targeted, Rule-Based Laws*

Laws that call upon enforcers and courts to make ex post substantive decisions about to whom duties are owed and the performance to be measured are inappropriate for the reasons discussed. But this analysis does not preclude targeted, rule-based laws from addressing specific abuses or contexts that arise with frequency in the nonprofit sector.<sup>146</sup> For example, a legislature can prohibit methods of soliciting small donors or self-dealing between board members if it appears to the legislature that certain behaviors warrant regulation.<sup>147</sup> A legislature can also impose organizational requirements on organizations—such as having independent directors—in order to qualify for nonprofit status or receive tax benefits under the law.<sup>148</sup> It can also directly regulate sectors in which nonprofits operate, such as education or healthcare. Such laws might be bad laws and make substantive decisions about the purposes of the nonprofit sector with which we disagree. But they are viable laws, because they provide clear directives to nonprofit boards, place substantive decisions about the purposes of the nonprofit sector in the hands of the political branch rather than the courts, and can be monitored and en-

---

<sup>145</sup> See, e.g., Reiser, *supra* note 65, at 206–09 (arguing that attorneys general focus on financial accountability at the expense of organizational and mission accountability, though concluding that other mechanisms are needed to provide broader accountability); Sugin, *supra* note 74, at 895 (“While greater financial accountability might protect against certain abuses or mismanagement, it seems to promise precious little in fostering the affirmative public benefits for which charities exist, and threatens to subordinate the mission-related objectives within the governance structure of organizations.”).

<sup>146</sup> See Melanie B. Leslie, *Helping Nonprofits Police Themselves: What Trust Law Can Teach Us About Conflicts of Interest*, 85 *Chi.-Kent L. Rev.* 551, 555 (2010) (arguing that conflict of interest transactions should be governed by clear rules rather than standards).

<sup>147</sup> See Fremont-Smith, *supra* note 13, at 445–46 (discussing charitable solicitation legislation).

<sup>148</sup> For an overview of proposed and enacted independent director requirements, see Dana Brakman Reiser, *Director Independence in the Independent Sector*, 76 *Fordham L. Rev.* 795, 798–805 (2007).

forced because the standard is transparent. Targeted, defined laws lack the flexibility of fiduciary duties to respond to and deter new situations, but we have seen that undefined fiduciary duties have enabled overly discretionary enforcement in addition to deterring obvious wrongdoing.

*B. Promoting Private Mechanisms for Monitoring Performance*

Although targeted rules are enforceable, they will typically provide only minimum standards of conduct rather than promote affirmative good governance. To promote good governance, the law can create conditions allowing private governance mechanisms to flourish. For example, the law can require private reporting of information needed for outsiders to analyze an organization,<sup>149</sup> and it can use the tax code to promote competition between nonprofits and for-profits in the same sector.<sup>150</sup>

There is no shortage of private mechanisms to police nonprofits by incentivizing them to organize and operate in ways that best serve their prevailing constituents and missions. Kathleen Boozang has argued that the most significant influences on nonprofit boards' behavior are not state regulation but rather "granting agencies, credit rating companies, insurers and bondholders, feeder organizations, donors, and institutional members, all of which frequently become intricately involved with the nonprofit and impose conditions that significantly affect governance and operations."<sup>151</sup> With the growth of the Internet has also come a host of online organizations that rate and monitor nonprofits in order to help everyday donors make sound decisions.<sup>152</sup>

Private mechanisms are imperfect definers and enforcers of good governance. Special interests can capture, for example, nonprofit boards or rating agencies. The market might not produce people interested in monitoring some types of nonprofits, especially small ones. But private mechanisms are a superior alternative to undefined fiduciary duty laws as a means of policing decision making, because they allow markets ra-

---

<sup>149</sup> For a discussion of nonprofit registration and reporting requirements, see Fremont-Smith, *supra* note 13, at 443–45.

<sup>150</sup> Cf. Anup Malani & Eric A. Posner, *The Case for For-Profit Charities*, 93 *Va. L. Rev.* 2017, 2021–23 (2007) (noting that nonprofits and for-profits engaged in the same activities receive different tax treatment, and arguing that they should receive the same tax treatment).

<sup>151</sup> Kathleen M. Boozang, *Does an Independent Board Improve Nonprofit Corporate Governance?*, 75 *Tenn. L. Rev.* 83, 117 (2007) (citations omitted).

<sup>152</sup> For example, Charity Navigator uses Form 990 filings to compile free ratings of 501(c)(3) charities. Charity Navigator, <http://www.charitynavigator.org> (last visited Sept. 1, 2012).

2013]

*The Principal Problem*

915

ther than courts to make substantive decisions about which missions and constituents the nonprofit will serve, an outcome more in keeping with the norm of an “independent sector” and more responsive to changing needs.

## CONCLUSION

Given the inability of fiduciary law to govern the nonprofit sector, efforts at addressing governance through law should focus primarily on targeted rules and promoting private governance mechanisms. Acceptance of a more limited role for fiduciary law in the nonprofit sector can be viewed as a loss of the promise of fiduciary duties to assure the integrity of the nonprofit brand. But fiduciary duties cannot, and thus never have, been able to fulfill that promise because the constituents and goals of the nonprofit sector are too diverse.

The tools left to law—the creation of specific rules and the promotion of private mechanisms—will likely prove unable to restore the halo to the nonprofit sector. Laws are not designed to achieve perfect governance, and private mechanisms typically work by publicly sorting the good nonprofits from the bad. Ironically, the impulse to seek uniformity across the nonprofit sector—to create, in other words, a nonprofit brand—might itself dampen efforts to promote good governance by allowing individual nonprofits to coast on the sector’s good name. Increased differentiation among nonprofits and demystification of the nonprofit brand could in fact incentivize consumers and nonprofits to seek excellence.

